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## Expanding And Renovating The Shopping Center

It has become increasingly expensive to build a new shopping center. Just the land costs are incredible. Locating a site for a mall is becoming more difficult each year. There aren't many suitable parcels available in most areas. Rather than build a new center, there might be good profits in buying an older center to renovate the existing buildings or add new selling space.

A successful expansion should, if possible, follow the master plan of the center. Added space should continue the existing plan of the center, the traffic pattern and the same mix of types of store.

### Examine Existing Leases Carefully

Some tenants may have leases requiring the owner to secure certain approvals. For instance, a merchant may have a lease that has provisions that the owner cannot rent out any space to another store that sells a similar kind of merchandise. Working with, and keeping current lessees informed of the plans for the center, the prospective new tenants, is essential.

The financing for the expansion would work in the same general way as

financing a new center. There usually would be advantages to working with the existing lender of the property, if possible. The existing lender has had experience with the property and has knowledge of the tenants. Usually bringing in a new lender for the expansion can be a problem since the existing lender probably has a lien on the land that must be used for the expansion. That could cause problems with getting releases of liens and then getting the new loans from the new lender.

One way of handing the expansion would be to secure a mortgage commitment from the existing lender for the whole center as it would be as expanded. On the basis of this commitment, a construction loan for the expansion could be obtained. The payments to the existing lender on the original loan would be continued until the construction is completed. Then the original loan and the new loan are consolidated. A developer in this situation might try for interest-only for a year or two on this loan after the construction, since all tenants might not be in the center immediately. Afterwards, ➤

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This publication is not a solicitation but is an information service from this office.

### In This Issue

- Expanding And Renovating The Shopping Center
- All Kinds of Commercial Leases
- Commercial Real Estate Representation

When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

### *Expanding and Renovating... (Continued)*

an amortized loan would be in effect.

### **Enclose And Renovate That Existing Center**

The economics in developing a new shopping center are in sharp contrast with the economics of remodeling an existing center. With much less cash spent, an older center can be updated, modernized, revitalized and made into a new-looking mall or Galleria to attract shoppers. Taking an older existing mall and enclosing it will give a new modern look. It will get the attention of shoppers who will not be deterred by rainy weather. This investment translates into more profit.

Some existing shopping centers may be attracting shoppers because of old habits. The proliferation of new shopping centers throughout the country during the past twenty years has created incredible competition. These old centers must modernize if the owners expect to compete for today's shopper's dollars. Their hours must be more flexible since there are many more two-income families with the money to spend. Here is an example of a successful remodeling project.

### **Restructuring In The Bay Area**

It has been many years now since San Francisco's Stonestown Center was enclosed, but it remains one of the best examples of a successful renovation. San Francisco's oldest shopping center was built about 40 years ago. It was originally an open mall. Located in a cold, windy section of the city, business was lost on blustery days. Foot traffic was minimal because the stores were deep with two-entrance sides. Shoppers coming to the center tended to go to only one or two shops in a visit. Nearby enclosed malls that were completed later competed for the shoppers.

Then Stonestown was entirely restructured. The name was changed to the Stonestown Galleria. Instead of the open mall, it now is a two-story structure with a vaulted, skylighted ceiling. The interior now has a bright airy look because of many overhead glass panels. Massive marble-patterned columns support the extremely high ceiling. The mall has an impressive glass brick entrance; interiors include fountains and balconies accessible by escalators. The original concrete basement was converted to a 350-car garage.

Stonestown Galleria has 144 shops and includes a food court with 13 restaurants and fast-food stores. This project took one year and \$55 million to complete.

### **Cash Flows**

A good shopping center investment brings in that steady cash flow generated by the solid anchor tenant and from aggressive merchants whose leases include provisions for percentage rentals.

While office space may be in supply in many parts of the country and hotels are vacancy sensitive, the shopping center market has always been income-based. Some other real estate businesses were tax-oriented and were in the business of creating tax losses, but cash flow has been the bottom line in shopping centers.

Recent healthy consumer spending growth should continue to bring good economic times for shopping centers. Most existing centers can now be refinanced on favorable terms, freeing up cash for upgrading.

### **The Renovation**

The Stonestown center in San Francisco was many years old. Many centers that are much newer than that are already in need of help. The shopping centers that were built 15 and 20 years ago are beginning to be outdated (and there are a lot of them).

At that number of years, a center may just need a face-lift to help stimulate consumer interest. One effective technique is to add a favorite department store or a new restaurant or food court. When trying to attract new customers, the owner must also continue to think about keeping the long-time shoppers. These may be more affluent and can afford to patronize boutiques and pay for high quality brand-name products and art treasures. The renovation should involve aesthetic improvements, expansion, and some changes in the tenant mix, things that will enhance the performance of the property that is already in operation.

### **The Benefits of Enclosing the Mall**

For the owner of an open mall center, here are some of the important reasons to enclose it.

1. Enclosing a shopping center mall makes the center appear to be new.
2. It stimulates and encourages the tenants to upgrade and remodel the interior of their stores.
3. It will provide a better customer draw and will keep them in the center longer. The longer they stay, the more they shop. This is a benefit for all of the tenants — and the owner.
4. Extreme weather has much less impact of an enclosed mall center except in case of a major storm when customers will not drive anywhere.
5. The enclosed mall provides ideal facilities for seasonal promotions, fashion shows, etc.
6. Changing the location of statuary, art works and changing the landscaped areas, the appearance of the mall can be changed constantly to present a new image weekly or monthly.

**One clear trend for developers, owners, investors and center operators is to upgrade existing centers, keep them current, and make them competitive. ■**

# All Kinds of Commercial Leases

Leases of office space can run anywhere from one to 25 years (in extreme cases, sometimes longer). The bargaining position of the tenant can range from practically none for a short term tenancy for a small office to the extremely strong position of a Triple-A tenant who will occupy the major part of the building.

Of course, the owner and the tenant know that rent will be required and paid. The question always is how much will be paid and how will it be computed. Following are points that are negotiated in leases for office space.

**THE FLAT RENTAL.** This lease calls for a rent amount that will be the same for the whole term and is most common in the short-term rental. The problem with the landlord is the failure to protect him against unreimbursed increases in taxes and operating expenses.

**THE STEP-UP LEASE.** This contract calls for a gradually increasing amount of rent, to be stepped-up a certain amount or percentage at specified intervals. It may be used to compensate the owner for expenses as they increase, but more often it is used as an inducement for a tenant who has recently started in business and may be only able to afford a smaller rent.

**EXPENSE PARTICIPATING LEASE OR ESCALATOR LEASE.** Many long-term office leases are written this way. The tenant pays a fixed rent plus a specified portion of the real estate taxes, insurance, and repairs other than structural ones. The expense participating lease requires the tenant to pay an immediate share of these costs, while with the escalator lease the tenant pays only a portion of any increases in costs during the lease term.

**COST OF LIVING LEASE.** With this lease, the tenant's rental amount is increased or decreased at specified intervals depending on the fluctuation of the dollar as shown by price indices or other agreed measures of the degree of inflation or deflation that has occurred.

**REEVALUATION LEASE.** This lease calls for an appraisal of the property and a fixing of the rent as a percentage of the appraised value at specified intervals. The new rental may be fixed on the basis of the value of the land and building, or on the rental value of the premises occupied by the tenant.

In addition to these computations of the amount of the rent, the lease should indicate the method of

payment. In some cases, the tenant's income is seasonal, and monthly payments can be of unequal amounts. The date of the first rental payment should be set forth specifically, and the intervals when subsequent payments are due. If any rent concessions have been granted by the landlord, the lease should clearly indicate the months that are to be rent-free.

## Ground Leases

With this discussion of leases, the ground lease occurs to us.

The technique of ground leasing results in the separate ownership of the land and the improvements on it. In this way, with the two owners, two types of investors come together; the capital needed for placing improvements on the leased land and the ownership of the land.

Often we see the situation of the land-owner wanting someone to develop the land but still wanting to continue in ownership. At the same time, we also frequently see the developer who prefers to rent rather than buy the property.

## Benefits to a Lessor

An example could be the developer of upscale homes who wants to keep the ownership of the land as an investment. The use of the ground lease can widen his market by reducing the purchase price of the house. In certain parts of the country, the value of the land equals the value of the house. Leasing the land can cut the purchase price nearly in half. With this type of ground lease, there is usually a provision for a rent increase halfway through the lease term in accordance with the results of a reappraisal of the land.

## Benefits to the Lessee

The ground lease results in the following benefits for a builder or developer:

1. He/she can acquire a valuable parcel of land with very little cash investment.
2. This leasehold that is acquired is an asset that can increase in value, and then could be used as security for a loan, or could be sold for a profit.
3. The rental payments are fully deductible by the lessee. If he/she had purchased the land instead of leasing it, only the interest portion of the payments would be deductible.
4. With a subordinated ground lease, the lessee-developer gets the equivalent of a 100% loan on the land.

## Ground Rent and the Term of the Lease

Usually, a developer-lessee will attempt to get the longest possible term in the lease because the shorter term ground lease would have a smaller →

*All Kinds of Commercial Lease... (Continued)*

market for resale. A long-term ground lease is generally a net lease under which the lessee pays the carrying costs, including real estate taxes.

When the ground rent is a fixed amount, it is a percentage of the fair market value of the land when the lease is executed. This lease will often include a provision for reappraisal of the land at fixed intervals, with new adjustments in the rent. In some cases, for instance with a shopping center, the landowner might demand a share of the percentage rentals over and above the fixed ground rent. (Much of the income in the shopping center will come from percentage overages from the sub-lessees.)

### **A Subordinated or Unsubordinated Lease**

If the owner of the land will not subordinate the lease to a leasehold mortgage, the developer should get a reduction in rent because the unsubordination will cause his financing to be more expensive. Subordination could be the most important item in the terms of the lease. Even a short *subordinated* lease might be better than a longer unsubordinated lease, even though the longer lease is more salable.

The landowner may or may not allow his interest as owner-lessor to be subordinated to the interest of a

leasehold mortgagee. When there *is* a subordination to the mortgage, the lender, in effect, gets a fee mortgage on the land rather than a leasehold mortgage.

When the lease is unsubordinated, the landowner-lessor has first rights over the lender in case the lessee-mortgagor should default. With these terms, the lessee could find that he cannot get a loan, or can get one only at a higher rate of interest. Without the subordination, the mortgage is, in effect, a second lien since the lessor's claim on the rents takes precedence over payments on the mortgage.

The objections of an owner to subordination of the lease could be as follows:

1. **He could lose the property if the lessee defaults on the leasehold mortgage.**
2. **Subordination reduces his possibility of mortgaging his fee interest in the land, which would be a logical move for the lessor.**

If the subordination is part of the terms, the landowner would record his right to receive any notice of default from the leasehold mortgagee and the right to cure the default. The expense would be reimbursed to the owner by adding the amount to the lessee's rent obligation. ■

## **Commercial Real Estate Representation**

**There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.**

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. A professional real estate practitioner must stay aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax

advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. ■



*A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.*

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