ProMS®

What is the value of a Longer Lease?

What is the value of a longer lease?
The Impact of Lease Length on Commercial Property Risk and Return

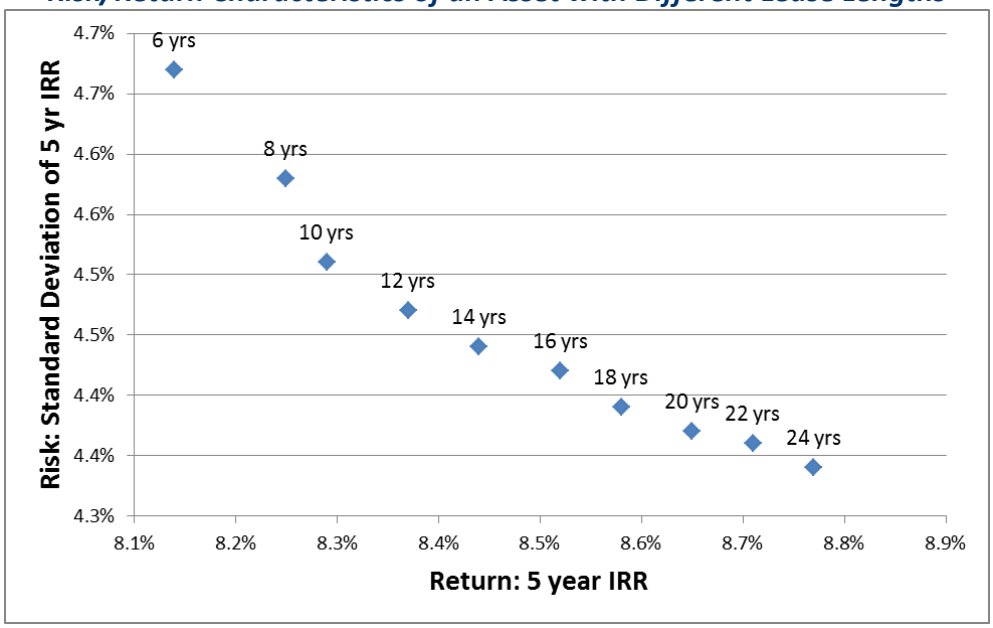
"A number of overseas investors are seeking to invest in commercial property assets with the stable income associated with very long leases"
Financial Times Jan 2013.

Measuring risk and returns

Using a cash-flow simulation*, we modelled a typical investment property through 1,000 different scenarios for the UK economy and calculated a 5 year Internal Rate of Return(IRR) in each scenario. We used the average of the 5 year IRRs as an expected return measure and the standard deviation of the returns as a measure of risk or volatility.

The template property is a building valued at £10m with a government tenant on a long lease with 5-year, up only rent reviews with no breaks. The ERV of the property is £750,000 and the proposed rent is £750,000.

Risk/Return Characteristics of an Asset with Different Lease Lengths



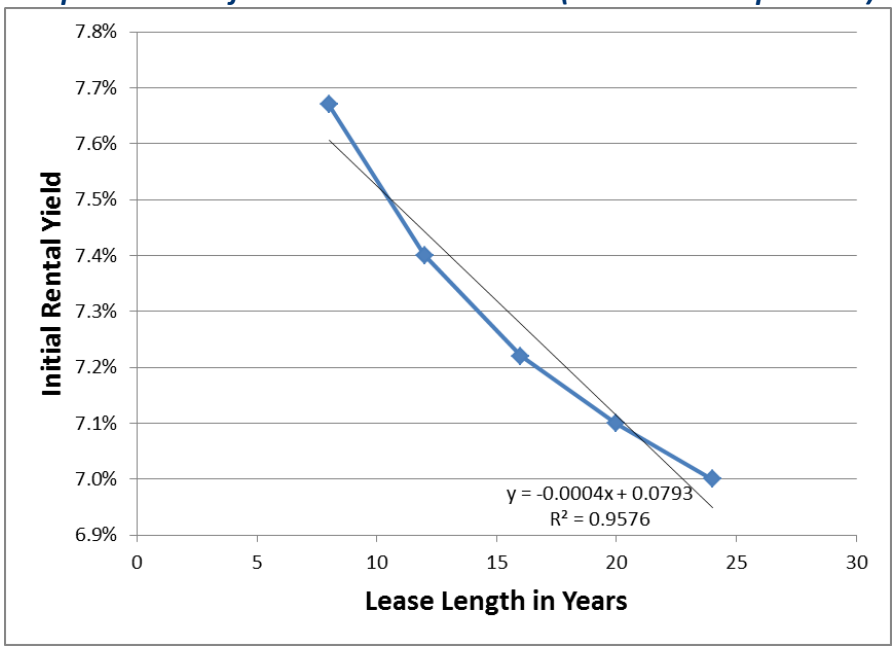
As expected, the effect of longer leases (at the same rent level) is not only to increase 5 year IRR, but also to increase the stability of returns (i.e. reduce the volatility of returns). Increased returns are driven by longer periods of certain income, reduced voids with associated void costs and postponed refurbishment costs. The improvement of a 20 year lease over a 10 year lease is an increase of about 36 bps in returns and a reduction

* Using ProMS Investor, a commercial property investment risk simulation system with 2012Q2 scenario set from Radley & Associates.

of 14bps in risk (i.e. standard deviation). In today's markets, investors are willing to sacrifice about 1% in returns for a reduction in volatility of 1% over a 5 year time horizon, so the improvement is worth about 50bps (0.5%) in risk adjusted returns.

Recognising, however, that longer leases might enable a tenant to negotiate lower rent, we asked, how much should a landlord be willing to reduce the rent to achieve the same, risk-adjusted, returns for a longer lease? By using the Sharpe ratio as a measure of risk adjusted returns[†] it is possible to see what rent level for different lease lengths would deliver the same risk-adjusted return.

Required Yields for Constant Risk Return (Constant Sharpe Ratio)



The simulation exercise suggests that rental yields can fall by about 4 basis points for each additional year on the lease. A 24 year lease with a yield of 7.00% would have the same risk adjusted returns as an 8 year lease with a yield of 7.67%

Conclusion

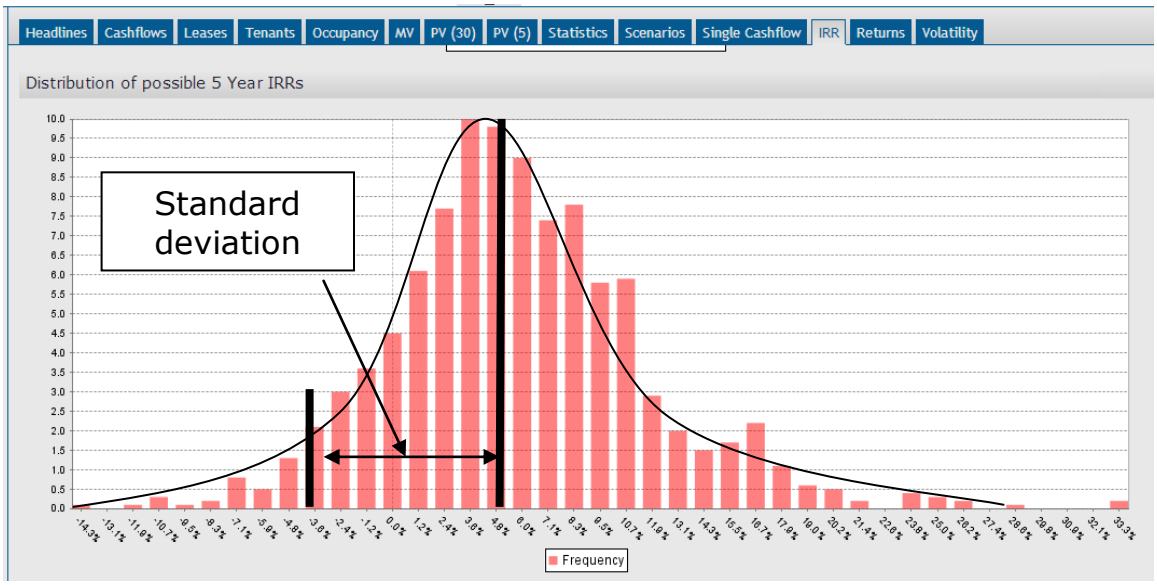
Although landlords typically reduce rent in return for longer leases, it is possible that landlords are over compensating tenants for the expected reduction in volatility. The trade-off is sensitive and depends significantly on the type and age of property amongst other factors.

[†] The Sharpe ratio S = (5-year IRR – Risk free rate)/(Standard deviation of returns)

Appendix

Example cash-flow simulation analysis of an investment property

In cash-flow simulation models, the cash-flows and terminal values of a rented property are used to calculate the 5 year IRR (or other investment return measures) in each of 1,000 realistic market scenarios. The resulting values for return are then viewed as a population or distribution of likely outcomes. A simple measure of risk is to measure the standard deviation or volatility of the returns across all the scenarios.



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Radley & Associates
2 Nottingham Street
London
W1U 5EF
0207 224 3079