REALPAC/ AIC

TERMINOLOGY STANDARDS WITH DETAILED DISCUSSION AND CALCULATIONS

First Edition, 2001

August 1, 2001

Prepared and Approved by:

REALpac
Real Property Association of Canada
Association des biens immobiliers du Canada

About the Real Property Association of Canada

REALpac is Canada's senior national real estate trade association comprised of the largest public and private real estate development and investment companies, Real Estate Investment Trusts, and the real estate investment arms of most of Canada's chartered banks, life insurance companies and pension funds. Please contact REALpac at:

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About the Appraisal Institute of Canada

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For Educational Purposes

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Comments
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FOREWORD

In June 1998, the Real Property Association of Canada ("REALpac") initiated discussions with the Appraisal Institute of Canada ("AIC") with respect to the need to develop standard definitions of terms that are often used in the real estate investment community, but which are not always used in the same context nor defined in the same manner. The inconsistency in the use and definition of terms creates complications for analyzing and comparing lease transactions, investment properties, portfolios and real estate markets in general. It also creates barriers to achieving credibility with tenants, investors, investment dealers, brokers, the public and government.

Many associations work on developing standards for their industries. The Canadian Chemical Producers' Association has established a Responsible Care Program; a system of principles and rules to improve the safe and environmentally sound management of chemicals through their life cycle. Notably, REALpac was established in 1970 for the purpose of developing accounting standards for the Canadian commercial real estate Industry ("the Industry"). To support standards setting initiatives such as these, the Standards Council of Canada has developed a National Standards System and has published a guide to developing and using voluntary codes entitled "Criteria and Procedures for the Preparation and Approval of National Standards in Canada (refer to http://strategis.ic.gc.ca/volcodes). The process that REALpac and AIC adopted to develop the standard definitions was adapted from this guide.

Through setting benchmarks for behaviour in the marketplace, voluntary codes or standards can encourage companies and organizations to conduct themselves in ways that benefit both themselves and the broader community, and they can serve as a sign to consumers that an organization's product, service or activity meets certain standards.

REALpac and the AIC believe that the Industry needs some standard points of reference so that tenants, investors, investment dealers, brokers, the public and government can comprehend what they are reading and hearing, regardless of where the information may have originated. The Industry must take steps towards standardizing terminology and practice if it is going to achieve greater credibility with stakeholder groups.

The voluntary adoption of the terminology standards by Industry participants will help achieve consistency in the use of standard terms and measurements (e.g. Market Rental Rate and Net Effective Rent). In turn, this will make analyzing, comparing and evaluating lease transactions, investment properties, portfolios etc. easier. It will also help to increase the Industry's credibility with the various stakeholder groups including tenants, investors and government.

The outcome of early discussions between REALpac and the AIC was the formation of the REALpac-AIC Terminology Standards Committee ("the Committee"), the objective of which was to develop a set of voluntary terminology standards that can be adopted by the Industry. The Committee's goal is for these terminology standards is to, over time, become as commonplace in the Industry as the Building Owners and Managers Association ("BOMA") 1989 or 1996 Area Measurement Standards that are used in most commercial lease transactions today.

Before the Committee considered a term, considerable background research was undertaken on existing definitions. This included background legal research, a thorough literature review of both printed and electronic sources, canvassing of the major investment and brokerage firms as well as key Industry and academic sources. A synopsis of the background research was circulated to Committee members for review and discussion. The Committee then drafted a definition, either by adapting an existing one if appropriate, or by creating a new definition. The Committee's experience was that the majority of existing definitions were general in nature and therefore not appropriate for adaptation.

The Committee is currently preparing additional definitions. This document will be updated from time-to-time as appropriate.

USE OF THE TERMINOLOGY STANDARDS

The terminology standards are presented in alphabetical order for ease of reference. Terminology standards are italicized and are catalogued using an alphanumeric identification system.

The identification of a REALpac/AIC terminology standard is composed of three parts as indicated below:

REALpac/AIC Identification	REALpac/AIC –	1.0 -	2001
Part	(1)	(2)	(3)

Part (1) consists of an acronym that identifies that the Real Property Association of Canada (“REALpac”) and the Appraisal Institute of Canada (“AIC”) prepared and/or reviewed the standard.

Part (2) is assigned by REALpac and is based on an established system used by REALpac to identify their standards.

Part (3) indicates either the year of publication as a REALpac/AIC standard or the year of the latest edition of the REALpac/AIC terminology standard.

When referencing a term, users are requested to reference the alphanumeric identification number of each terminology standard. For example, if the term Contract Rent was to be used in a document, it should be referenced as follows:

> **Contract Rent is the Rent promised to be paid by a written lease, license, contract or offer to lease (REALpac/AIC-CR-1.01-2001).**

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1. The use of the alphanumeric identification number of each terminology standard (see above) is intended to demonstrate that the definition is authentic, accurate and unamended. The use of the alphanumeric identification number is a representation that the fixed language of the original definition has not been changed from its original form.
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A

Actual Net Effective Rent. *Actual Net Effective Rent is common Net Effective Rent, together with the present value of lease takeover costs, mandatory tenant space take-up costs, early termination and space put costs, the cost of limits on recoverable costs, the costs of holding space for expansion, moving, and other tenant relocation costs.* (REALpac/AIC-ANER-1-01-2001)

Discussion

Actual Net Effective Rent is not recommended for use outside of the firm using it, but just for internal purposes by owners as a management accounting tool.

	Financial Term	Discussion: Included Costs
1	Lease takeover costs (Includes sublease to Landlord, assignment to landlord, or rent indemnity from landlord)	Discussions regarding lease takeover costs generally considered the time period within which a "deemed" financial cost should be included in the Actual NER calculation. As it is reasonable to assume that the landlord could sublet the remote space if the remaining term is beyond a period of three years, a cut-off point of 36 months is recommended. Include actual annual Gross Rent payable under the old premises lease to be taken over by the landlord if there is less than 36 months remaining on the term of such lease as at the new lease commencement date. If more than 36 months is remaining on the old premises lease as at the new lease commencement date, then include only 12 months Gross Rent as a cost, since the assumption is that the space is sublettable if one can offer a tenant at least a three year term. The 12 months Gross Rent deduction is meant to represent potential discounts on subletting for the remaining period to the Contract Rent of the remote premises, and lease, commissions, legal and other costs associated with the sublease process.
2	Mandatory tenant space take-up obligations (vacant period)	If the tenant must expand into additional space within the building, then the landlord may have to hold it off the market until the expansion obligation starts. This would create an opportunity cost to the landlord, since additional rentable space is sterilized. If the expansion space is to be taken up within 36 months from the lease commencement date, then the Committee feels the space is effectively sterilized, and the Net Rent per square foot otherwise payable for the initial premises (which is the simplest proxy for space at the time in the Committee's view) is applied to the expansion and reported as a landlord cost and is included in the Actual NER calculation. The costs of space held vacant could be recovered through sub-leasing if the time to mandatory take-up is beyond 36 months from the lease commencement date. If it is longer than 36 months from the lease commencement date until the mandatory take-up obligation, Net Rent for the entire interim period is not included, but 12 months of the Net Rent for the initially occupied space is added as an Actual NER cost. A 12 month deductible is chosen not only to be consistent with lease take over issues as in #1 above, but also to better reflect the rent to be paid for such space.

	Financial Term	Discussion: Included Costs
3	Tenant option to terminate lease before expiry	If the tenant has an option to terminate the lease at a certain point or points in time during the term of the lease, then two (or more, if there is more than one option to terminate the lease) rental streams need to be discounted: the one assuming no option(s) to terminate are exercised, and one for each option to terminate, including any termination payment. The Rent component for Actual NER is the lowest of all of the NER calculations, since that is the only NER that is certain to be received. However, if the landlord receives all of its unamortized costs on termination calculated at 10% (the Common Discount Rate), then for the purposes of determining the NER calculation, the NERs should match and therefore, one would not need to do all calculations.
4	Put (an option to reduce space)	An option for a tenant to unilaterally reduce the amount of space subject to the lease at a defined point in time is treated the same way as a tenant's unilateral right to terminate the lease early described above. In these cases, one NER calculation is done assuming the "put" right is exercised (including any one time payment as Rent), and one NER calculation is done assuming it isn't, and the lower of the 2 NER calculations determines Actual NER. Similar to item number 4 above, if the landlord recovers all of its unamortized costs in respect of the space excised from the lease by way of payment from the tenant, calculated at the standard (10%) Discount Rate, then for the purpose of calculating the actual NER, the multiple calculations could be ignored as the NERs should be identical.
5	Cap or limited recoverability of operating costs	Where an operating cost cap (i.e., an artificial maximum on the amount of costs that can be re-charged to the tenant), reduced set of recoverable operating costs and/or taxes leaves the landlord with an actual or potential expense, or an inflation limit is below an expected market level (deemed by the Committee to be 4%), the difference or estimated difference should be included as a cost. In order to avoid minute variances, no expense should be deemed to impact the Actual NER calculation unless it is less than 95% of operating cost and /or taxes otherwise rechargeable to the tenant in a fully Net Lease. The 5% allows for some variation in recoverability from lease to lease without requiring an audit.
6	Tenant expansion option	A tenant's option to expand is only contingent income to a landlord, since the landlord does not know at the lease outset if the option will be exercised, and thus option Rent is not counted as landlord revenue or a cost. However, to the extent that it creates "shadow space" for the landlord (i.e. Space that it must hold off the market to allow for the exercise of the option at the stated time), there is a cost to the landlord. If the expansion option is to be taken up within the first 36 months of the Term, the Net Rent for the balance of the space must be imputed to such shadow space and added as a landlord-side cost of the transaction to arrive at Actual NER. In other words, it's handled the same way as a mandatory take up obligation by the tenant as in #3 above.
7	Moving costs paid by landlord	Include in Actual NER only if paid by the landlord as a tenant inducement. If it is an internal tenant cost, it should not be included.
8	Other tenant relocation to facilitate this lease	Landlords are sometimes required to relocate one or more existing tenants within a building in order to facilitate a new lease deal. In so doing, the landlord incurs a number of costs such as moving costs, space fit-up, costs of re-printing of tenant letterhead etc. The Committee recommends that the costs of relocating a tenant within the building, if paid by the landlord and caused by the new lease deal, be included in the calculation of Actual NER.

The following costs, while carefully reviewed by the Committee, are recommended to be excluded from Actual Net Effective Rent:

	Financial Term	**Discussion: Excluded Costs**
9	Fixturing (existing in place)	The Committee recommends that this financial cost be omitted from the calculation of Actual and Common NER as: a) it is not standard in the market; b) it is too hard/subjective to value; c) it is not clear what is base building and what is fixturing; and, d) NER formula should have a bias towards out of pocket costs.
10	Tenant pays for new fixturing (for example leasehold improvements)	The fact that the tenant may pay for new fixturing may be imputed in the Contract Rent. Otherwise, these costs are omitted from Actual NER because of transparency (it is difficult to determine what the number to attribute is going to be) and for the purpose of consistency; it is easier to exclude the calculation than to include it. They may also be internal to the tenant, not undertaken prior to occupancy but from time to time.
11	Demolition of existing fixtures / restoration at end of term	Demolition costs may be paid for by the landlord or by the tenant. Sometimes, the landlord has the option to require the tenant to demolish its leasehold improvements at the end of the term. Sometimes the landlord can ask for a cheque for the costs of restoration. The Committee recommends that this financial cost be omitted from the calculation of NER since it is too uncertain, and the costs too difficult to accurately predict. Again, landlord may not require restoration if the existing fixturing may be re-useable by a future tenant.
12	Early occupancy for fixturing	The Committee discussed the difficulty of determining a standard fixturing period for all space. Because of the difficulty in quantifying this financial cost, and the general practice of providing a fixturing period, the Committee recommends that a deemed rent for early occupancy for fixturing be omitted in the calculation of NER. The norm in the industry is not to include this in the NER calculations. However, the fixturing period is intended to be limited, allowing the tenant to fixture the premises only, and not for any other purpose that might otherwise extend the time attributed to a "fixturing period". Any period of time exceeding such reasonable period of time to fixture premises should be included on the same basis as if it was "Free Rent".
13	Base building costs	Additional costs such as sprinkler construction, drywall to perimeter wall, surface ceiling tiles and broadloom are regarded as base building costs and omitted.
14	Space marketing costs	Such costs are too indirect and too subjective to be used in the formula, and may not be attributable to any specific lease deal, they may reduce comparability and add unnecessary complexity. They are not generally "deal specific", and accordingly should be omitted.
15	Space planning costs	Again, these costs are not deal specific, could be incurred for failed deals, and therefore should remain in landlords' overhead and not as a cost attributable to the deal omitted from Actual NER.
16	Landlord’s and tenant’s legal costs	These costs are prevalent in most deals, variable and to be considered generally part of normal overhead: therefore, omitted.
17	Renewal options	Rent for potential renewal term is not included since it is not guaranteed, and the potential margin between fair market rental rate and actual renewal rate is too speculative to estimate. It is a contingent number. Therefore, omitted.
18	Inflation	It is too hard to pick inflation rates, so no inflation percentage is imputed. The committee recommends that the NER not be modified by the expected impact of future inflation or by the value of a rental dollar. It is too subjective. Therefore, there is to be no discounting of the future rental impact of inflation (i.e. calculate on current dollars).

	Financial Term	Discussion: Excluded Costs
19	General and Administrative Expenses	Too subjective, too remote, therefore omitted.

C

Common Discount Rate. *Common Discount Rate means 10% per annum compounded annually not in advance.* (REALpac/AIC-CDR-1.01-2001)

Discussion

The rate at which the cash flows are discounted and then amortized can take either a variable or fixed rate. A variable rate can be adjusted over time referenced to government bonds of a similar term, a prime rate of interest, or a stipulated premium thereto. A fixed rate might be held at 10.0%.

Some participants felt that a variable rate should be allowed, should there be a shift in market conditions. The Committee felt that the need for simplicity and consistency was more important.

Considerable discussion occurred as to what the fixed rate should be. REALpac members acknowledged the variability of interest rates. Some suggested it be priced off of Government of Canada Bonds having a similar maturity as the lease termination date. However, this would reduce the comparability of the calculation, and add complexity.

While fixed rates of 6, 8 and 10% per annum were considered, a standard rate of 10% was agreed to as the closest single proxy to current practice. Accordingly, the Committee has adopted a fixed rate of 10.0% as the discount rate for the REALPAC-AIC Standard for Common Net Effective Rent (refer to REALpac/AIC-CNER-1.01-2001).

Some firms discount monthly to mirror cash receipts. The Committee believes that monthly discounting may make the calculation more difficult requiring, in essence, a monthly net effective rent calculation. While firms are free to do so, it was felt that for the purposes of the Common NER, that annual discounting is sufficient, simple, and will facilitate comparability.

Common Gross Effective Rent. *Common Gross Effective Rent is calculated by combining the Common Net Effective Rent with the building's quoted realty taxes and operating costs, but excludes direct billed or separately metered tenant hydro consumption* (REALpac/AIC-CGER-1.01-2001).

Common Net Effective Rent. *Common Net Effective Rent is the true Rent related to a certain lease transaction, based on the present value using the common discount rate, of all Rent receivable by a landlord over the initial fixed term, less the present value of all tenant inducements, free rent periods and commissions payable, with such remainder present value then amortized over the fixed initial lease term* (REALpac/AIC-CNER-1.01-2001).

Discussion

Rental rates charged for the use of premises are a critical component to the forecast of income, and thus market value of rental property. However, since the financial terms of rental contracts have become complex, the measurement and description of Rent has become inconsistent between the various stakeholders such as owners, building managers, investors, tenants, lenders, brokers, advisors, financial analysts and government. The resulting confusion has led to uncertainty and a lack of confidence, thus motivating a need to provide an improved and effective method of measuring an "effective" Rent.

The Committee is defining Net Effective Rent ("NER") to provide some consistency and certainty within the Industry with respect to the measurement of "effective" Rent.

Users of the Net Effective Rent Measurement

There are several different users of the NER measurement. First, management uses NER for the purposes of budgeting, performance measurement, decision-making generally, lease approval specifically, and bench marking with other properties and organizations. Other investment stakeholders such as investment dealers and analysts may use it for performance measurement, for estimations of the direction of markets, and to estimate future earnings. Real estate brokers may use the NER measurement to estimate the Market Rental Rate for landlord clients, to advise their tenant clients as to expected costs of rental for budgeting purposes, and to help determine movement in the market. Tenants may use it to estimate their complete costs of renting and to compare amongst alternative premises.

The purpose of the NER standard is to assist in real estate management accounting, and not to affect financial accounting. Readers should be cautioned that the Committee is not attempting to write accounting policy, and that generally accepted accounting ("GAAP") standards are not intended to be affected. Thus, the professional accounting community will still account for real estate rents and expenses in accordance with the Accounting Standards Handbook of the Canadian Institute of Chartered Accountants, as discussed in more detail in the REALpac Real Estate Accounting Standards Handbook available from REALpac (www.realpac.ca).

The broad range of users and their varying levels of access to information raise several issues with respect to determining a standard measurement of NER. While tenants and brokers may know the costs reflected in an offer to lease, the lease document may not show all the costs affecting the transaction from the landlord's point of view. There may be many types of undisclosed landlord costs that are known or reasonably estimated by the landlord, but not known to the tenant (e.g., upgrades to base building costs for the space, partial demolition and restoration of previous leaseholds, and commission payments). In these situations, is the NER figure sufficient, as visible to and reported by, say, a tenant's broker, and based on an analysis of the lease document alone?

A landlord seeking to establish an NER either to evaluate a specific offer to lease transaction available to it, or to establish threshold NER rents it wishes to achieve before entertaining offers for lease of space for internal budgeting and performance measurement purposes, may want to know all of the costs associated with a certain lease transaction including internal lease-specific costs and soft costs that might not otherwise be apparent on the face of the lease document.

Some users may prefer that a standard definition of NER be created that deals only with the visible costs and revenues contained in a lease document. The benefits of such a standard would include ready calculation, simplicity and reliability. Proponents of this approach would argue that other costs would surface in the landlord's balance sheets and that some of these may be less reliable, capable of manipulation, or invisible to the wider community.

There is clearly a tradeoff between accuracy and simplicity/usability that presents itself in creating a standard for NER. When considering leasing transactions involving lease takeovers, expansion spaces and put options, there is the potential for the formula to become exceedingly complex.

The Committee believes that simplicity and usability ought to be the paramount consideration, realizing that sophisticated users would be free to add their own additional calculations for additional cost, contingent cost and revenue items as they saw fit. For most professionals in the industry, a more simple calculation that would apply to the vast majority of leasing transactions, would enhance usability, would make training easier, and would foster quicker adoption of the standard.

Therefore, the NER, or "Common" NER term as recommended by the Committee, only deals with five key variables: rent, tenant inducements (of most types), rent-free periods, commissions, and the discount rate.

Method of Calculation

The NER measurement seeks to establish the true present value of all cash or near cash inflows and outflows for a given lease deal. NER is generally calculated as follows:

1. Prepare a cash flow forecast showing Rent payable and expenses payable under the proposed lease deal covering the fixed lease term (excluding optional renewals) broken out by month, quarter or year, as the case may be.

2. Discount the Rent to a present value using an annual discount rate, or the monthly or quarterly equivalent.

3. Deduct the present value of lease deal expenses, such as tenant inducements and leasing commissions, from that present value of the future Rent calculated in #2 above.

4. Deduct the value of any Free Rent periods from the present value of the future Rent calculated in #2 above.

5. Amortize the remaining present value in even amounts over the duration of the fixed lease term, excluding the term of optional renewals. Generally, an annual per square foot rental rate is the desired resulting value for NER.

A detailed explanation of recommended methodology to determine Common NER is described in the table below:

	Financial Term	**Instructions**	**Rationale and Comments**
1	Rent Payable	(a) List each month's Net Rent payment in a spreadsheet for the entire initial fixed term of the lease. (b) Discount each months' Net Rent payment to the commencement date, using 1/12th of the annual Common Discount Rate (c) Add up all the monthly discounted rental payments to arrive at a single aggregate number. (d) This is the present value of future Net Rent	Rent is included as revenue in the NER calculation. It is obviously the core financial element of a lease transaction. The Common NER assumes Net Rent is discounted only (i.e., not gross Rent), resulting, effectively in a net effective Net Rent. The tenant would be responsible for its share of realty taxes, operating costs and utilities. Any parking or storage or additional service charges that other tenants typically pay for at a standard quantifiable rate is generally not included in the Net Effective Rent calculations.
2	Common Discount Rate	(a) Use 10% per annum as the Common Discount Rate. (b) If another discount rate is used, disclose and describe why	See discussion under the definition of Common Discount Rate
3	Tenant Inducements (generally)	Deduct from present value of future Net Rents calculated in #1, above.	Tenant inducements may come in many forms. They include cash inducement payments, landlord payments for new fixturing and tenant improvements, and tenant-specific building upgrades including custom signage (e.g., building top signage). Because building upgrades that are exclusive to a tenant are similar to a cash inducement or a tenant specific allowance, they should be counted as an expense and included in the calculation of Common NER. Base building standard ready for tenant fixturing is expected and therefore is not costed into the Common NER calculation. However, if non-base-building fixturing is to be undertaken by the landlord, the cost of such work is to

	Financial Term	Instructions	Rationale and Comments
			be included based on the total costs actually paid, or to be paid. These costs may include some demolition costs.
4	Rent Concession or “Free Rent”	Deduct from present value of future Net Rent calculated in #1, above.	A deemed cost of “holding space vacant” or “free rent” is only included in the calculation of Common NER if the time allowed is outside of the normal fixturing period given to such types of tenancies. If it is, then the costs of such vacancy imputed at the daily Net Rent for Common NER or Gross Rent (for Common GER) as the case may be, is added for each day of free rent. There may be variations in such rent concessions and it may range from an absolutely rent-free period in which the landlord receives no "Contract Rent", operating costs or taxes or, indeed, even payment towards utilities consumed during such period at all (in which case Gross Rent is imputed as a cost), to situations where the landlord receives payments on account of operating costs, realty taxes and utilities, but does not receive any "Contract Rent" during such time (in which case Net Rent is imputed as a cost). It is the difference between the total amounts received and the Common Net Rent and should be imputed in the Net Effective Rent definition that should be added as a cost and it is a difference between the total amount received and the Gross Rent that should be imputed in the Gross Effective Rent definition.
5	Realty Commissions	Deduct from present value of future Net Rent calculated in #1, above.	Realty commissions are payable on most lease transactions. The commissions can be large but vary deal to deal. Only realty commissions paid to arms length third parties should be included in the Common NER calculation. Realty commissions should not include in-house leasing department's general and administrative costs if outside brokers are not used. There may be more than one commission, such as commissions payable to a listing agent, a selling agent, and in some circumstances a third party property manager to the extent it receives an override above third party broker commissions. All should be counted.

	Financial Term	Instructions	Rationale and Comments
6		Amortize the remaining balance of Net Rent over the fixed term of the lease to get Common Net Effective Rent expressed as an annual effective Net Rent number	

For those landlords and observers interested in developing a more sophisticated analytical model to determine NER, recommended approaches to additional cost categories are contained in the discussion under "Actual Net Effective Rent" in this document. However, given that practice may vary between users, Actual NER is recommended for guidance and internal use only, and the additional cost categories in Actual Net Effective Rent are not part of the Common NER standard described herein.

Contract Rent. *Contract Rent is the Rent promised to be paid by a written lease, license, contract or offer to lease* (REALpac/AIC-CR-1.01-2001).

Discussion

The Committee found only a few extremely general existing definitions of Contract Rent during its background research on the term. As such, the Committee arrived at its own definition of the term.

Contract Rent is a useful term to describe rents payable under existing leases and licenses for a purchaser of income producing real estate.

Contract Rent may not disclose the entire financial arrangement(s) made between the lessor and the lessee. The present value of Contract Rent may be significantly different than the Common Net Effective Rent (refer to REALpac/AIC-CNER-1.01-2001). Contract Rent may be Net Rent or Gross Rent, may be expressed either as a total annual sum or as a per square foot per annum amount, and may be expressed as a total monthly sum or a monthly square foot amount.

M

Market Rental Rate. *Market Rental Rate is the most probable Rent which a leased property should bring for the relevant lease term in a competitive and open market under all conditions requisite to a fair lease transaction, the lessee and lessor each acting prudently and knowledgeably, and assuming the Rent is not affected by undue stimulus between the parties.*

Implicit in this definition is the consummation of a lease transaction as of a specified date and the passing of occupancy from lessor to lessee under conditions whereby:

i. Lessee and lessor are typically motivated;

ii. Both parties are well informed or well advised, and acting in what they consider their best interests;

iii. A reasonable time is allowed for exposure in the open market;

iv. Payment is made in terms of cash in Canadian dollars or in terms of financial arrangements comparable thereto;

v. The Rent represents the normal consideration for the leased property in its highest and best use, unaffected by special or creative leasing incentives or allowances granted by anyone associated with the lease transaction; and,

vi. The prospective lessee is not then in occupation of or has no obligation in respect of the building. (REALpac/AIC-MRR-1.01-2001)

Discussion

The Committee found no existing precise definitions for the term Market Rental Rate despite considerable background research on the term. As a result, it decided to develop its definition of Market Rental Rate from the Uniform Standards of Professional Appraisal Practice ("USPAP") definition of Market Value which was developed in the United States with consultation with the AIC and which is the universally accepted definition of Market Value in North America. (Note that USPAP has not defined Market Rental Rate).

The Committee received permission from The Appraisal Foundation (U.S.) to adapt the USPAP definition of Market Value for the purposes of defining Market Rental Rate on July 14, 1999.

The Market Rental Rate definition is more robust than the types of definitions currently used in leasing practice in many Canadian provinces (e.g. "the rent charged for comparable premises in comparable buildings in the vicinity of the Premises…"). These shortened definitions refer to data sets without qualifying what should be in and out of those data sets, and which data ought to be given reduced weight. These types of definitions do not deal with possible exceptions to the data set, such as renewal deals, or non-arms length deals. It may not specify that the applicable rents should be based on comparable lease terms. It does not exclude other subjectively inferior comparables, whereas the proposed REALpac/AIC definition allows for a more pure data set. In addition, the USPAP-based definition is likely the one an appraiser will use if the rent is arbitrated without a standard, since it is in widespread use in Canada and the United States. However, as in current practice, the REALpac/AIC standard is still based on real transactions in the marketplace.

Market Rental Rate data may therefore include comparable transactions in the marketplace. In doing so, all economic elements of these comparable transactions, such as tenant improvement allowances, will have to be considered and factored in.

If the parties to a leasing transaction were not at arms length to each other, the Committee would regard the transaction as being affected by undue stimulus, contrary to the above definition, and the data should be disregarded for Market Rental Rate purposes.

Particularly in a retail context, there may be some variances in the data depending on the tenant's specific use and profitability, and, accordingly, the amount of rent that such tenant would be willing to pay. This is to be expected, but must be recognized in assigning weight to any particular retail leasing transaction.

It is important to note that Market Rental Rate, as defined by the Committee, can only be determined based on new direct transactions. With these types of transactions, prospective tenants are free to select all competitive buildings whilst landlords are able to select from all available tenant types permitted under applicable zoning. This type of transaction offers the most consistent, stable and plentiful base of comparable information.

The definition of Market Rental Rate cannot be determined based on the following types of transactions for the reasons discussed below:

- **New Sub-Lease or Assignment of Lease Transactions**

With this type of transaction, tenants typically do not have the same motivation as landlords do in achieving a market rental rate. The tenant's prime motivation may be to reduce the occupancy cost of space not required as quickly as possible. The landlord may have rights to receive any sublease rent in excess of the rentals otherwise chargeable under the lease. The use may change. In practice, our Committee's experience is that subleasing tenants rarely achieve a rental rate similar to that achieved by a landlord for directly leased comparable space. A landlord is motivated to achieve a higher rent over the longer term even at the expense of a short-term vacancy, since higher rent is converted directly into value. In addition, many new sublease situations deal with odd or shorter terms.

- **Renewals, and Blend and Extend Deals**

Transactions that involve renewal of a former leasehold interest will frequently achieve rates and terms different from other types of lease transactions due to the established relationship of the tenant and landlord and, more importantly, between the tenant and the building. The costs and disruption of moving (switching costs), coupled with familiarity with the building, will positively influence the negotiation process from the landlord's perspective. A landlord may be able to undercut its competition because a tenant may face moving costs and fit-up costs if it chooses to relocate to alternate premises in another building. Alternatively, a landlord may be able to extract a premium over posted rents or rents for comparable buildings because of the existence of the tenant's switching costs. On the other hand, the landlord may fear the risk and cost of vacant space in a declining market and accordingly be prepared to offer a low renewal rent to a stable credit-worthy tenant. Which influence is strongest will be generally undetectable.

The definition of Renewal Rental Rate has been developed to address this sub-market (refer to REALpac/AIC-RRR-1.01-2001).

Blend and extend transactions, which involves extending the term of an existing lease and blending the rental rates or expanding the physical extent of existing premises, is clearly influenced by the existing relationship of tenant and landlord. In negotiations, much depends on the term of the existing lease and the status of the parties involved and, as such, there is very little consistency between transactions. Tenants may be bargaining out of a position of weakness, due to declining competitiveness or reduced creditworthiness. This type of data is therefore excluded.

- **Gross Rent or Net Rent-based Data**

Data for Market Rental Rates may, in parts of Canada, reference Gross Rent, while other data may define Market Rental Rate in terms of Net Rent. REALpac/AIC did not feel it necessary to restrict the Market Rental Rate definition to only Net Rent or Gross Rent data sets, since practice may vary across Canada in respect of how Rent is quoted and reported. Users of the term Market Rental Rate, however, should clarify whether they are referring to Net Rent or Gross Rent in quoting a Market Rental Rate.

N

Net Effective Rent. For Net Effective Rent, refer to the definition of Common Net Effective Rent (REALpac/AIC-CNER-1.01-2001).

Net Rent. *Net Rent is Rent, excluding a tenant's share of real estate taxes, operating cost, and other costs directly related to the tenants' occupancy of the space* (REALpac/AIC-NR-1.01-2001).

Discussion

Despite the historical usage of semi-gross, *net*, *net net*, and *net net net* to describe various degrees to which landlord's operating costs are passed on to a tenant in a lease as additional Rent, such distinctions are commonly misunderstood, are not useful and/or are incapable of precise definition. Developing a precise definition of operating costs is itself difficult, since practice may vary from building-to-building. Operating costs may include capital tax or the current portion of amortized major capital expenditures.

Describing Net Rent in the context of a future event will require operating costs and taxes to refer to budgeted operating costs and budgeted taxes. Since Rent has been defined to include Percentage Rent, if any, in a retail context, Net Rent may include Percentage Rent if payable unless otherwise specified.

The terms "basic rent" and "minimum rent" as used in certain landlord forms of leases may also be describing "Net Rent" as defined herein.

Q

Quoted Rental Rate *Quoted Rental Rate is that Rent disclosed by the Landlord as the demanded Rent for new or renewing tenants having regard to Market Rental Rate and Renewal Rental Rate data, and demand for space within the building (REALpac/AIC-QRR-1.01-2001).*

R

Renewal Rental Rate. *Renewal Rental Rate is the most probable Rent which a leased property should bring for a relevant renewal term between a lessor and a lessee in occupation of such leased property for such use as is carried on by the lessee at the time of renewal, the lessor and lessee each acting prudently and knowledgeably. Implicit in this definition is that:*

i. Lessee and lessor are motivated as is typical in renewal situations;

ii. Both parties are well informed or well advised, and acting in what they consider their best interests;

iii. Payment is made in terms of cash in Canadian dollars or in terms of financial arrangements comparable thereto (REALpac/AIC-RRR-1.01-2001).

Discussion

It is clear that the definition of Market Rental Rate, for the reasons described above, could not include renewal rent data. Notwithstanding, a definition of Renewal Rental Rate may be useful to define a data set. The Committee based its definition of Renewal Rental Rate on a subset of the Market Rental Rate definition for consistency.

The function of a Renewal Rental Rate definition is to clarify the distinction from other definitions, and in particular, Market Rental Rate.

The application of this definition is cautioned where settlement of Rent is to be based on the Renewal Rental Rate definition, since there may be very limited consistent evidence or data upon which a conclusion can be drawn. Renewal Rental Rate expects an undue stimulus due to the pre-existing relationship of the parties that is about to be renewed, and differs from Market Rental Rate in this regard. It is the extent of the stimulus, and the resultant effect on Rent, that may increase the variability from one renewal agreement to another. Thus, a comparable Renewal Rental Rate agreement that might act as a proxy or benchmark for a subject property may be a poor basis for comparison.

The Committee generally recommends Market Rental Rate be used as a standard for renewal rent.

Rent. *Rent is the total consideration payable for the use or occupation of real property for a specified period (REALpac/AIC-R-1.01-2001).*

Discussion

Rent needs to be defined accurately since many other definitions are based on rent. The Committee conducted considerable background investigation on the definition of *Rent* including legal research and research on professional and lay definitions of the term. Various statutory definitions were found, primarily in residential tenancy acts. In terms of professional and lay definitions, most include the concept of the use of something for a certain period of time in exchange for monetary or other consideration. The Committee has accordingly chosen to modify slightly the Black's Law Dictionary definition of Rent.

In general, Rent applies for the use and occupation of property for a certain period of time. Consideration may be in the form of cash or services or any other item of value to the lessor. Rent is typically stipulated to be on an annual basis, but could just as easily apply to a weekly, monthly or quarterly basis. Rent may also be calculated on profits or earnings of the tenant, such as in some shopping center leases where it may be described as percentage rent, and in ground leases where "participation" rent may be re-set every five or ten years.

Rent can mean "Net" Rent (refer to REALpac/AIC-NR-1.01-2001) or it could mean a "Gross" Rent. "Gross Rent", as that term is used in the industry is Rent, since both gross rent and rent include a tenant's share of real estate taxes, operating costs, and other costs directly related to a tenant's occupancy of the space, and may or may not include utilities.

In the context of a retail lease, Rent may be inclusive of marketing costs, promotion fund costs, merchant association charges, advertising and circular charges, food court charges (such as capital installation charges for public seating), other variable re-charges, and other such similar retail charge backs.