

RESEARCH REPORT

COMMERCIAL LEASE AGREEMENTS – A CLOSER LOOK

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DEDICATION

In loving memory of Mary-Lisa Magondo

ABSTRACT

This study is about the complexity of lease agreements, it seeks to establish why lease negotiations have become have become complex leading to slower turnaround time of finalizing the lease agreement. A survey approach was adopted and data was collected through questionnaires and interviews from landlords, managing agents of listed property funds and national tenants in the commercial retail property industry in Gauteng . The findings indicate that the turn-around time of finalising lease agreements is affected by complicated negotiations that are a result of both parties to a negotiation having a standard lease agreement, lease agreements that come in a large variety, lease clauses that cannot be reduced to a monetary value and factors affecting the the property market.

I therefore recommended that to improve the turn-around time of lease negotiations by setting aside our standard lease documents and negotiating a new lease, negotiating upfront all terms and conditions to be included in the lease, understanding the market conditions prevailing at the time of negotiation is pertinent and Pricing lease clauses should become an industry norm. It was further identified that research should be conducted on the use of lease agreements, pricing of lease clauses and identifying when standard lease agreements are usefull, which were outside the scope of this study but are essential to fully understanding the complexity of lease negotiations in commercial properties.

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DECLARATION

I, Nyaradzai Bessie Foya, declare that this research report is my own, unaided work. It is submitted in partial fulfillment of the requirements for the degree of Master of Science in Building in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

Nyaradzai Bessie Foya Date

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CHAPTER 1

INTRODUCTION

1. Background – Commercial Lease agreements

Commercial Lease agreements have governed the relationship between landlord and tenant for thousands of years. Historical evidence suggests that leasing was in widely practiced by the ancient Sumerians several thousand years B.C and has continued through almost all advanced civilizations since (Grenadier, 1995).

The lease agreement is defined as contract to let and hire immovable property, an agreement between one person, the “landlord” and another, the “tenant” in terms of which the landlord binds himself to give the tenants the temporary use and enjoyment of property, wholly and in part (Delport, 2005).

The five essentials which have to be agreed upon by both parties before a legally binding and enforceable contract is formed are; the parties to the agreement, the property, the price- rent, the period and the parties’ intentions. The lease agreement has other clauses which can be grouped into two categories which are *consequences* of the lease agreement and *incidentals* of lease agreement (Smith, 2006).

The terms and conditions contained in the Lease agreement in one way or another influence the rent income negotiated in the lease agreement. These terms and conditions cannot be ignored or over simplified. Rowland P (1996) is of the view that valuers must consider the responsibilities created by a lease agreement covenants in assessing rents. The valuer or appraiser often cannot avoid adjusting the rent to reflect variations in responsibility of the landlord and tenants.

It is evident that the role of the lease agreement has changed since the 1800s during the feudal system. Leasing is often perceived as a substitute for debt for firms that are too risky or unable to access conventional debt markets (Mc Connell and Schallheim, 1990).

In many countries, valuers are called on to assess open market rent values for mid term rent reviews, for options to renew at market rent and to advise landlords and tenants negotiating new lease agreements (Rowland, 2000)

In South Africa the listing of Property Loan Companies and Property Unit Trusts on the JSE has introduced another vital role for the lease agreement. The cash flow contained in the lease agreement indirectly affects the share price of the listed property funds.

The focus of lease negotiations was on offer and acceptance and the five essentials required for a lease agreement to be in place. It is evident that this focus has shifted .The terms and conditions contained in a lease agreement form part of the lease negotiation and agreeing on some of these conditions is proving to be difficult as tenants occupy premises without a lease agreement, signed by both parties. It often happens that lease agreements may expire before the new lease agreement is concluded.

Common law and the law of contract do not require a lease agreement to be in writing. The problems associated with not having a written lease agreement in place are, lack of clarity regarding the parties' rights and obligations, should a dispute arise. With no written lease agreement, resolving a dispute may be difficult. Where offer and acceptance is in writing, it is clear that the parties intention is to reduce their agreement to writing. Verbal agreements are usually difficult to prove or enforce.

The importance of the lease agreement and the risk of not having a written lease agreement in place form the core of this research. The lease negotiations have become complex as a result of the intricacy of the demands from both parties as each seek to minimize their risk exposure, leading to occupation of leased premises without a written and signed lease agreement. This report will identify what factors have led to the complexity of these lease negotiations.

1.1 The History

Lease agreements have been in existence for hundreds of years, though not as detailed and complex as they are now. As early as the 1500's a system of leasing land in exchange for labour and or crops was used in Europe particularly in France and England, the feudal system. This is a system of living where one lived on someone else's land and paid in crops, labour and loyalty (Vorster, 1995). The clergy and nobility were the "landlord" and the peasant was the "tenant".

The landlord and tenant relationship was derived from the lord and peasant relationship and the agreement between them is now known as the lease agreement. In South Africa, a system similar to the feudal system is seen after the white immigrants succeeded against the Khumalo-Ndebele of Mzilikazi in the 1830's where they claimed land in the central and western parts of Transvaal now known as Gauteng. By the early 1870's labour - tenants contracts were concluded between white settlers (landlord) and the African communities (tenants) (Bergh, 2005).

Today the lease agreement has evolved and continues to do so in light of the ever changing environment in which the property market operates. Changes in legislation, interest rates, inflation including other government policy and real estate cycles, affect the property markets and environment they operate in and in turn the lease negotiations.

(Pyhrr , Roulac and Born, 2007) stress the importance of understanding real estate cycles. Their view is that estate cycles have been a significant underlying

reason for the financial successes and failures of real estate investments throughout history. Understanding the micro and macro relationship is believed to be a good foundation of for understanding real property performance in a specific market.

The landlord's "standard lease agreement" continues to evolve in response to the changes within the property markets. The creation of a "standard lease agreement" by the tenants is to mitigate the risks created by the ever changing landlord "standard lease agreement" and to simultaneously respond to changes affecting their security of tenure.

1.2 Complex Lease Negotiations

The retail property sector has developed over the centuries into one of the biggest industries globally. McAllister's is of the opinion that there has been a major shift in lease agreement structures within the property market in the 1990's which has lead to an increase diversity of investment characteristics as a result of commercial property investment assets.

South Africa has seen the retail commercial property industry growth that has led to large property funds being listed on the JSE as Property Loan Stocks or Property Unit Trusts. The growth and diversity that the property industry has experienced has led to the lease agreement playing a more important role compared to a few decades ago.

The importance of the lease agreement is shown by the Literature available , studies done and models created in order to calculate the value of clauses entailed in a lease agreement into a monetary value.

It is common practice that the landlord provides the so called "standard lease agreement", however, more tenants are seen to have a "standard agreement" in attempt to mitigate risk created by the landlords "standard lease".

It is difficult for both landlords and tenants to negotiate a package of lease terms unless all can be reduced to a common unit. Business negotiations are more effective when each issue can be expressed as a monetary equivalent because this encourages the parties to trade concessions to reach mutually beneficial agreements (Rowland, 1999).

Negotiation of lease agreements is no longer focused only on the rent but the clauses entailed within the lease agreement, as tenants and landlords take into consideration the changing economic environment they operate in. Changes to lease clauses influences the rent value because they shift opportunities, responsibilities and risks between the two parties (Rowland, 2000).

In an attempt to respond to the changes in the economic environment and the property industry, the players in the industry have complicated the lease negotiations further. Hybrid lease agreements are as a result of the tenant's and the landlord's attempt to incorporate the elements of their "standard lease agreements". This creates a more complex negotiation as the two lease agreements are merged into one.

The function of Property Management Companies acting on behalf of the landlords and Property Leasing Departments is to lease premises and conclude the lease agreements, while addressing any leasing complexities on behalf of the parties. Some Property Management Companies have their own "standard lease agreements" complicating lease negotiations even further as three standard lease agreements are merged into one.

The type of lease agreements is another factor that will be discussed in this report and the role it plays in complicating negotiations. The term 'standard lease agreement' is used very liberally as the type of lease agreement signed varies depending on the type of tenant, the premises and the negotiating power of either party.

Etter and Figueroa (1995) however, believe there is no such thing as a standard lease agreement. Their view is that negotiation between the parties always results in addition or subtraction of wording from the standard contract. They highlight the fact that lease agreement terms of commercial property lease agreements may vary significantly even from among tenants in the same building

There are several types of lease agreements. A gross or net lease agreement can be a percentage lease agreement (Galaty, Allaway, Kyle, 2006). Risk averse tenants will prefer percentage lease agreements while risk neutral tenants will generally prefer fixed lease agreements (Chun, Eppli and Shilling, 2003).

The purpose of this research is to highlight what has caused negotiating lease agreements to be complex and how the increased complexity has affected the turn around time of concluding the lease agreement.

1.3 The Research Purpose

This research seeks to identify the factors affecting the turnaround time of concluding a lease agreement so that the risk of occupancy without a lease agreement is eliminated.

1.3.1 Purpose of the Research

Despite the importance of lease agreements, these contracts have remained relatively understudied (Stanton and Wallace, 2009). The cash flow contained in the lease agreement plays an important role in the share price of listed companies, for property valuations and as security for financing. Besides the many theoretical advances in lease pricing (valuation of lease clauses) not much has been done with regard to the lease negotiations.

There are several factors that have been seen to influence lease negotiations over the years. The many different standard lease agreements as a result of risk

aversion by tenants and landlords and other factors for example interest rates, inflation, legislation and other government regulations.

This research report seeks to determine if;

- the creation of “a standard lease agreement “and if dedicated Property Leasing companies and Leasing Divisions address the issue of occupation of premises before the lease agreement is concluded.
- Finalization of new lease agreements occurs prior to expiry of the existing lease agreement expires.
- the above actions being undertaken have affected the turn around time of concluding a lease agreement .

1.3.2 Importance of the Lease Agreement

Lease agreements are among the most important financing sources of corporation (Stanton and Wallace, 2009). Not only has the cash flow contained in a lease agreement become crucial to the commercial property industry as security when borrowing finance but, changes to lease agreement clauses influences the rent value because they shift opportunities, responsibilities and risks between the two parties (Rowland, 2000).

Lending Institutions scrutinize lease agreements for any onerous clauses that may affect the Cash flow document in the lease agreement. Clauses like break clauses would mean the investor can lose part of the income projected in the lease agreement should the tenants elect to use this clause and terminate the contract prematurely before its expiry date.

Lease agreements are used to calculate the value of properties. The value of any property primarily depends on the lease agreements cash flow. Should for example the annual escalation clause in the lease agreement be very low, it would mean that low rent income would be achieved over the period of the lease agreement.

From a tenant's perspective, the lease agreement gives the tenants security of tenure. It assists in forecasting the tenants' costs with regard to the rent costs. Most national tenants have rent costs as their second largest expense after salaries. The rent payments made by corporations are substantial even when compared with interest expense incurred in all forms of debt (Grenadier, 1995). Again like the investor, there may be clauses that could threaten the tenants' security of tenure or lead to inaccurate forecasting of the rent cost of the leased premises in the future.

1.4 The Problem Definition

The research problem is “why slow turnaround time of Lease negotiations can result in occupation of leased premises without a signed lease agreement in place ”

The Sub Problem

- Identify how standard lease agreements lead to the complexity of lease negotiations
- Establish clauses that are contention points in the different “standard lease agreements” to landlords and tenants.
- Determine how the prevailing conditions within the property market affect the turnaround time of lease negotiations

“That the differences contained in the “standard lease agreements “of the Landlord, Tenants and Managing Agent influence the complexity of lease negotiations and in turn the turnaround time to conclude negotiations.

The research methodology used in this report is the qualitative research method. This type of methodology is deemed appropriate as it is a descriptive method commonly used in management and commercial fields.

The type of study undertaken was that of observation as the report attempts to explain how things have come to be the way they are. Data was collected using of survey questionnaires and semi structured interviews.

1.5 The Scope of Study

This research will be limited to commercial retail property within Gauteng. The focus is on national tenants and Property Listed Funds as the landlords. The research focuses primarily on national tenants and listed fund Landlords.

1.6 Structure of Research Report

This report will commence with Literature review on preference of standard lease agreements, lease pricing (valuation of lease clauses) and effects of market conditions, in Chapter Two. The research methodology, research design and data collection and analysis used will be discussed in Chapter Three, and the results of the research undertaken and support for the research propositions highlighted in Chapter Four. Chapter Five will present the discussion of collated data, recommendations and conclusion.

1.7 Conclusion

The effects of having no lease agreement in place as a result of complex lease negotiations are; risk of security of tenure, uncertainty of financing real estate projects and the uncertainty of the cash flow of a property portfolio.

These are problems that the industry faces when tenants occupy premises without a lease agreement. Both tenants and landlords are exposed to some level of risk as a result of slower turnaround time to conclude lease agreements.

CHAPTER 2

LITERATURE REVIEW

This is a review of the literature relating to lease agreements, lease clauses and various factors affecting the property market. It begins with an introduction that set the tone of what will be discussed in the chapter. It covers the literature review on preference of the different lease agreements, the pricing of lease clauses and the property market and its fundamentals. The objective of this chapter is to identify relevant information and outline existing knowledge on lease agreements, producing a composite of what has been learned of previous reviews. A gap has been identified hence the purpose of this research.

2.1 Introduction

Standard lease agreements have become common in the Property Industry. Etter and Figueroa (1995) however, believe there is no such thing as a standard lease agreement. Their view is that negotiation between the parties always results in addition or subtraction of wording from the standard contract. They highlight the fact that lease agreement terms of commercial property lease agreements may vary significantly even from among tenants in the same building.

Grenadier (2005) suggests that standard lease agreements come in almost endless varieties and Galaty, Allaway and Kyle, (2006) support this stating that a gross or net lease agreement can be a percentage lease agreement. As tenants and landlords attempt to mitigate the risks created by a lease agreement, variation of occurs.

Research on risk preferences proposes that the popularity of a percentage lease agreement is linked directly to risk sharing preferences. Risk averse tenants will prefer percentage lease agreements while risk neutral tenants will generally prefer fixed lease agreements (Chun, Eppli and Shilling, 2003).

Lease negotiations become complex when offer and acceptance is based on agreement of the five essentials of a lease agreement; the parties to the agreement, the property, the price- rent, the period and the parties' intentions and no other terms and conditions are negotiated.

Rowland (1999) is of the same view that on many occasions lease negotiations appear to be carried out in two stages, with fixed rent before any other terms are considered. Negotiations dominated by one point of contention are more prone to breaking down than those in which a range of issues are brought to the table.

The other terms and conditions are just as important as the rent and escalation and affect the value of the lease agreement in the long run. Rowland, (2000) correctly stated that changes to lease clauses influences the rent value because they shift opportunities, responsibilities and risks between the two parties.

There has been growing interest in researching ways to measure in monetary value some of the lease clauses entailed in the lease agreement. Rowland (1999) believes that it is difficult for either landlords or tenants to negotiate a package of lease terms unless all can be reduced to a common unit. Business negotiations are more effective when each issue can be expressed as a monetary equivalent because this encourages the parties to trade concessions to reach mutually beneficial agreements.

McAllister (2001) is concerned about the diversity of the lease structures and how this poses as a limitation to valuation of lease clauses. He is of the opinion that when in the 1990s the commercial property market saw a largely led acceleration in the evolution of leasing and occupational practices with proliferation of serviced offices, short lease agreements and break clauses. Given that the main valuation

models rely upon transaction evidence involving comparable properties, the increasing diversity of lease structures exacerbates the methodological limitations of such models.

Hamilton, Lim and Mc Cluskey (2005) see the effects of the changing market environment as influencing negotiations and they argue that the changing lease structure is due to pressure from tenants who had to trade and make profits in capricious and rapidly changing markets under adverse economic conditions.

As a consequence, landlords resort to a number of tactics to persuade tenants to take premises. Shorter lease agreements, break clauses, capital payments, rent free periods and other inducements to let, were identified as being common practice.

Lease structures are changing as lease negotiations occur in continually changing property environments. Negotiations are complicated by; the almost endless variety of lease agreements that come about in attempt to mitigate risk, by the ever-changing lease clauses proven difficult to measure in monetary value and finally the effects of the economic environment.

2.2 Preference of the type of “Standard lease agreement”

There are several views regarding what influences the type of lease agreement used in a lease negotiation. These are same factors that influence the turn around time of concluding the lease agreement.

The first factor which supports the findings in this report is risk. It was not common practice for tenants to have their own standard lease agreements. This has come about as they attempt to mitigate risk for example financial risk, where they are tied in a lease agreement but are making a loss. Tenants have created clauses within their standard lease agreements that address the risks that may be created by a lease agreement.

Chun, Eppli and Shilling (2003) focus on a percentage lease agreement and why it is preferred in the retail sector. They examine the proposition that the choice of retail lease agreements is driven by need to avoid cost debt covenant restrictions. Their findings show that retail tenants with a high debt asset ratio prefer a retail lease agreement.

They are of the view that risk averse tenants will generally prefer percentage lease agreements while risk neutral tenants will generally prefer fixed lease agreements. The former occurs because a risk averse lessee prefers a certain income to a risky income and the latter occurs because the risk neutral lessee is indifferent to certain or uncertain income and hence willing to absorb the entire risk or uncertainty with respect to retail sales demand.

This model is based on the assumption that there are two types of tenants and one type of Landlord, risk averse tenants, risk neutral tenants and a risk averse landlord. It proposes that a percentage lease agreement results in higher reported equity therefore tenants with a high debt to asset ratio will select this type of lease agreement. The findings suggest that the percentage lease agreement is preferred over the gross lease agreement because gross lease agreements increase the probability of negative income beyond the point that the tenants is willing to tolerate, especially where net income is extremely volatile

A survey conducted by Rowland (1996) in Perth via mailed questionnaires to industrial tenants had the following results;

- of 75 Tenants, 47 strongly agree that it is simpler to pay gross rent and 53 percent agree that it is not fair for tenants to pay running costs of a property for the benefit of their landlord
- 57 percent dislike the idea of paying running costs and 48 percent are inclined to believe landlords overstate the running costs.
- only 59 respondents paying net rents stated they would be willing to pay more gross rent than net rent and operating costs.

Rowland's survey results show that both the tenants and landlords do not want the risk of under-recovery of maintenance costs of the property.

The different lease agreements benefit the parties differently. A lease agreement that benefits the landlord would be onerous or have high risk implications for the tenants.

Rowland (1996) explains further the differences in the lease agreements and who is responsible for maintenance costs in the different lease agreements. Under the terms of a gross lease agreement, the tenants' pays one amount to occupy the premises and the landlord runs the property. Under the terms of a net lease agreement, either the tenants runs the leased property (arranging for repairs, insuring, negotiating property tax assessments and making sure that the building functions adequately) or the tenants reimburses the landlord for the costs of running the property by way of service charge.

Rowland (1996) expands on his argument by elaborating are what running costs. He expands on his argument by incorporating running costs, which in his view include maintenance, insurance, property taxes and for multi tenanted properties, the provision of shared building services such as heating, air-conditioning, cleaning and management of communal areas. The lease agreement covenants will reveal whether these responsibilities are borne by the landlord or tenants or are shared between them. The rent will presumably reflect the responsibilities of the parties, as well as attributes of the property itself

The initial theoretical model of Mooradian and Yang (2000) suggests that landlords use cancellation and downsizing clauses as a screening device to separate high space-reduction-risk tenants from low-space-reduction-risk tenants. Lease agreements with a downsizing clause are priced higher than other lease agreements, making them attractive only to high-space reduction-risk tenants.

In support of Rowland's view, Mooradian and Yang (2002) argue that given asymmetric information with respect to expected tenant utilization and/or damage of the leased space, the landlord will offer both a gross and net lease agreement, where the higher expected utilisation tenants select a gross lease agreement and the lower expected utilization tenants select a net lease agreement.

Their model is based on the assumption that tenants whose running costs are expected to be lower will prefer a net lease agreement while tenants whose running costs are expected to be high will choose a gross lease agreement passing the risk of under recovery to the landlord.

Mooradian and Yang (2002) believe that in a monopolistic market relative to a competitive market a landlord charges higher rent for a gross lease agreement relative to a net lease agreement in order to extract a portion of operating costs from shifting services to the landlord. They emphasize the importance of the type of market on lease agreement preference.

Their model looks at what determines the landlord and tenant choice between a gross and net lease agreement. Mooradian and Yang (2002) have applied their model in both monopolistic and competitive markets centered around the tenant's potential usage of the property (tenant private information). Their model highlights the preference of tenants is influenced by risk relating to high cost of utilization of premises (running costs).

Gherzi (1996) has a slightly different theory but the end result remains that of being risk averse. His theory is that a triple net lease agreement would be beneficial to the landlord assuming inflation rate for expenses is above fixed escalation. He highlights advantages of a triple net lease agreement to the landlord as being;

- passing on inflation risk to tenants by indexing part of the rent to inflation
- income benefits, should operating costs inflation rates be higher than the rent escalation rate.

Different theories and models discussed all come to the same conclusion. Lease preference is driven by risk associated with the responsibilities created by the lease agreement.

The second factor identified in the literature review as affecting preference of lease agreement is made up of several interconnected factors. The type of tenants, the nature of the business and the level of influence play a role in influencing the type of lease agreements selected.

Mooradian and Yang (2002) acknowledge that there are other factors at play that affect the selection of which type of lease agreement to use. These are the parties, the property and the nature of the business.

Rowland (1996) in his research in Perth regarding the preference of different lease types, it was found that;

- 82 percent of the agents and landlords advertising commercial space were offering net rent lease agreements.
- of the 82 percent, 24 percent would not consider gross lease agreements.

The following reasons were found for such attitudes;

- the type of property being leased. Owners of retail properties were less inclined to offer gross lease agreements as industrial and office property owners.
- the size of the premises, larger premises would less likely be leased with a gross lease agreement
- landlords advertising their own properties were more inclined to accept gross lease agreements than those represented by real estate agents.

Chun, Eppli and Shilling (2003) supported this view as they raised several arguments including;

- That tenants with brand drawing power pay less base rent and a lower percentage of their sales owing to the customer traffic they are able to generate for other tenants in the center.
- Retail tenants prefer percentage lease agreements over gross lease agreements because the former is expensed when incurred and the latter capitalized.

National tenants have specific space requirements as a result of the nature of their business. Their brand drawing power will allow them more of their standard lease agreement in the lease negotiations.

Etter and Figueroa (1995) acknowledge that negotiations differ depending on the type of tenants. Their view is corporate tenants will negotiate a lease agreement that would differ to that of a non corporate tenants in the same building

Every lease agreement has its advantages and disadvantages. The disadvantages are the risks entailed in that type of lease agreement. Most negotiations occur in attempt to rid the disadvantages or reduce them. For the most part the parties attempt to shift the risk to the other party, complicating lease negotiations.

Bierschenk, Bierschenk, and Bierschenk, (1999) are of the opinion that a triple net lease agreement can be one of the most challenging types of real estate investments to structure. They are of the view that the net lease agreement may seem advantageous with regard to reduced management of the property by the landlord but inflation traps and tax burdens are apparent disadvantages.

A comparison between a percentage lease agreements (turnover lease agreement) and a rent review lease agreement (upward only lease agreement) is provided by Hendershott (2002). His view is that the percentage lease agreement is a better lease agreement because the landlord can receive turnover rent over and above the basic rent in year one instead of waiting till year five as with a rent

review lease agreement and it provides valuable information on the performance of the individual tenants.

The view of Gherzi (1986) supports the fact that the parties attempt to pass the risk created by the lease agreement to the other party. He argues that tenants will always compare gross rents to net rent plus expected recoveries for the first year, therefore eliminating any benefit the landlord may have recovered from a gross lease agreement.

Risk aversion remains the dominant factor affecting the preference of a lease agreement and is the reason national tenants have created their own standard lease agreements, complicating negotiations.

2.3 Pricing of Lease clauses

The need to value lease clauses in monetary terms has come about as the parties to the agreement attempt to pass on the risk created by lease agreements to each other. Lease negotiations become complex when clauses entailed in the lease agreements cannot be measured in monetary terms.

Rowland (1996) is of the view that valuers must consider the responsibilities created by a lease agreement covenants in assessing rents. The valuer or appraiser often cannot avoid adjusting the rent to reflect variations in responsibility of the landlord and Tenants.

The belief that lease agreements are one of the most important sources of financing has led Grenadier (1995) to his study of valuing lease agreement contracts using a real options approach to derive the entire structure of lease agreement rates by developing a unified framework for pricing lease agreement. The model is applied to real world leasing contracts.

Lizieri, et. al. (1997) believe one reason why lease negotiations are restricted often to discussions of rent is that there are no established methods of converting the other lease covenants to rent equivalent.

The problem with this is it increases the turn around time of lease negotiations as it takes longer to come up with some sort of value on specific clauses entailed in the lease agreement.

Rowland (1999) supports this view and is of the opinion that negotiation of lease agreements is reduced sometimes to agreeing the rent based on the assumption that all other terms of the lease agreement are immutable.

However, he does agree that it is difficult for either landlords or tenants to negotiate a package of lease terms unless all can be reduced to a common unit. "Business negotiations are more effective when each issue can be expressed as a monetary equivalent because this encourages the parties to trade concessions to reach mutually beneficial agreements."

Rowland (1999) reviews the research into ways in which the lease agreement covenants alter rents. He presents the initial prototype computer based operational routine to help landlords, tenants and other property practitioners assess the impact of changing lease terms on acceptable rent terms.

The model was tested using some of Rowland's colleagues who negotiate lease agreements as or on behalf of tenants. The respondents were of the view that this model was too complicated.

Rowland (2000) further demonstrates an operational model that reduces changes in lease clauses to their rent equivalent. He correctly highlights that changes to lease clauses influence rent value because they shift opportunities, responsibilities and risk between the two parties. The covenants that have received the most

attention are options to renew, break clauses, rent reviews, leasing incentives and liability for property responsibilities and expenses.

These clauses are generally seen as contention points because their inclusion in a lease agreement may mitigate risk for the one party but will simultaneously create risk for the other party.

Mooradian and Yang (2000) acknowledge that new clauses have added to the complexity of lease agreement and their view is lease downsizing has become more complex than the conventional cancellation of the entire leased space. Many firms seek to reduce the amount of leased space rather than cancel the entire leased space. Accordingly, with increasing frequency corporate lease agreements contain clauses permitting down-sizing, for example lease agreements include the option for the tenants to cancel a portion of the leased premises.

Rowland (2000) undertook two methods in this study of pricing lease clauses, a desktop statistical analysis from Gazette Interactive Database of transactions and a survey questionnaire analysis of office occupiers in Belfast.

The statistical analysis conducted reveals the following;

- a large number of modern lease agreements contain break clauses with incentives, combined with shorter lease agreements indicating the dominance of the Tenants bargaining position.
- Tenants want flexibility and long net lease agreements with upward rent review seemed a thing of the past.

The questionnaire analysis conducted revealed the following;

- Belfast office tenants had concerns relating to upward only rent reviews to market value, length of lease agreement and lack of break clauses and onerous repairing and insuring obligations.

On the basis of his research findings, Rowland (2000) indicates that tenant's desire for shorter more flexible lease terms, rent reviews on market value basis, an increase in break clause provision and greater flexibility in relation to repair and insurance clauses.

Rowland's research findings suggest that the clauses favoured by the tenants are beneficial to the tenants and would be included in a lease agreement if its market conditions favoured the tenants or the tenants had bargaining power. This stresses the differences in focus when negotiating a lease agreement between a tenants and landlord, explaining why negotiations become complex.

Rowland's findings supports Albert and Buetow (1998) suggestion that lease agreement options would be of value to the tenants while being a cost on the landlord. Their view is that lease agreement options have not been clearly priced as they have value which is reflected in the rent stream

Their study analyses the appropriate partial differentiation equations which model the situation where the tenant has an option to purchase or renew at a price indexed to the consumer price index or some other measurable variable. This study examines different options common in commercial lease agreements and develops models to price the options.

Albert and Buetow (1998) believe given the extent to which options components are negotiated into lease agreements, that both property/ asset managers as well as tenants would have substantial interest in formal and quantitative method of incorporating the option value into income stream. The ability to explicitly identify the value of embedded options would make the negotiation of their inclusion a more straightforward and exact process.

This would shorten the turn around time of lease negotiations, reducing the risk of occupancy of premises without a lease agreement. Both parties are exposed to

some level of risk when premises are occupied and the lease agreement is not concluded.

The incidence and nature of break clauses in the lease agreement is examined by McAllister (1999) as he analyses their pricing implications. He looks at the key factors influencing these variables and presents a framework incorporating their effects to conventional models.

McAllister's view is that there has been a major shift in lease structures within the property market in the 1990's which has led to an increase in diversity of investment characteristics as a result of commercial property investment assets.

We support this view that lease agreements continue to change with the economic environment. McAllister (1999) further explains that essentially there are three types of break clauses; landlord only, tenants only or mutual. In most cases the break clause will be tenants only. For the landlord the existence of a break clause in a lease agreement will only be financially beneficial when the benefits of the tenant's vacation exceed cost.

McAllister (2001) examines the changes in the length of the commercial property lease agreements over the last decade, presenting an analysis of the consequent investment and occupational pricing implications of commercial property investment. He identifies the eleven factors with a high probability of influencing these variables and presents a model that incorporates these effects into the pricing model. Some of those factors identified include length of notice period, amount of financial penalty, expected cost of dilapidations, estimated fit out cost, and expected availability of alternative premises

Introduction of break clauses and short lease agreements has altered the distribution of risks and rewards between landlords and tenants. Moreover it is apparent that diversity in lease structures exacerbates the existing drawback of conventional appraisal (McAllister, 2001). This is not the only thing exacerbated by the diversity in lease structure, the complexity of negotiations is affected too.

Grenadier (2005) focused on the economic aspect of leasing and the economic benefits accruing to the user of an asset as his concern. His view is commercial real estate, which includes office and retail properties, represents a significant fraction of the analysed investment universe and the ultimate value of the commercial real estate emanates from its rent flow, which reflects the price of the market is willing to pay for space.

Grenadier (2005) uses the game theoretic variant of real options analysis to value commercial real estate lease agreements. His model provides equilibrium values for purchase options, forward lease agreements, gross and net lease agreements, cancellation clauses, ground lease agreements, escalation clauses and lease agreement concessions. While he acknowledges the complexity of lease agreements and that lease agreements come in almost endless varieties he remains of the view that lease clauses can be reduced to numbers.

Despite Grenadiers optimism with regard to reducing lease clauses to numbers, the Property industry remains to be educated on this and the models available wait to be refined. Inability to measure lease clauses in monetary terms creates complex negotiations but it is the complexity of the lease agreements that makes the measurement of such clauses difficult.

Despite the importance of these markets to the U.S economy, lease agreements have remained relatively understudied (Stanton and Wallace, 2009). The importance of the property markets is echoed again by Stanton and Wallace (2009). They acknowledge the vast theoretical lease agreement pricing models in existence but argue that there has been little systematic attempt to estimate such models. They propose a lease agreement pricing model that utilizes a large data set of lease agreements on several property types.

Stanton and Wallace (2009) argue that though lease agreements are similar to bonds they have not received as much attention due to lack of available data. They indicated that all that is observed are the terms of the lease agreement and the fact that both landlord and tenants were willing to sign the contract on a particular date. Their observation emphasizes the importance of negotiating all clauses upfront and not only rent.

Their model allows one to estimate unobservable parameters such as market price for lease agreement risk. The new measure proposed by Stanton R and Wallace N (2009), Option Adjusted Lease Spread allows lease agreements with different maturities and contract terms to be compared on a consistent basis.

Lease agreements are negotiated every day with clauses such as break clauses and option to renew clauses but there is little or no knowledge as to the value of these clauses in the lease agreements they are contained. Hence, these lease agreements clauses become a point of contention during lease negotiations. Pricing of lease clauses would reduce the complexity of negotiation and turnaround time of concluding negotiations.

2.4 Effects of Property Market Conditions on Negotiations

i. The Property Market

The property market conditions cannot be ignored. Lease negotiations are done within the confines of the prevailing market conditions. These conditions influence negotiations both directly and indirectly. The conditions are the property market, inflation and interest rates, legislation and government policy and real estate cycles

McAlister (1999) argues that it is recessionary conditions of the early 1990's that have lead to tenants being empowered by such market conditions and thus seeking lower risk, shorter lease agreements, renewal options and break clauses. Despite this argument he does highlight the fact that break clauses have continued to be included in lease agreements even after market conditions had improved.

Largely market led change has resulted in a significant reduction in effective length of lease agreements as tenants have used the preceding oversupply in the market to negotiate shorter lease terms and break clauses (McAlister, 1999). The effect of market changes in lease negotiations is seen as lease clauses change.

The property market is defined as a mechanism through which goods and services are voluntarily exchanged among different owners (Ball, Lizieri and MacGregor, 1998) and it comprises of two major markets; space market and asset market

In support of this view Geltner and Miller (2001) define the space market as a market for usage of real property with two segments, the user market and the land market.

- The user market is demand and supply for space and the interaction of the demand and supply curves gives the market rent.
- The land market is the supply of vacant land.

Ball, Lizieri and MacGregor (1998) further identify the price for vacant land as being determined by the existing stock of land used for commercial purpose.

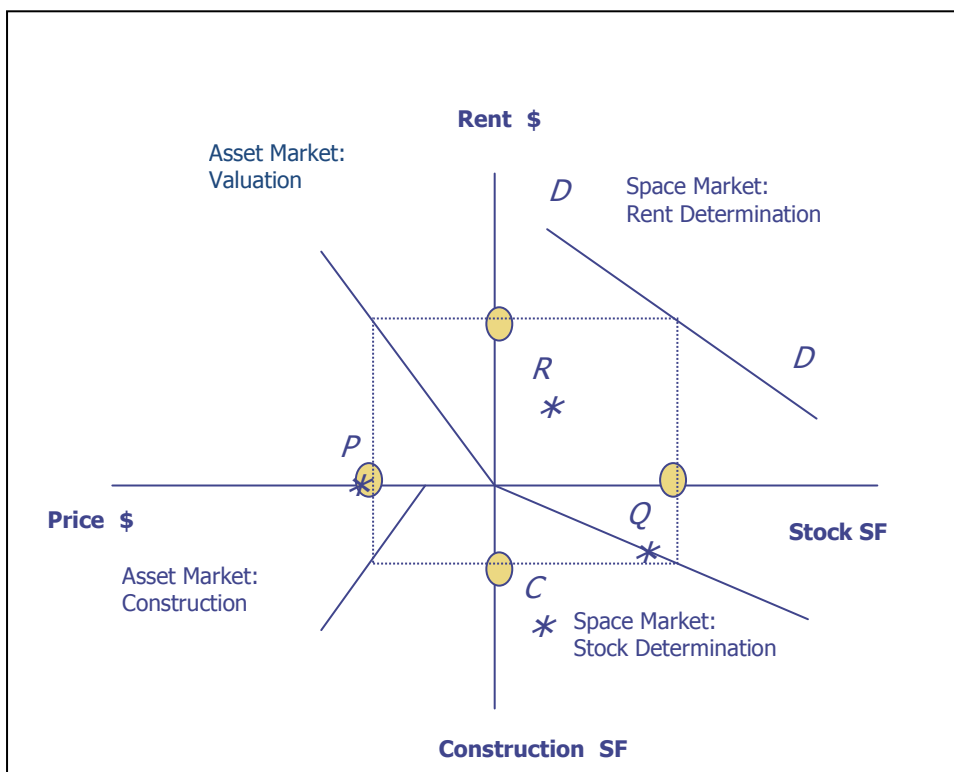
Geltner and Miller (2001) identify the asset market comprising of two segments; capital market and construction market

- The capital market is the value of buildings at a given rent
- The development market is the rate of construction at a given property value and supply of land

Analysis of the property market is believed by Geltner and Miller (2001) to assist with different real estate decisions. They utilize the four quadrant model depicted in Figure 2.3 below to analyse the property cycle more specifically the boom and bust periods.

The four quadrant model is a graphical representation of real estate system. It depicts four binary relationships that together complete the linkages between space and asset markets. It is most useful as it looks at the long run equilibrium simultaneously both within the space and asset markets (Geltner and Miller, 2001). This model allows one to understand how changes in one part of the property market affects the rent market and in turn lease negotiations.

FIGURE 2.1 FOUR QUADRANT MODEL



Geltner D.M and Miller N.G (2001) " Commercial Real Estate Analysis and Investments"

Mooradian and Yang (2002) in their model discussed earlier in this chapter have identified several factors that affect the type of lease agreement negotiated including the type of Property market .The effects of changes in the property market are illustrated in by Mc Allister (2001) in his study of pricing short lease agreements and break clauses. He has observed how the recessionary conditions

of the early 1990 saw a change in the leasing practices, a market environment that empowered tenants.

As the market environment changed with it the negotiations as clauses that address tenants' risks are included into the lease.

The study undertaken by Viezer (2001) presents a model that integrates the two markets. This model is referred to as the Real Estate Econometric Model and it integrates the two markets econometrically. He does acknowledge as a result of his findings that interest rates and investment are difficult variables to model.

The theory by Gibson and Lizieri (2009) suggests that business reorganization and new working practices are transforming the nature of demand for business space. Downsizing, de-layering, business process reengineering and associated initiatives alter the amount, type and location of space required.

They are of the opinion there are implications for the contractual arrangements and believe a number of interrelated trends have combined to alter the nature of business activity.

They are of the opinion that these forces change the way that business activity is carried out and must, in turn, have an impact on the demand for business space and the contractual agreement. They demonstrate in their study that, although new working practices are widespread, the current impact on the corporate property portfolio is muted.

Their study was focused on the UK market and the results showed increasing evidence that change is occurring, which may have a profound impact on the market structure.

Gibson and Lizieri (2009) view that change in business activity has a muted effect on property supports Englund , Gunnelin , Hendershott and Soderberg (2008) thinking. They suggest that markets for property space adjust only gradually because tenants and landlords are constrained by long-term lease agreements and transaction and information costs.

Not only do rents adjust slowly, but space occupancy, which depends on historical rents, often differs from demand at current rent. This creates “hidden vacancies,” vacancies that will develop in the future if market rent and the space demand drivers are unchanged.

Englund, Gunnelin , Hendershott and Soderberg, (2008) acknowledge the complexity of property markets and lease negotiations. Lease agreements are typically for multiple periods, and costs are too high for tenants to adjust their space consumption continuously. As a result, vacancies are a central feature of property markets.

ii. Inflation and Interest Rates

Geltner and Miller (2001) discuss the effects of inflation on the property market. They highlight the fact that higher inflation is associated with economic booms and lower inflation with recession. Their study focuses on the effects of higher inflation in a recession, stagflation and how it affects demand and supply for commercial property space.

Complex negotiations are as a result of the ever-changing market conditions. The turn around time of negotiating a lease agreement increases as the parties attempt to address the changes in market conditions.

Ball, Lizieri and MacGregor (1998) argue that the impact of monetary policy on the property sector has changed over the last decades as interest rates may consequently have weakened over time. Their view is that in a situation where the

Central Banks policy of increasing interest rates to curb inflation is perceived by the property markets as short term, such action will not affect the markets.

Should the property markets perceive the short term rise to indicate further increases in rates, then the players in the market will tread cautiously reducing the effect of such on the property market equilibrium.

Perception of the effects of interest rates and inflation on the market lead to changes in the market. This illustrates how volatile the markets are; hence the continuous changing environment. Lease negotiations are complicated by the volatility of the markets.

iii. Legislation and Government Policy

Ball (2006) looks at government intervention and the positive effect it has on the property market, where it redirects development for example provision of infrastructure such as roads and rail networks.

The analysis of the property market in Europe and North America conducted by Ball , Lizieri and MacGregor (1998) draws attention to the fact that that demand and institutional development of new buildings are highly sensitive to short term output changes. This though irrational does occur. The building industries response to such changes is usually noted months after the change and this can cause an oversupply or shortage of property in the market.

Government intervention in the construction sector may result in negatively affecting the market because of the time lag experienced in the building environment.

Viezer (2001) underlines the effects of time lag on the property market. This suggests that the past academics and investment managers have had difficulty linking information from the markets for leasable space and the asset ownership claims. The Former is often referred to as space market and the latter as capital

market. His opinion is that in the capital market, institutional development drove the price of real estate assets higher than their replacement cost.

Developers responded but ignored the slower demand for real estate space, leading to a rapidly overbuilt space market.

iv. Real estate cycles

Pyhrr, Roulac and Born (2007) suggest that real estate cycles have been a significant underlying reason for the financial successes and failures of real estate investments throughout history. Understanding the micro and macro relationship is believed to be a good foundation of for understanding real property performance in a specific market.

They argue that real estate cycles are a major determinant of success or failure because of their pervasive and dynamic impacts on real estate returns, risks and investment values over time that should not be ignored or over simplified. They highlight the importance of the real estate cycle to property practitioners in their strategic decision making processes.

The purpose of the study done by Pyhrr, Roulac and Born (2007) is to create relevant research and commentary on real estate cycles in a micro decision making context. Their belief is that understanding complex macro to micro relationships is the foundation for understanding real estate property performance in a specific market.

Understanding real estate cycles, property markets and their fundamentals may assist the parties in understanding the conditions of the market environment they trade in. Complex lease negotiations would be rare and occupation of premises without a lease agreement would be reduced.

2.5 Conclusion

Lease structures are changing as lease negotiations occur in continually changing property environments. Negotiations are complicated by;

- the almost endless variety of lease agreements that come about in attempt to mitigate risk
- by the ever-changing lease clauses proven difficult to measure in monetary value
- the effects of the economic environment.

Risk aversion remains the dominant factor affecting the preference of a lease agreement and is the reason national tenants have created their own standard lease agreements, complicating negotiations.

Lease agreements negotiated with clauses such as break clauses and option to renew clauses which cannot be reduced to monetary value become a point of contention during lease negotiations.

Real estate cycles, property markets and their fundamentals affect lease negotiations as a result of the ever changing environment. Understanding the market conditions lease agreements are negotiated in is pertinent to the turn around time of lease negotiations.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 Introduction

Research can be defined as a process of finding out new data based on facts collected in ways to minimize observer prejudice. There is a general consensus that research methodology is a systematic and methodical process of enquiry and investigation that increases knowledge (Boorsma, 2007).

Most of the research available on commercial lease agreements focuses mostly on pricing of the lease clauses. However, not much research has been done on factors affecting negotiation of lease agreements. Therefore, for this reason this research topic requires better understanding and the qualitative research method will be applied.

3.2 Research Paradigm

This report investigates factors affecting the turn around time of finalizing a lease agreement. The proposed research paradigm for this report is a qualitative. Qualitative research methodology is seen to be subjective, holistic descriptive, naturalistic and inductive while quantitative research methodology is seen as objective, scientific, experimental and deductive (Hancock, 2002).

Qualitative research is a descriptive method focusing on interpretation common in management or commercial fields.

There are several different qualitative research methods defined by Hancock (2002) as namely;

- Phenomenology begins with the acknowledgement that there is a gap in our understanding and that clarification or illumination will be of benefit

- ethnography is a methodology for descriptive studies of cultures and peoples
- grounded theory is the development of new theory through the collection and analysis of data about a phenomenon.
- case study is used to describe an entity that forms a single unit such as a person, an organisation or an institution
- Narrative research is where one or more individuals provide stories about their lives (Creswell, 2009).

Quantitative research focuses on cause and effect, using experiments to prove or disprove such the hypothesis. Hence this methodology is commonly used in Science research. Two different quantitative research methods identified by Creswell (2009) are;

- Survey research which provides a description of trends, attitudes or opinions of a population by studying a sample of that population including the use of questionnaires and or structured interviews.
- Experimental research which seeks to determine if a specific treatment influences an out come.

Punch (2000) is of the opinion that there is no major difference between qualitative and quantitative research methods except their applications. This view is supported by Hancock, Ockleford and Windridge (2007) who believe that the differences between the two methods have been often exaggerated in the past. They define these two research methods as follows;

Quantitative research method is a method used when quantifying how often something happens. Researchers working in the Sciences use this method.

Qualitative research method is a method used when one is attempting to explain how things came to be the way they are.

The Triangulation (Mixed) Research approach uses a combination of qualitative and quantitative methods. It has vital strengths, encourages productive research, enhances qualitative methods and allows complementary use of quantitative methods (Jick, 2009).

Three methods of mixed research methodology with several variations are defined by Creswell (2009) as namely;

- Sequential mixed methods – This may begin with qualitative interview for exploratory purposes and following up with a quantitative survey method or vice versa.
- Concurrent mixed methods – qualitative and quantitative data is merged for a comprehensive analysis of the data
- Transformative mixed methods – This is where within the selected research method is a data collection method involving sequential or concurrent approach.

The type of research undertaken in this report is exploratory research. This type of research asks both “what” and “why” questions (Wisker, 2001). The research problem is “ why lease negotiations have become complex leading to a slower turnaround time of finalizing the lease ”. To address this question requires the identification of factors that cause lease negotiations to be prolonged.

Firstly the identification of factors influencing lease negotiations would require a qualitative approach. This approach using survey research would assist in identifying the factors that influence a lease contract. This method allows one to

study the opinions of the property market population using questionnaires on a sample of that population.

Semi structured interviews; a qualitative approach has also been used because of its exploratory nature (Creswell, 2009). Exploring peoples' experiences and views with regard to the lease agreement is pertinent to the research.

Hussey and Hussey (1997) are of the opinion that both interviews and questionnaires are associated with both positivist and phenomenological methodologies.

Combining surveys with interviews and observations known as Qualitative research and has been adopted in this report as a research method for the following reasons;

The property industry is made up of a large population. In order to collect the required information for this report a large number of people had to be approached. The use of a questionnaire was the best way of collecting information from a sample of the property industry population.

Qualitative survey methods started to gain prominence in development projects during the 1980s, primarily in response to the drawbacks of questionnaire type surveys, which were considered time-consuming, expensive, and not suitable for providing in-depth understanding of an issue (Chambers and Pretty, 1995).

Questionnaires are still used in qualitative research but Marsland , Wilson , Abeyasekera and Kleih (1998) are of the opinion that it is the drawbacks of questionnaires that have led to a polarization in collection and analysis of information with 'traditional', quantitative techniques on the one hand, and qualitative methods, on the other.

Mouton (2001) states that the strength of the qualitative paradigm is that it looks at peoples own definitions (insider perspective) hence the need to use semi structured interviews. Interviews conducted are in depth in order to derive as much information from the respondents as possible. In depth interviewing allows for the interviewer to gain a “rich picture” of what is actually happening (Fox, 2006).The essence of this technique is it allows you to capture peoples’ opinions, feelings and their experiences (Wisker, 2001).

The research method chosen here was as a result of the fact that the research to be undertaken entailed collection of data from individuals using interviews and surveys which were the best instruments. These instruments reflect the research paradigm of this report because it is peoples’ experiences, behaviors and opinions that are of importance.

3.3 Research Design

The research design is initiated by identifying the research problem. The research problem is; that *slow turnaround time of lease negotiations can result in occupation of leased premises without a signed lease.*” The “why” and “how” are raised by such a statement highlighting the fact that this research will be exploratory by nature. Creswell (2009) is of the view that research design is the plan to conduct research, involving the intersection of philosophy, strategies of inquiry and specific methods based mainly on interviews and questionnaires.

3.4 Population and Sample

The research population in this study is a pool of professionals in the property leasing industry dealing with lease negotiations on a regular basis. Purposeful sampling was utilized.

The interview candidates were selected as follows;

- from Property Listed fund companies, representatives from the two largest listed funds at the time were identified
- from the property management companies, representatives from two renowned companies, managing on behalf of Property Listed Funds
- 2 national tenants were selected, one, a renowned anchor tenant and the other, one of the big four in the Banking environment.
- The final respondent is a regional shopping centre developer who had just completed a regional shopping centre with 60% national tenants in the centre.

This selection was done to ensure a wider perspective on lease agreements from different players in the same market. The number years of leasing experience was the main selection criteria used.

Interviews Sample

Participants were selected from the property industry at large focusing mainly on the Gauteng area. The 12 candidates were identified for interviews and 7 candidates (58%) agreed to be interviewed. Purposeful sampling was used as the candidates were differentiated by the role their company plays in the property industry and more importantly their years of experience in the Property Industry.

The interview candidates comprised of senior level persons in the property field who hire or lease commercial space. This sample of interviewees included the Directors, Chief Executive Officers and Senior Portfolio Managers selected from leading property companies, property management companies and national tenants depicted as in Table 3.1 below.

TABLE 3.1 - SAMPLE OF INTERVIEW RESPONDENTS

DESCRIPTION	SECTOR	DESIGNATION
LANDLORD	LISTED FUND	SENIOR RETAIL MANAGER GROUP LEGAL ADVISOR
LANDLORD	LISTED FUND	CEO
MANAGING AGENT	PROPERTY SERVICES	SENIOR PROPERTY MANAGER
MANAGING AGENT	PROPERTY SERVICES	DIRECTOR (PROPERTY MGT)
TENANT	FINANCIAL INSTITUTION	PROVINCIAL MANAGER-LEASING
TENANT	RETAIL GROUP	SENIOR PROPERTY MANAGER/ LEGAL
PROPERTY DEVELOPER	PROPERTY SERVICES	GENERAL MANAGER

Survey questionnaire Sample

35 participants were selected from the property industry at large focusing mainly on the Gauteng area.

The survey sample was selected as follows;

- from Property Listed fund companies, representatives from 10 listed funds at the time were identified

- from the property management companies, representatives from 10 property companies, managing on behalf of Property listed funds
- 10 representatives of National tenants were selected, from the big four in the Banking environment.
- 5 representatives from Property development companies, who had completed a regional shopping centre.

The sample population was much smaller than intended. The 35 candidates were selected for survey but 15 candidates responded.

The survey candidates are a made up of professionals at all levels, from senior to junior levels in the property field who hire or lease commercial space. This sample of candidates includes the Directors, Senior Portfolio Managers, Property Managers, Leasing consultants and Leasing Administrators. Candidates were selected from leading property companies, property management companies and national tenants as depicted in *Table 3.2* below

TABLE 3.2 Survey Respondents

DESCRIPTION	COMPANY	DESIGNATION
TENANT	BANK	LEASING CONSULTANT
TENANT	BANK	LEASING ADMINISTRATOR
MANAGING AGENT	Managing listed funds	LEASING CONSULTANT
TENANT	BANK	MANAGER-LEASING
TENANT	BANK	MANAGER-CONSULTANT
MANAGING AGENT	Managing listed funds	PROPERTY MANAGER
PROPERTY DEVELOPER	Developed a regional mall	BUSINESS AND LEGAL ADVISER
LANDLORD	Listed fund	PROPERTY MANAGER
MANAGING AGENT	Managing listed funds	PORTFOLIO MANAGER
PROPERTY DEVELOPER	Developed a regional mall	LEASING ADMINISTRATOR
PROPERTY DEVELOPERS	Developed a regional mall	ASSET MANAGER
LANDLORD	Listed fund	DIRECTOR
TENANT	BANK	NATIONAL MANAGER

3.5 Data Collection and Analysis

The method of collecting data for any research will depend on the research problem and selected research method. The data collected in this study differed in terms of interviews having more open ended questions and questionnaires have more closed ended questions.

Interviews

The interview requests were done telephonically and a brief summary of the purpose of the interview being requested including the estimated duration of the interview were given. Meeting times were arranged within a space of a month with all the candidates.

Interviewing is a qualitative method and one characteristic of this type of data collection is the researcher tends to collect data in a natural setting with face to face interaction (Creswell, 2009). Interviews were all held at the candidates offices as it was most convenient for them. Holding the interviews at the candidates' premises puts them at ease as the researcher conducts the interviews. Notes were taken during the interviews, no other equipment was deployed. Mouton (2001) states that the strength of the qualitative paradigms is that it looks at peoples own definitions (insider perspective.)

Interviews were semi-structured as it allowed the researcher to cover the pertinent issue and then addressing the open ended questions. These questions allowed the candidates to express their opinions even if some of those views were not inline with their standard lease documents.

The interviews were conducted in order to understand the views of the players in the industry regarding the standard lease, what type of lease the interviewee's company used, what factors impacted on lease negotiations and which clauses they used to counteract some of these factors.

Questionnaire Surveys

The survey requests were done telephonically and a brief summary of why the survey was being undertaken was given including the estimated duration of answering the questionnaire. Questionnaires were conducted via e-mail and the questions comprise of closed and a few open ended questions. The questionnaires were structured to save time and were e-mailed to players within the industry, namely leasing administrators, property managers and brokers as they deal with lease negotiations for leases as small as that for ATM space of about 9m² to that as large as anchor tenant space of about 6000m².

The pressures of the property industry, would probably explain why almost 19 people failed to complete the questionnaire. The number of fully completed questionnaires is sufficient for this research paper bearing in mind that with quantitative research bias would be overcome by the qualitative data collected using the interview methods.

Differentiation between data analysis and data collection is not always clear depending on which method is utilized. Meyers (1997) is of the view that in quantitative research it is easier to differentiate collection of data from analysis of data than in qualitative research. Creswell (2009) identifies the mixed approach as having several data analysis approaches;

- Data transformation –qualitative data transformed to being quantifiable in order to compare it to the qualitative data.

- Exploring outliers – outlier cases resulting from analyzing quantitative data are explained by analyzing qualitative interviews
- Instrument development- obtaining themes from participants in the initial data collection phase, then utilize such statements to create a survey instrument
- Examine multiple levels – conducting a survey and gathering the quantitative results, and interview individuals from the same sample to explore the phenomenon with the specific individual.
- Create a matrix – combining information from both quantitative and qualitative data collection into a matrix.

The data analysis method used here is a form of qualitative analysis known as reflex data analysis as information was revisited to refine focus and understanding.

3.6 Conclusion

The Research methodology undertaken in this report is qualitative research methodology. Qualitative research is a descriptive method focusing on interpretation common in management or commercial fields with is suitable for this type of research. 7 interviews were conducted and 15 questionnaires were administered and received from a pool of landlords, managing agents.

CHAPTER 4

INTERVIEW AND SURVEY RESULTS

4.1 Introduction

The objective of this Chapter is to evaluate and discuss the results of the in-depth semi-structured interviews and questionnaire surveys conducted with the respondents. Representatives of some the property listed funds and some national retail tenants were interviewed. Survey questionnaires were targeted predominantly at middle management involved with concluding lease agreements on a daily basis.

The interviews and surveys were successful and the respondents were enthusiastic in their responses. The respondents felt comfortable, and were forthcoming and candid in providing information. The data drawn from the interviews and questionnaire surveys is discussed below. Comments from the transcribed interviews are used to provide additional insight into each of the factors associated with complex lease negotiations and the turnaround time of concluding the lease agreement.

To understand why lease negotiations have become complex affecting turn around time of concluding lease agreements, the following are discussed:

- how standard lease agreements have lead to complex lease negotiations
- lease clauses that are contention points for landlords and tenants in the different “standard lease agreements”.
- how the prevailing market conditions affect the turnaround time of concluding lease agreements.

The purpose of this Chapter is to present and discuss the findings of the research undertaken in relation to the issues raised above, in particular the differences contained in the landlord and tenant “standard lease agreements “.

How these difference influence the complexity of lease agreements will be discussed and in turn the turnaround time to conclude negotiations. Each issue raised above is considered separately in the relevant subsections below.

4.2 Research Proposition 1

“Do standard lease agreements lead to the complex lease negotiations”

Complex lease negotiations are as a result of several factors. This chapter will identify these factors which affect the turn around time of finalizing the lease agreement.

TABLE 4.1 - INTERVIEW RESULTS; RESPONDENTS WITH STANDARD LEASE AGREEMENTS

	DESIGNATION	STANDARD LEASE AGREEMENT	TYPE OF LEASE AGREEMENT USED
LANDLORD	SENIOR RETAIL MANAGER GROUP LEGAL ADVISOR	YES	NET
LANDLORD	CHIEF EXECUTIVE OFFICER	YES	GROSS
MANAGING AGENT	SENIOR PROPERTY MANAGER	YES	NET
MANAGING AGENT	DIRECTOR (PROPERTY MGT)	YES	ALL TYPES
TENANT	PROVINCIAL MANAGER LEASING	YES	GROSS
TENANT	SENIOR PROPERTY MANAGER/ LEGAL	YES	GROSS
PROPERTY DEVELOPER	GENERAL MANAGER	YES	GROSS

TABLE 4. 2**SURVEY RESULTS; RESPONDENTS WITH STANDARD LEASE AGREEMENTS**

	DESIGNATION	STANDARD LEASE AGREEMENT	TYPE OF LEASE AGREEMENTUSED
TENANTS	LEASING CONSULTANT	YES	GROSS
TENANTS	LEASING ADMINISTRATOR	YES	GROSS
TENANTS	LEASING CONSULTANT	YES	GROSS
TENANTS	MANAGER-LEASING	YES	GROSS
TENANTS	MANAGER-LEASING	YES	GROSS
MANAGING AGENT	PROPERTY MANAGER	YES	GROSS
PROPERTY DEVELOPER	BUSINESS AND LEGAL ADVISER	YES	GROSS
LANDLORD	PROPERTY MANAGER	YES	GROSS
MANAGING AGENT	PORTFOLIO MANAGER	YES	TRIPLE NET
PROPERTY DEVELOPER	LEASING ADMINISTRATOR	YES	GROSS
PROPERTY DEVELOPERS	ASSET MANAGER	YES	GROSS
LANDLORD	DIRECTOR	YES	ALL TYPES
TENANTS	NATIONAL MANAGER	YES	GROSS

To get to the root of the research problem, we first had to establish whether or not the respondents had 'standard lease agreements.' The results in Tables 4.1 and 4.2, show that all interview and survey respondents have standard lease agreements. Risk aversion was the main reason that was ascribed to standard lease agreements coming in almost endless variety. Both tenants and landlords want to mitigate risk in the lease agreement

Preference of a gross lease agreement by the tenants is to pass on all maintenance and operating costs to the Landlord and the risk of under recovery of such costs. The same can be said about the Landlords' choice of a net of triple net lease agreement. The risk is passed on to the tenants as the obligation of payment of these costs becomes the tenant's including any inflationary risk associated with such cost.

Chun, Eppli and Shilling (2003) model where tenants will generally prefer percentage lease agreements while risk neutral tenants will generally prefer fixed lease agreements is echoed by the research findings. Risk aversity explains why retail tenants prefer a percentage lease agreement.

The tenants' main focus is security of tenure and lease agreement flexibility while the landlords concerned is revenue and low vacancies. Lease agreement flexibility is the opposite of low vacancies, therefore it is evident why lease negotiations become complex. The standard lease agreements of the parties differ because their focus when entering into a lease agreement differs. Reconciling these differences into a lease document creates complex negotiations

This raises the question of whose lease agreement is then used when premises are leased. The decision to which lease will be used has to be negotiated and this may slow down the turn around time of finalizing negotiations.

All the respondents are of the opinion that they use their standard lease agreements as depicted in Tables 4.1 and 4.2 above, but do acknowledge that by the time a lease agreement is concluded, their standard lease document has varied somewhat.

The gross lease agreement is depicted as the most common type of standard lease agreement used by the respondents. One of the survey respondents highlighted that standard lease agreements are used for line shops but with the national tenants the lease negotiations are more complex. The question that arises then is why then negotiations are complex if both parties hold the same type of standard lease agreement.

Grenadier's (2005) is of the view that commercial lease agreement contracts, which include gross and net lease agreements, come in almost endless varieties. The research results support this view which explains why the lease terms will still be negotiated even if the both parties use the same type of lease agreement.

Lease agreements signed without amendments

Results depicted in Tables 4.3 and 4.4 below indicate that standard lease agreements are amended as some of the terms in such agreements will not be acceptable to one party to the agreement. All the respondents indicated that they do not sign a standard lease agreement that is not theirs without amending it.

It is agreeing on such amendments that affects the turn around time of finalizing a lease agreement, it can take months even years before the lease agreement contract is signed by both parties. Some lease agreements are never concluded on lease expiry but the tenants may be in occupation.

TABLE 4.3
INTERVIEW RESULTS; LEASE AGREEMENTS SIGNED WITH AMENDMENTS

	DESIGNATION	STANDARD LEASE AGREEMENT	SIGNED LEASE WITHOUT AMENDMENTS
LANDLORD	SENIOR RETAIL MANAGER (GROUP LEGAL ADVISOR)	YES	NO
LANDLORD	CHIEF EXECUTIVE OFFICER	YES	NO
MANAGING AGENT	SENIOR PROPERTY MGER	YES	NO
MANAGING AGENT	DIRECTOR (PROPERTY MGT)	YES	NO
TENANTS	PROVINCIAL MANAGER	YES	NO
TENANTS	SENIOR PROPERTY MANAGER/ LEGAL	YES	NO
PROPERTY DEVELOPER	GENERAL MANAGER	YES	NO

**TABLE 4.4
SURVEY RESULTS - LEASE AGREEMENTS SIGNED WITH AMENDMENTS**

	DESIGNATION	STANDARD LEASE AGREEMENT	SIGNED WITHOUT AMENDMENTS BY THE OTHER PARTY
TENANTS	LEASING CONSULTANT	YES	NO
TENANTS	LEASING ADMINISTRATOR	YES	NO
TENANTS	LEASING CONSULTANT	YES	NO
TENANTS	MANAGER-LEASING	YES	NO
TENANTS	MANAGER-LEASING	YES	NO
MANAGING AGENT	PROPERTY MANAGER	YES	NO
PROPERTY DEVELOPER	BUSINESS AND LEGAL ADVISER	YES	NO
LANDLORD	PROPERTY MANAGER	YES	NO
MANAGING AGENT	PORTFOLIO MANAGER	YES	NO
PROPERTY DEVELOPER	LEASING ADMINISTRATOR	YES	NO
PROPERTY DEVELOPERS	ASSET MANAGER	YES	NO
LANDLORD	DIRECTOR	YES	NO
TENANTS	NATIONAL MANAGER	YES	NO

In 2007, Apex-Hi was granted a court application to evict the Johannesburg Deeds Office from their 2 Rissik Street Building as a result of occupation of the leased premises with no lease agreement in place (E-prop news, 2007). There was acknowledgement of the difficulty of negotiating lease agreements as David Rice, CEO of Apex –Hi at the time of the eviction was quoted on E-Prop news as saying *“Government departments occupy a large portion of our office space, but we struggle to negotiate lease agreements with this particular department, as there seems to be a lack of capacity to deal with leasing issues,”*.

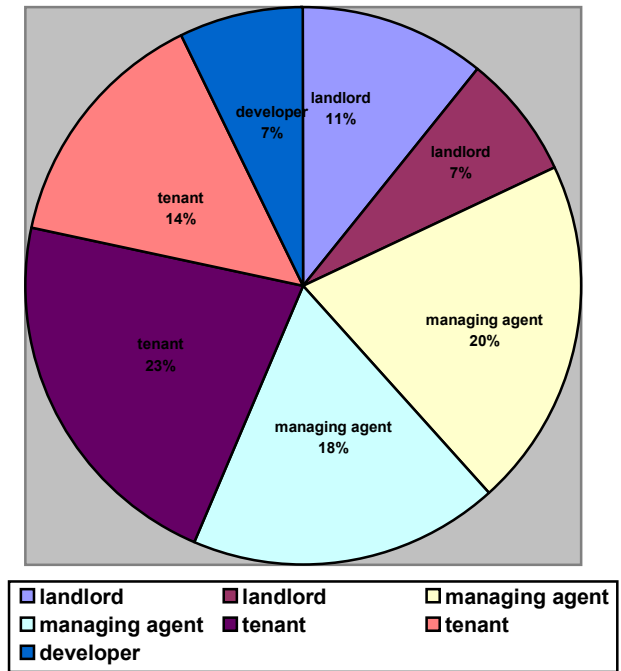
However, the problem of occupation of leased premises without a lease agreement in place still persists and has been exacerbated even further by the number of standard lease agreements incorporated in a negotiation. Most of the respondents played down the degree to which they had occupied premises with no lease agreement

Figure 4.1 shows that all landlord and managing agent respondents have leased premises that are occupied without concluded lease agreements. The results depicted in **figure 4.1** show that tenants have a larger percentage of unconcluded leases. Their security of tenure is threatened by occupation of premises without lease agreements. Therefore what their standard lease agreement is created to address, is at greater risk as the lease negotiations drawn out beyond the expiry of the existing lease.

With property management agents having their own lease agreement, the landlords they represent having their own lease agreement and the tenants likewise. The end result is very complex negotiations as elements within each of these lease agreements are incorporated into one

Figure 4.1

PERCENTAGE OF PREMISES OCCUPIED WITHOUT LEASE AGREEMENTS



The respondents all have standard lease agreements in place but the turn around time of finalizing the lease agreement is affected by complex negotiations. What is being amended and what is complicating the negotiations.

The following questions were addressed in the interviews and surveys;

Type of Lease preferred

The results show that the lease agreement utilised is not necessarily the lease agreement preferred. Table 4.5 shows that the 57% of the respondents preferred to use a gross lease agreement, with a 43% preferring a net lease agreement. After taking a closer look at these results it is evident that gross lease agreements were

preferred by tenants and managing agents while net lease agreements were preferred by landlords.

The difference in the preferred lease agreement to the standard lease agreement in place is the first factor identified as influencing the complexity of negotiations. The research results show that 100% of the landlords preferred net lease agreements. Two landlord respondents, however, use gross lease agreements in retail centers differing from their preference as it is not practical to use when you have multi-tenanted property.

The net and triple net lease agreements are perceived by Landlords as being easy to manage as very little input by the Landlord is required to manage such a lease agreement. The net lease agreement passes most obligations to the tenants and it is the degree to which such obligations lie with the tenants that determines perceived ease of management by the Landlord. Landlords interviewed admitted that a net lease agreement would be more favourable to the landlord as it limits risk of recovery of operating costs and utilities. Risk mitigation therefore influences the Landlords preference as to which type of lease agreement to use.

**TABLE 4.5
INTERVIEW RESULTS; TYPE OF LEASE AGREEMENT PREFERRED**

	DESIGNATION	TYPE OF LEASE AGREEMENT USED	TYPE OF LEASE AGREEMENT PREFERRED
LANDLORD	SENIOR RETAIL MANAGER	NET (HYBRID)	NET
LANDLORD	CHIEF EXECUTIVE OFFICER	GROSS (HYBRID)	NET
MANAGING AGENT	SENIOR PROPERTY MANAGER	NET (HYBRID)	NET
MANAGING AGENT	DIRECTOR (PROPERTY MANAGEMENT)	ALL TYPES	GROSS
TENANTS	PROVINCIAL MANAGER-LEASING	GROSS (HYBRID)	GROSS
TENANTS	SENIOR PROPERTY MANAGER/ LEGAL	GROSS(HYBRID)	GROSS
PROPERTY DEVELOPER	GENERAL MANAGER	GROSS/ (HYBRID)	GROSS

The above results support the survey undertaken by Rowland P (1996) in Perth regarding the preference of the different lease types, both parties prefer not to be responsible for property running costs. With the landlord, it is the net lease agreement that passes the cost to the tenants and with the tenant it is the gross lease agreement as it passes the cost to the landlord.

Tenants view gross lease agreements as easier to manage, the research results depicted in Table 4.5 both acknowledged this. The gross lease agreement has

one main advantage for any tenant which is related to the ease of administration. Tenants prefer the gross lease agreement for the following reasons;

- budgeting of rent costs is more accurate because there are no variables in gross lease agreement
- the maintenance costs are passed on to the Landlord.
- ease of administration of the lease agreement yet they manage property on behalf of the Landlords who prefer a net/triple lease agreement.

The complication in negotiation arises right at the beginning of the negotiation, what type of lease agreement will be utilized. The landlord prefers a net lease agreement and the tenants prefer a gross lease agreement.

i. Type of Tenants

It is evident that the complex lease negotiations occur between your national tenants and the landlords because of tenants having standard lease agreement. In most cases the national retail tenants preferring a gross lease agreement will utilize a gross lease agreement because the landlord/developer is left with no option but to offer such to attract these national tenants for example the Pick and Pay, Edcon, Foschini Groups and even the Retail Banks.

Etter and Figueroa (1995) share the same view that tenants with brand drawing power pay less base rent and a lower percentage of their sales owing to the customer traffic they are able to generate for other tenants in the center. National tenants will negotiate a lease agreement that would differ to that of a non-corporate tenant in the same building. Therefore, as Mooradian and Yang (2002) assert, landlords' beliefs with respect to lessee utilisation of the space and the tenant's market power influences the type of lease agreement selected. The type of Tenants and their power of influence determine type of lease agreement selected in a lease negotiation. The landlord will have to incorporate elements of their lease agreement into the tenants lease agreement and convince the tenants to accept these elements. This complicates negotiations.

ii. *Type of Property*

The type of property is seen to affect the lease negotiations. The Landlord cannot offer the tenants a triple net lease agreement in a multi-tenanted building. The findings of the survey conducted by Rowland (1996) regarding what influences the decision to select a type of lease agreement are inline with these findings. The type of property being leased and the size of the premises will influence the type of lease agreement used.

Do the standard lease agreements take into account the type of property to be leased? The issue of preference of the lease differing from the standard lease agreement in place shows that consideration of the type of premises is taken into account. However, this only further complicates negotiations because the standard lease agreement used by the Landlord is not their preferred lease agreement and therefore there is a tendency to incorporate elements of the preferred lease agreement into negotiations.

iii. *Nature of Business*

The nature of a business also determines the type of lease agreement that can be utilized. Generally retail premises warrant a percentage lease agreement because of the turnover rent. The retail tenants pay a low basic rent plus a percentage of their monthly revenue. However, not all retail lease agreements allow for turnover rent as several tenants utilizing retail space are not retailers in the truest sense. Banks for example lease agreement retail space for their banking halls but do not have turnover rent in their lease agreements as they provide a service and do not sell consumables as most retailers would.

The opinion of Etter and Figueroa (1995) that retail tenants prefer percentage lease agreements over gross lease agreements because the former is expensed when incurred and the latter capitalized concur the results that show that anchor tenants pay lower rents including other concessionary clauses.

The standard lease agreements from both parties would still need to have their elements incorporated. The tenants would have specific terms and conditions pertinent to the nature of their business that is in their standard lease agreement, while the Landlord as a generic standard retail percentage lease agreement. It is agreeing to these conditions that affects the turn around time of lease negotiations. The terms and conditions may become a point of contention, complicating negotiations even further.

Summary of Research Proposition 1

Both parties to the negotiation have standard lease agreements in attempt to mitigate risk which creates complex negotiations. The difference between the preferred lease agreements and the standard lease agreements exacerbates the complexity of negotiations as characteristics of the preferred lease agreement are brought into the negotiations.

The focus when negotiating a lease differs between the Landlord and tenants making it more difficult to reconcile the elements of the two standard lease agreements into one. Standard lease agreements add to the complexity of lease negotiations as the type of tenants, nature of business and type of building all create variation of the so called "standard lease agreement"

4.3 Research Proposition 2

"Lease clauses that are contention points in the different "standard lease agreements" to landlords and tenants."

In the recent years there has been greater focus in the study of lease agreement pricing because of the critical role lease agreements play as a source of financing and valuation of the property, even in the share price of listed property trusts and funds. Lease agreement pricing focuses on measuring the value in monetary terms of specific lease clauses, for example the break clause.

It is clear from the respondents feedback that the theory of lease clause pricing is not applied in their lease negotiations. Initial negotiations are limited to rent as the other terms and conditions are difficult to convert to rent equivalent.

Both tenants and landlords have specific clauses they deem important and include in their lease agreements. The parties must then in the negotiation motivate why the specific clause must be included. If a clause is seen to be unbeneficial or onerous to the other party, negotiations will become complicated and reaching consensus more difficult.

The respondents particularly those representing the Landlord were clear about clauses they will not accept in their lease agreement. Looking at Figure 4.1 below, it is clear that exclusive trading clause will not be accepted by Landlords. Should an anchor tenants insist on such a clause it would confer unto them great power of influence in a centre because they draw the feet to the centre.

Rowland's (1999) view that negotiations of lease agreements is reduced sometimes to agreeing to the rent base on assumption that all other terms are immutable may be true when one standard lease agreement is at hand, but where both parties have a standard lease agreement, each party to the lease agreement will negotiate clauses pertinent to their business which forms part of their standard lease agreement.

The results in Figure 4.2 show maintenance clauses and relocation/rebuilding clauses as the clauses deemed most important by the Landlords. The tenants on the other hand deem break clauses, renewal options and exclusive rights as important and maintenance and building clauses not so important according to the research results. These results are consistent with the survey results undertaken by Rowland (2000) in Belfast which indicates that the tenants' desire for shorter

more flexible lease terms, rent reviews on market value basis, an increase in break clause provision and greater flexibility in relation to repair and insurance clauses.

These results are consistent with the survey results undertaken by Rowland (2000) in Belfast which indicates that the tenants' desire for shorter more flexible lease terms, rent reviews on market value basis, an increase in break clause provision and greater flexibility in relation to repair and insurance clauses.

Lease clauses are not normally negotiated upfront in the offer to lease agreement. This behavior is inline with the view of Lizieri, Crosby, Gobson and Ward (1997) that lease negotiations are often restricted to discussions of rent. The other clauses come up when the lease agreement has to be signed.

Figure 4.1: IMPORTANT CLAUSES TO LANDLORDS AND TENANTS



The reasons for the negotiation of clauses comes back to risk mitigation and the tenants risk will differ from the landlords risk, so will their pertinent clause as is illustrated by the Figure above. The difference in the lease clauses and that these

clauses can not be measured in monetary terms promotes complex negotiations, increasing the turnaround time of the finalization of the lease agreement.

Renewal of a lease agreement would be perceived to be easier to negotiate because the Principal lease agreement is in place. However, the property market conditions continue to change and in turn so do the lease clauses as risk changes. Lease renewal negotiation end up having a turn around time similar to that of new lease negotiations as the lease clauses are re-looked at in light of the changing market conditions.

Summary of Research Proposition 2

Without a monetary value measure of the different clauses entailed in lease agreements, incorporating the different standard lease agreements into one hybrid lease agreement will continue to complicate the lease negotiations affecting the turnaround time of finalization of the lease agreement. Changes to lease clauses influences the rent value because they shift opportunities, responsibilities and risks between the two parties (Rowland, 2000).

4.4 Research Proposition 3

“Effects of prevailing property market conditions on turnaround time of lease negotiations”

Effects of the economic environment on negotiations

The interview and survey responses showed that 80%of the respondents had never thought about what factors influence a negotiation. 100% of the respondents identified inflation and interest rates as factors affecting the escalation rates negotiated in a lease agreement.

When asked if changes in the economic environment affected the lease agreement, the resulting answer was no. However, 20% of the respondents did

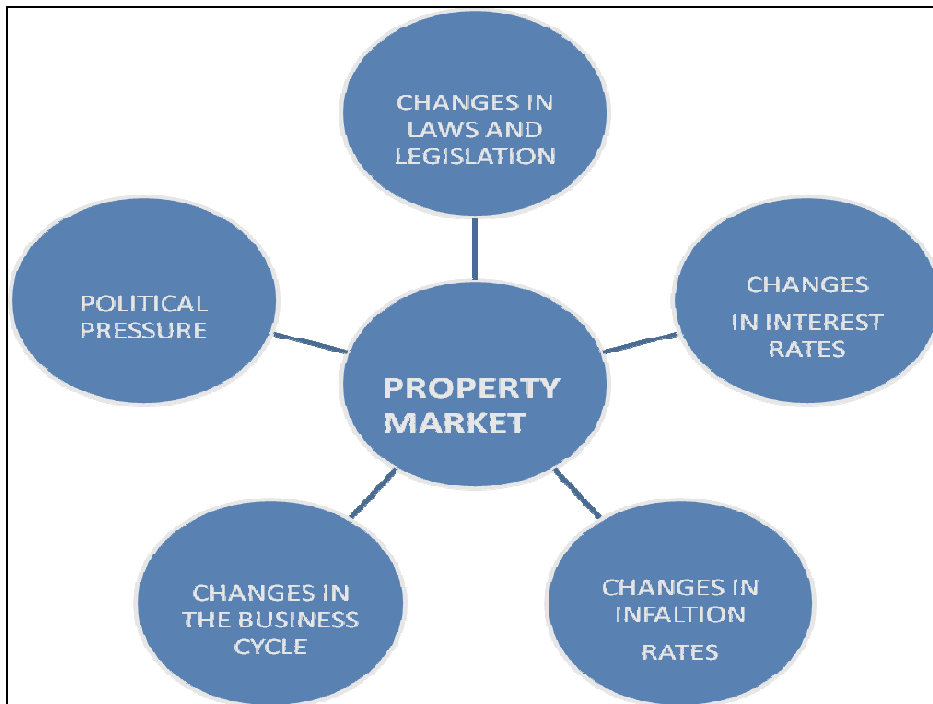
note that turnover rent was affected by changes in the economic environment but not specifically the lease agreement especially the clauses entailed within.

4% of the respondents acknowledged that clauses such as relocation clauses, subletting, legislative clauses, recoveries and deposit requirements had changed to suit the changing economic environment as a result of changes in legislation regarding assessment rates for a property .

The exogenous factors that cause changes within the property market identified in this Chapter were not all as a result of the surveys and interviews conducted. The literature review has assisted in highlighting the factors affecting the property market and in turn the lease negotiations.

The 4 Quadrant model discussed in Chapter 2 illustrates how changes in the asset market or construction market or land market affects the rent market and in turn affect lease negotiations. The following macro factors have been identified as factors affecting the lease negotiations (Figure 4.3).

FIGURE 4.3
MACRO –FACTORS AFFECTING THE PROPERTY MARKET



Author (2009)

i. Interest and inflation

Interest rates and inflation were identified by the survey and interview respondents as factors affecting negotiation but limited to escalation rates. Changes in the actual rent paid, the rate per square meter and escalation rate negotiated are perceived to be the most affected by interest rates and inflation. The effects of inflation and interest are mostly noted in lease renewals.

The impact of changes in interest rates on the property market has been a fairly common phenomenon in South Africa;

- When interest rates were declining in 2003, development of shopping centers increased as financing of such projects through gearing became cheaper.

- A decline in interest rates increased construction and quantity of new shops but reduces the capitalization value of retail property.
- The average market rent would decline as supply exceeds demand, creating a new equilibrium.
- Low interest rates creates oversupply of space as financing of a property development becomes cheaper .
- Again it is the time lag that creates the oversupply because by the time the developments are complete the business cycle would have changed. Low capital values and low rents create a Tenants market as discussed in the literature review,Chapter 2 of this report..

The effect the tenants market had on lease negotiations was that Landlords began to accept more tenants favouring clauses to reduce the vacancies. This complicating the negotiations because the Landlord is exposed to risk of uncertain income as flexibility in lease agreement was negotiated by the tenants.

Changes in values of commercial properties are inversely related to changes in the interest rates .When interest rates rise, investment in new property falls. Ball, Lizieri and MacGregor (1998) argue that the impact of monetary policy on the property sector has changed over the last decades as interest rates may consequently have weakened over time.

Inflation indirectly affects lease negotiation by influencing the property market. The discussion by Geltner and Miller (2001) regarding the effects of inflation on the property market including the fact that higher inflation is associated with economic booms and lower inflation with recession shows the effects inflation has on the property market as it affects demand and supply for commercial property space.

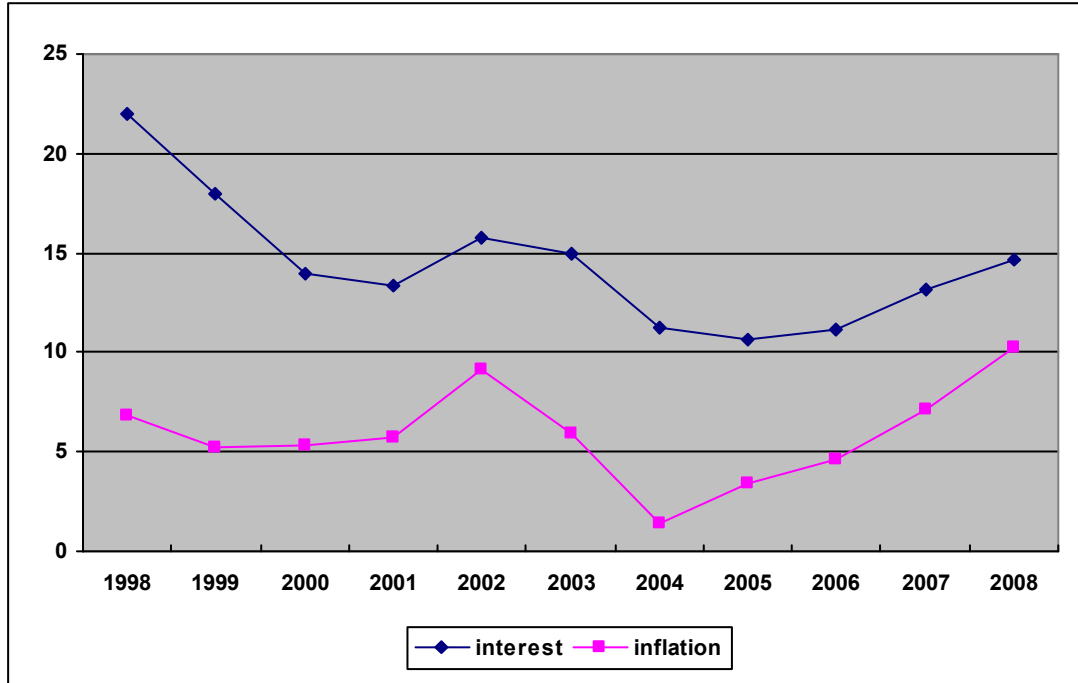
Low performance of the retail industry is experienced when inflation is high and has an adverse effect of the lease negotiated. Rent turnovers are affected and in

some cases high vacancies of retail space are experienced as the smaller retailers' battle to do business in such conditions. Landlords with retail space suffer more vacancies when the inflation rate is high as more and more retailers are unable to break even. Such a change in the retail sector leads to rent concessions, lower escalation rates to retain existing tenants and attract new tenants. Gross lease agreements prevail in this type of market conditions.

The South African economy experienced the highest interest rates ever in 1998 followed by 2002/3. This rise in interest rates had a huge impact on the property industry affecting the building industry in all sectors, residential, commercial and industrial sectors. Market rents were seen to increase as supply of space did not change and demand for space was rising. This type of market commanded lease agreements with net lease agreement characteristics as this market was moving towards favouring the landlord.

The Figure 4.4 below shows that there is a positive correlation between interest and inflation further supporting the fact that interest is used as a tool to control inflation by the Reserve Bank. The fluctuations indicated in the figure below are a good indication of the fluctuations experienced by the property market equilibrium.

Figure 4.4 AVERAGE ANNUAL INTEREST RATE AND INFLATION (1998-2008)



IDC (2007) "Overview of recent trends in the South African economy"

The rise in interest rates affected the property market but because of the time lag, the response by the players in the market was felt in early 1999 as the commercial property sector experienced high vacancy levels which created a tenants market.

Interest rates and inflation affect the supply and demand for space in the property market. Landlords and tenants in attempt to respond to the changes in the market look for clauses that mitigate risk for the parties.

ii. Political Pressures

Political uncertainty or instability can also have a negative effect on the property market. When investor confidence is lost as a result of political uncertainty or instability, businesses close down or relocate. For example, central business districts in major cities of South Africa experienced high vacancy levels and a decline in rent levels when the political powers of the country changed in 1994

when corporate tenants migrated out of the Central Business Districts. This changed the property market equilibrium in South Africa's Central Business Districts at that time.

In such conditions lease clauses such as subletting, option to renew, low escalation rates, rent free periods and high tenants allowances would have been conducive. Such clauses would have been negotiated in response to the decline in demand for space in the market. The clauses would be used to attract potential tenants, increasing demand for space to address the high vacancies in the market. It is finding the balance between a tenants favouring market and the Landlords exposure to risk that would create complex negotiations. <Evidence>.

In such conditions lease clauses such as subletting, option to renew, low escalation rates, rent free periods and high tenant allowances would have been conducive. Such clauses would have been negotiated in response to the decline in demand for space in this market. The clauses would be used to attract potential tenants, increasing demand for space to address the high vacancies in the market. It is finding the balance between a tenant favouring market and the landlord's exposure to risk that would create complex negotiations. The landlord wants to reduce vacancies but at the same time, not compromising on revenue or share/unit price.

iii Legislation and Government initiatives

The effect of Legislation on the property market, for example stringent building regulations can also reduce construction. Government intervention in the land market through policies such as taxes, planning controls and building regulation affects the supply of land, affecting the property market and lease negotiations thereof.

The regeneration project in the Johannesburg CBD has led to arise in the demand for space in this area. Rents were seen to increase as a result of the rise in demand for space without corresponding increase in supply of space. Ball (2006)

observed that government interventions can have a positive effect where it redirects development for example provision of infrastructure such as roads and rail networks. An example of this is government intervention in the central business districts of the major cities in South Africa. Cleaning up the streets, improving security, the regeneration project in Johannesburg Inner City has led to improvement in rents in this area.

Lease agreements concluded in such a market climate of rising demand for space and high rents would be a net lease agreement as the Landlord has the upper hand in this type of property market environment. If gross lease agreements are used they would most definitely have net lease agreement characteristics in such market conditions.

In 2008 to 2009, Eskom's limited electricity supply and higher electricity charges have led to a decline in the number of retail outlets being developed, as fewer developers receive Eskom approval regarding the supply of electricity.

As supply of retail space slows down, the rent for such space tends to rise. Landlords would now negotiate net lease agreements as recovery of the electricity costs becomes vital. Market conditions do affect the retail sector and Legislation, laws and by-laws are factors influencing such lease negotiations.

Again as demand and supply changes within the property market, the dynamics for lease negotiations change in response. With or without a principal lease agreement in place, when the market changes the clauses entailed in the lease agreement will change. Lease negotiations of a lease agreement renewal will be similar to that of a new lease agreement, hence affecting the turn around time of concluding the lease agreement.

iv Real Estate Cycles

The business environment is constantly changing and such changes are shown by the movements in a typical property cycle. These cycles affect the businesses of potential and existing tenants. Real estate cycles have been a significant

underlying reason for the financial successes and failures of real estate investments throughout history and should not be oversimplified or ignored. Pyhrr, Roulac and Born (2007) share this view.

Temporary upturns in demand for property, for example the cost of building new offices, finding office space and moving in, can take place over two business cycles. The by Ball, Lizieri and MacGregor (1998) analysis of property market in Europe and North America shows that demand and development of new buildings are highly sensitive to short term output changes. The building industries response to such changes is usually noted months after the change and this can cause an over supply or shortage of property in the market. Such changes will affect lease negotiations.

Business downturn and overbuilding in the business cycle occurs when the market is flooded with space because of the time lag created by the time it takes to build property. A large percentage of developments undertaken in the business upturn period are only ready for occupation when the business cycle has already adjusted.

The Business Cycle in between its upturn and downturn goes through a period of adjustment. A typical adjustment would be described as a fall in demand for new space coinciding with a peak in supply for space. Vacancy rates rise above equilibrium and rents fall. Developers generate insufficient incomes to cover the interest payments on their completed developments, bankruptcies and poor returns lead to disinvestment from the property market. The market attempts to reach equilibrium.

The property market equilibrium will constantly be changing as a result of Macro factor influences. The property market conditions will always play a role in determining the type of lease agreement used in such market conditions. It is the changes in the market conditions that lease agreement to complex negotiations as

Tenants and Landlords respond to these changes by amending the lease agreement.

Summary of Research Proposition 3

Negotiation of lease agreements is no longer focused only on the rent and lease term but the clauses entailed within the lease agreement, as tenants and landlords take into consideration the changing economic environment they operate in.

4.5 Conclusion

Standard lease agreements come in almost endless varieties in attempt to mitigate risk but instead have created complex negotiations. All respondents each have standard lease agreements. Standard lease agreements add to the complexity of lease negotiations as the type of tenants, nature of business and type of building all create variation of the so called "standard lease agreement".

The tenant respondents all identified the option to renew clause as most important while all the landlord respondents identified the rebuilding clause as most important. Without a monetary value measure of the different clauses entailed in lease agreements, incorporating the different standard lease agreements into one hybrid lease agreement will continue to complicate the lease negotiations affecting the turnaround time of finalization of the lease agreement. Changes to lease clauses influences the rent value because they shift opportunities, responsibilities and risks between the two parties (Rowland, 2000).

Pyhrr, Roulac and Born (2007) view that real estate cycles are a major determinant of success or failure because of their pervasive and dynamic impact on real estate returns, risks and investment values over time that should not be ignored or over simplified confirms that it is pertinent to understand what affects lease negotiations and the turn around time thereof.

Tenants are in occupation after the existing lease agreement has expired and the new lease is not finalised. This is as a result of an attempt to mitigate risk by the parties creating complex negotiations which slow the turn around time of concluding the lease agreement.

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The importance of the lease agreement and the risk of not having a written lease agreement in place form the core of this research. Lease negotiations have become complex as a result of the intricacy of the demands from both parties as each seeks to minimize their risk exposure, leading to occupation of leased premises without a signed lease agreement

The Landlord's "standard lease agreement" continues to evolve in response to the changes within the Property markets. The "standard lease agreement" by the Tenants is to mitigate the risks created by the ever changing "Landlord standard lease agreement" and to simultaneously respond to changes affecting their security of tenure.

The effects of having no lease agreement in place as a result of complex lease negotiations are; risk of security of tenure, uncertainty of financing real estate projects and the uncertainty of the cash flow of a property portfolio.

5.2 Literature Review – A Summary

The literature review undertaken in this research report is on preference of the different types of leases, pricing of lease clauses and the property market fundamentals. Most of the literature is centered around the value of lease clauses in monetary terms.

Lease structures are changing as lease negotiations occur in continually changing property environments. Negotiations are complicated by;

- the almost endless variety of lease agreements that come about in attempt to mitigate risk,
- by the ever-changing lease clauses proven difficult to measure in monetary value
- effects of the market conditions on the turn around time of negotiating a lease.

Risk aversion remains the dominant factor affecting the preference of a lease agreement and is the reason national tenants have created their own standard lease agreements, complicating negotiations.

There is little or no knowledge as to the value of the clauses in the lease agreements when negotiating, therefore this becomes a point of contention. Importance of understanding real estate cycles, property markets and their fundamentals is pertinent in assisting the parties in understanding the conditions of the market environment they trade in.

5.3 Research Methodology – A Summary

The type of research undertaken in this report would be defined as exploratory research as it asks both “what” and “why” questions (Gina; 2001). To address the research problem which is “why lease negotiations have become complex leading to a slower turnaround time of finalizing the lease”, the qualitative research method has been used as the research methodology in this paper for the following reasons;

Qualitative research is a descriptive method focusing on interpretation common in management or commercial fields.

A qualitative approach has been used because of its exploratory nature through semi structured interviews. The property industry is made up of a large population. In order to collect the required information for this report a large number of people had to be approached. The population sample used consisted of Senior and

middle management professionals in the industry. The use of a questionnaire was the best way of collecting information from a sample of the property industry population.

The research method chosen here was as a result of the research to be undertaken which entailed collection of data from individuals using interviews and surveys. These instruments reflect the research paradigm of this report because it is peoples' experiences, behaviors and opinions that are of importance.

5.4 Interview and Survey Results – A Summary

The purpose of the research results chapter is to present and discuss the findings of the research undertaken in relation to the problem statement “That standard lease agreements create complex negotiations.”

The following was concluded from the results collected;

- Standard lease contracts have contributed to the property industry having an almost endless variety of lease agreements because of the parties attempt to reduce risk created by the lease agreement.
- Most lease clauses become a point of contention in negotiations when they create a risk for the other party.
- The perception within the industry is limited to effects of inflation and interest rates on the escalation rates. Lack of understanding of the impact changes in the property market have on lease negotiations is evident from the research results.

The lack of understanding of the effects of such dynamics on lease negotiation may be attributed to time lag experienced in the property industry in response to changes in these Macro factors. It is crucial to understand these dynamics in order to be able to expedite lease negotiations regardless of the economic climate.

5.5 Research Question Answered

The research question was answered by addressing issues relating to:

- how different types of standard leases have come about resulting in complex negotiations
- lease clauses that are contention points contained in the different “standard lease agreements”
- changes in market conditions that affect the turnaround time of lease negotiations

Identifying these factors assisted in answering the research question “ why lease negotiations have become complex leading to a slower turnaround time of finalizing the lease”.

The standard lease agreement has been identified as being the root of the problem. It increases the level of amendments that have to be undertaken before the lease is concluded. The continuously changing market conditions affect turn around time of negotiations as leases clauses are amended in response to the market changes.

5.6 The Research in a broad perspective

This research has been undertaken with the main focus on retail premises. However, the findings can be applied to the whole commercial property industry including office and industrial lease negotiations.

This study can also be utilized in any industry where standard contracts exist and each party to the contract has their own standard contract in place, the service industry where service level agreements are utilized is one example.

As long as the economic environment continues to change so will factors affecting such agreements and their negotiations. The Property industry is one of many industries that face the problem of complex negotiations.

5.7 Recommendations and Further Study

Markets for property space adjust only gradually because tenants and landlords are constrained by long-term leases and transaction and information costs. Not only do rents adjust slowly, but space occupancy, which depends on historical rents, often differs from demand at current rent. This creates “hidden vacancies,” vacancies that will develop in the future if market rent and the space demand driver are unchanged (Englund , Gunnelin , Hendershott and Soderberg;2008)

Their view that if all lease contracts were renegotiated every period and there were no search and transaction costs and other market frictions, then there would be no vacancies. Rents would continuously adjust to equate demand and supply. However, they do acknowledge the complexity of property. Leases are typically for multiple periods, and costs are too high for tenants to adjust their space consumption continuously. As a result, vacancies are a central feature of property markets.

The recommendations made are as follows;

Proposition 1

The players in the industry start to take a closer look at lease agreements and the effects on lease negotiations.

Proposition 2

If two parties to an agreement both have a standard lease, set both lease agreements aside and negotiate a new lease with terms and conditions that are not onerous to either party.

Proposition 3

It is pertinent to understand prevailing market conditions at the time of negotiations.

Proposition 4

Lease negotiations must include all terms and conditions of the lease in the initial stages of negotiation. Offer and acceptance must not be limited to the five essentials of a lease agreement.

Proposition 5

The commercial property industry needs to look at these models in depth. The ability to reduce lease terms and conditions to monetary value would assist when negotiating a lease agreement

Creation of a new type of lease with each negotiation is inevitable but identifying the benefits of creating such a lease is important. Understanding the dynamics of a lease negotiation is pertinent in this industry.

Future work that could be done is as follows;

- What is the use of lease agreement
- Pricing of lease clauses to eliminate the risk from such clauses
- looking at standard lease agreements, when are they useful

There has been very little focus on lease negotiations. More work can be done relating to pricing of lease clauses. The lease agreement continues to play an important role in the property industry, more work with regard to measuring its value, terms and conditions both, is recommended.

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Appendix A

Interview questions

- How long have you been in the industry-brief background of interviewee?

- Do you have Standard Lease contracts?
- If you have standard lease contracts what type of lease are they (e.g. gross)?
- Why do you as a company prefer this type of lease?
- What are the disadvantages of such a lease compared to the others?
- In your experience which is the best type of lease to use?
- What % of your lease contracts are not concluded yet (estimate) Why?
- How are lease contracts affected by changes in the property markets (give examples of the changes in the property market as well)
- Are lease contracts in your professional opinion affected by changes in the economic environment (e.g. inflation)?
- What clauses specifically have you experienced being changed to suit the changing property market?
- Which clauses do your tenants/landlords frequently insist on having in a lease contract?
- Which clauses do you accept or decline and Why?
- Which clauses do you deem important and insist on having in a lease contract?

Appendix B

Survey questions

Please answer the questions below as briefly as possible (no more than 2 lines for brief answers please)

Questions

- Do you have Standard Lease contracts, if so are they gross net or triple net?
- Why do you as a company prefer this type of lease.(**very brief answer please**)
- Are lease contracts in your professional opinion affected by changes in the property market? (**yes/no**)
- Why do/don't you think lease contracts are affected by changes in the Property market (**very brief answer please**)
- Which clauses do your tenants/Landlords frequently on having in a lease Contract (**name one**)
- Do you accept or decline such clauses, and why? (**very brief answer please**)
- Which clauses do you consider important and insist on having in a lease Contract (**name one**)
- Do you have out clauses or rent review periods in these long lease Contracts (**yes/no**)
- Why do you have these types of clauses in your lease?(**very brief answer please**)