Not all Leases are Created Equal. Understanding the lease types.

What is your rental rate? How does it compare to the tenant next door, down the block or across town? While rate per square foot is the most common metric, in order to understand the validity of a comparison, it's important to understand the differences and nuances definitive of each lease type.

Types defined: The three most common lease types used today are: Full Service (Gross), Triple Net (NNN) and Modified Gross.

(http://www.mcmsonline.com/sites/default/files/legal_update.jpg)

The simplest and most tenant friendly is the **Full Service or Gross Lease**. A full service lease is simple for the tenant because all a Tenant is required to pay is one bill and the landlord covers all expenses including but not limited to: weekday janitorial service, restocking bathroom supplies, general property and suite maintenance, changing of light bulbs, plus structural, glass, door, roof, mechanical and plumbing maintenance, property insurance, parking lot, landscaping, utilities…everything needed to maintain a professional environment for your patients except the phones and internet. In addition to the benefits of a single invoice, there is usually a single point of contact for a property manager who handles the coordination of the above-mentioned services. Depending on the age and size of the property, this is often a full time job and may also include a day porter or maintenance engineer. Up until recently, this was the most common type of lease for medical providers.

The most complex lease type is the **"NNN" or "triple net"** and is often defined by the tenant paying base rent to the landlord plus its proportionate share of the following three "NNN" categories: property taxes, insurance and maintenance/utilities (as defined under full service above). The concept was initially seen with retail buildings because the landlord's did not want to get involved in the operational aspects of typical retail businesses such as restaurants, retail merchandise, movie theaters, convenience stores, automobile maintenance, etc. In the last ten years however, we've seen many newly developed medical buildings utilize NNN leases. Additionally, some existing medical office buildings have been converted to NNN leases to satisfy their institutional owners.

Most development in this past cycle was done during a time of extremely high demand for new office product on the periphery of the city. While some offices were built with the ability to separately meter utilities, there were minimal alternatives in these areas and so tenants were forced to accept a NNN lease as they tend to favor landlord's as described below.

As institutional owners (REIT's, Pension Funds, TIC's) began to purchase real estate in our market, they began converting buildings from Full Service to NNN as was possible. Most landlords would still handle all maintenance and repairs and many of the utilities are not separately metered but all cost are passed through directly to the tenant on a proportional basis without any risk of increasing operating costs for the landlord. To illustrate: a popular medical building was developed in midtown Phoenix in the late 1990's with a Full Service rental rate near $28/sf. Sometime in the early 2000's the building was purchased by an institutional investor and as tenant's began to renew, the rental rate was changed to $18/sf NNN with $11/sf in NNN expenses. In this example, it's only a $1 increase in rate, the tenants still have a full service property management team, but the landlord receives $18/sf net profit (before debt service) regardless of operating expenses. This net profit metric allows an institutional landlord to more effectively compare rental rates across markets nationally.

A **Modified Gross** lease is a hybrid concept that starts with a Full Service lease and then removes services such as janitorial or utilities to create a better value or lower rental rates in a competitive market.

The next time you hear an abnormally low rental rate or are quoted something for a new office, be sure to ask questions related to the lease type and operating expenses. You might be surprised to learn what the true comparative number is and it will eliminate your surprise at a later date.

About the Author: Aaron Kuhl is the Designated Broker for Medical Office Brokers (MOB) and has more than 15 years of experience in commercial real estate and contract negotiations. MOB is endorsed by the Maricopa County Medical Society as a preferred vendor and specializes exclusively in the representation of medical tenants and buyers throughout Arizona. ***www.arizonaMOB.com***