

RE 618 / Fin 618 – Real Estate Investment Analysis

Homework – Effective Rent

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- 1) A tenant would like to lease 4,000 square feet of space over the next ten years, and is evaluating the following alternatives:

Option 1: Gross lease with base rent of \$16 psf each year.

Option 2: Gross lease with base rent of \$15 psf with rent rising by \$0.50 psf every other year; the first year of adjustment is year 3.

Option 3: Absolutely net lease with base rent of \$12 psf, increasing to \$14 psf starting in year 6.

Operating expenses for the space are expected to be \$2.50 psf in the first year; these expenses are expected to increase at the same rate as overall inflation, which is expected to be 3 percent per year.

- a) Calculate the tenant's effective rent (after expenses) for each lease alternative using a 12 percent discount rate.
- b) How would you rank the alternatives in terms of risk to the tenant?
- c) Considering your answers to parts (a) and (b), which option would you choose if you were the tenant? Explain your reasoning briefly.