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Commercial Real Estate Services

What Are the Major Types of Leases?

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Many tenants become confused when they are quoted lease rates. It sometimes seems like each landlord is using a different language. What does triple-net mean? What is an expense stop? What are common area or CAM charges? What is a gross-industrial lease? What is a base year? All of these terms impact the rate that is quoted. Thus comparing different leases requires an understanding of these terms and the different types of lease that are being quoted.

There are in general four basic types of leases. They are gross lease, full service lease, gross industrial lease, and triple net lease. There are of course variations of these but they are built from one of these basic forms. Each landlord decides which type of lease he believes best fits his specific needs. The tenant's attorney and broker need to understand the differences and communicate them to tenant. A rate of $18.00 per square foot definitely does not mean the same thing under each lease.

The gross lease is the simplest lease form and one not often used today. In this format the tenant simply pays a stated amount each month. This rate covers all the basic expenses that the landlord would normally incur including taxes, insurance, utilities, trash, lawn care, snow removal, janitorial services, repairs and maintenance, etc. The landlord takes care of everything and the rate does not change. Any increase in the cost of these items is simply absorbed by the landlord. Most landlords are not willing to take the risk of inflating costs. Gross leases are therefore usually for short time periods where inflation and escalating costs are not a factor. They are often found in lower priced properties.

The triple net lease is almost the reverse of the gross lease. There is a quoted base rent but the tenant is responsible for all the costs incurred with the operation of the space. The tenant pays the taxes, insurance premiums, utilities, etc. The tenant has all the responsibilities of ownership with none of the advantages. This concept is best understood if the property has only one tenant. But, often the tenant's space is part of a larger complex and some of the expenses need to be shared by all the tenants. In this situation, the landlord pays for these expense items as they occur but each tenant pays in advance for his estimated share of the expenses. Thus the landlord estimates the cost of taxes and spreads the amount bases upon the percentage of the property each tenant occupies. In the same way he spreads the cost of insurance among the tenants. The landlord also will provide some of the services needed for the common area and will assess a common area maintenance charge (CAM) to the tenants. These CAM charges are for the expenses not specific to a tenant. For example, the electricity charges for the parking lot lights is paid by the landlord under CAM, but, each tenant would have a separate bill for the electricity used in his space. The landlord will estimate the charges for taxes, insurance and CAM at the beginning of the lease and will bill the tenant for 1/12th of these estimated charges with the monthly rent. At the end of each year the landlord will compare the actual expenses with the estimated expenses. If the landlord has spent more than estimated the tenant will receive a bill for the difference which is to be paid immediately. The triple net lease is usually found in retail situations or in single tenant properties. The quoted rate does not include the cost of taxes, insurance or CAM.

The full service lease is similar to the gross lease except it contains provisions to pass on escalating costs to the tenant. The landlord quotes a rate that includes paying the taxes, insurance premiums, utilities, and CAM. In order to protect himself from escalating costs the landlord will include either a base year or expense stop. To understand full service leases it is imperative that one understand these concepts. In a base year approach the landlord represents that the quoted rate will include the costs that were incurred for taxes, insurance and CAM equal to what was spent in a given year. The year could be last year, this year or next year. Which one is used often depends on the time of the year that the lease is signed. Note that the landlord and tenant will not know at the time of signing the lease what the base year amount is if either this year's or next year's expenses are used. It will usually be to the landlord's advantage to use the earliest year possible and to the tenant's advantage to use the latest. An expense stop is similar to a base year except instead of using the actual number for a given year the landlord simply quotes an amount. If the expenses are higher than that amount the tenant will have to pay his prorata share of the increase. Tenants should take care that the expense stop is in line with expected costs. If it is too low there will be significant overages to pay. Most office leases are full service.

The gross industrial lease is similar to the triple net lease except the lease rate includes the payment of taxes and insurance. The tenant is responsible for paying any increase over the amount of taxes and insurance for a given year much like a base year. If the property is a multi-tenant property the common area charges will also be added and usually are quoted as a per square foot cost much like an expense stop. Industrial leases are generally gross industrial or triple net leases.

A major area of difference between the four types of lease regards repairs and maintenance. In the full service lease and gross lease the landlord is responsible for repairs and maintenance and the estimated cost of these is included in the quoted rate and also in the base year or expense stop quoted. In a triple-net or gross industrial lease the tenant is responsible for the repair and maintenance of his space. A major area of concern and expense is the HVAC system. The tenant is responsible for the HVAC system and may even be required to replace equipment if it breaks.

As a result of the above it can be seen that a quoted rate of $18.00 can mean several things. It could include everything in a gross lease or everything but increases in a full service lease. In a retail lease it would not include the operating expenses which could be significant. This is especially true in a retail lease. The taxes on retail property are usually much higher than on other types. The operating expenses are also usually much higher. Thus a tenant should never just compare the quoted rate but must always determine the type of lease and how the expenses are handled.

Lease rates are greatly impacted by the market place. Over the last few years there have been many changes in how expenses are handled. Some capital expenditures are now charged back to tenants on an amortized basis. These used to be the sole responsibility of the landlord. Further, lease rates are now being adjusted annually to take into consideration overages that occur in expenses. The lease rate increases and the expense stop are increased. This helps the landlord with cash flow and keeps the annual overage payment from growing too large. Care should be taken before signing a lease to study these items carefully.