Negotiating a New or Expiring Wireless Lease with Monetization in Mind

Part I: Rent Escalation Provisions

First in a multi-part series

by

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The behind the scenes work done by prospective buyers to value cellular leases for purchase is rarely known or understood by sellers. As an existing or new landlord to the wireless carriers or tower companies, understanding the methods behind wireless lease valuation that are undertaken by the aggregation community can be a critical component of your negotiation of a new lease or re-negotiation of a soon-to-expire lease - whether you plan on monetizing the lease or not.

TCA received many calls every week from property owners who have been either approached by tenants looking to put infrastructure on their property or who are in the early stages of lease re-negotiation. In that regard, I have decided to memorialize my thinking with respect to what a landlord to the wireless carriers or tower companies can do to maximize their future possible revenue opportunities, whether via monetization or purely as it relates to increasing their chances of seeing additional income. I have started below with an explanation of the effect of escalation on lease value.

The importance of getting the right rent / escalator combination:

Over our 16 years in the space, we have tracked the average rents and escalators for both tower ground leases and rooftop leases across the US. Along with tracking these averages, we have priced innumerable individual leases for purchase and sold two sizable portfolios of wireless easements/leases.

Over the course of time, we have seen an initiative by tenants to lower escalators and rents, both for existing leases and new sites. While historically the average rents and escalators for ground leases and rooftop leases have been in the $1,500/month range with 3% per year or 15% per 'term' (every 5 years), new leases are more likely to be offered in the $500-$1,000 per month range today with 10% per term escalations.

Many landlords have accepted these new terms while others have pushed for higher rents and escalation provisions. Some landlords are willing to trade a lower rent for an 'above market' escalator in the 4% or 5% (or equivalently, 20% or 25% per term) escalator.

The purpose of this analysis is to show that there is an optimal escalator for any given rent when (and if) a landlord is interested in possibly monetizing his or her lease for the most amount of money possible.

Which is better, annual or term escalations?

Annual escalations have the effect of compounding the overall increase to the advantage of the landlord. For example, a 3% escalator compounds to a rate of 15.93% every 5 years (1.03 ^ 5 power). The answer is annual escalations tend to be better than 'term' escalations.

Isn't a 4% or 5% per year escalator better than a 3% escalator?

This is the interesting dynamic, and it relates to limitations imposed on the community of buyers in the aggregation space by their exit strategy for the assets and/or their financing sources. Specifically, at a given price, while the returns are better for a buyer when the escalators are high, most buyers are *de-limited* in one of two (or possibly both) ways:

- Overall multiple of annual rent that they can or will pay for a lease.

  and/or...

- The 'capitalization rate' associated with the purchase. Commonly known as 'cap rate', this is a simple calculation that helps in real estate investments and is defined as the Net Operating Income (in this case the annual rent) / Current market value (in this case, the sales price).

Which of the two limiting factors is in play depends to a large extent on the type of buyer and the nature of their financing or exit plans for the lease. Leave it to say that when renegotiating a lease or negotiating a new lease, a seller should assume both factors will be germane to value down the road.

Maximum 'all-in' multiple limitations of buyers

While not applicable in all cases, today's market buyers seem to have settled on maximum 'all-in' costs of lease purchases at 16-16.5 X the annual rent. This is not the amount the seller should expect to be offered, but rather is the price to the seller PLUS the costs to close the transaction. Costs typically include the costs to both underwrite (e.g. expenses for title, environmental, surveys, recording fees, etc.) and costs of overhead / compensation for the originator (internal or external). This is TCA's estimate based on our recent experience over the last two years, and not a hard ceiling.

Minimum 'all-in' cap rate limitations of buyers

Some buyers, again depending on their financing structure and exit, must also look at the cap rate of a lease purchase. For example, if the rent is $1,000 a month ($12,000 per year) and the purchase price paid to the seller is 14 X the annual rent ($168,000), the cap rate associated with that purchase is $12,000/$168,000=7.14%. Factoring in closing costs, compensation and overhead, the 'all-in' cost to the buyer might be as high as 15.8 X the annual rent ($189,600) making the cap rate associated with the purchase $12,000/$189,600=6.3%.

Again, while not applicable in all cases, those market buyers that are sensitive to 'cap rate' equivalent floors seem to have settled on minimum 'all-in' cap rate of about 6%. This is TCA's estimate based on our recent experience over the last two years, and not a hard floor.

So what escalator should a landlord target to maximize future possible lease sale value?

Taking the above two limitations into account, we have come up with the following analysis (see Table/Graphs below). In general, a landlord negotiating a new lease should **try for the highest possible rent with a 3%-3.5% annual escalator**. A fall-back position would be to settle for a 15% per term escalation.

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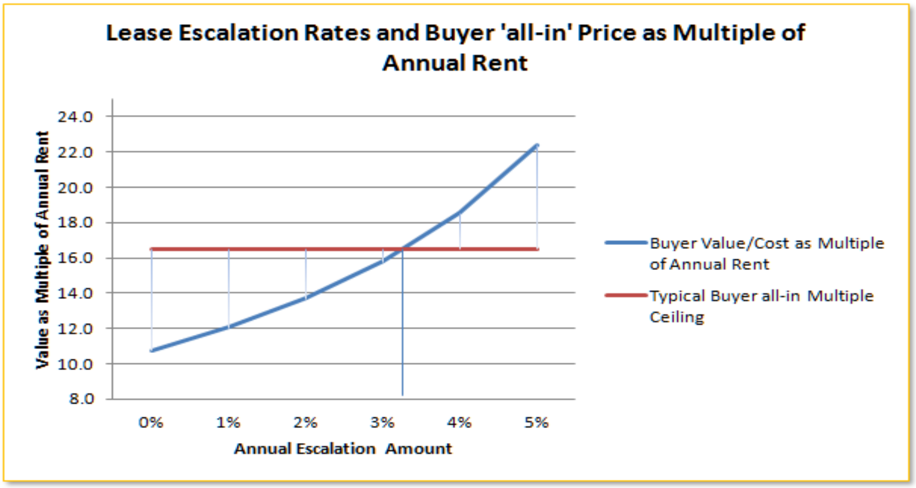
Valuations as Multiple of Annual Rent and their Cap Rate Equivalents - Effect of Buyer ceilings and floors

Annual Escalator

	0%	1%	2%	3%	4%	5%
Buyer Value/Cost as Multiple of Annual Rent	10.8	12.1	13.7	15.8	18.6	22.4
Typical Buyer all-in Multiple Ceiling	16.5	16.5	16.5	16.5	16.5	16.5

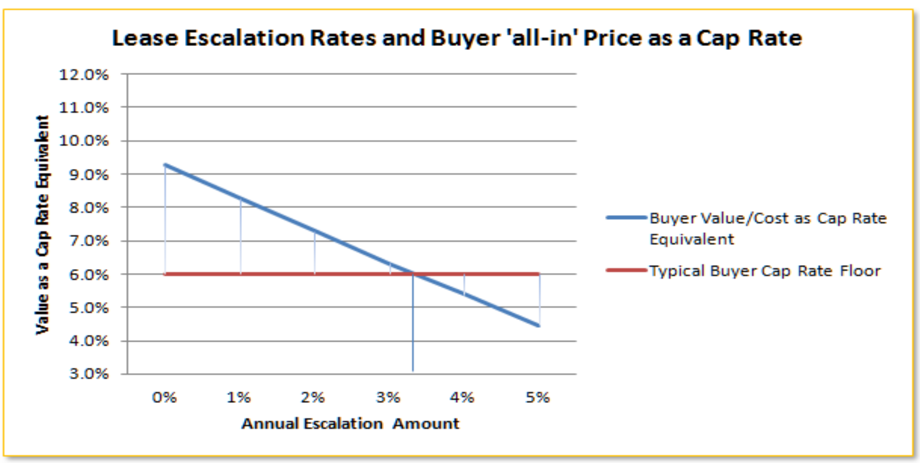
Optimal Escalator for Seller = between 3% and 3.5%



Annual Escalator

	0%	1%	2%	3%	4%	5%
Buyer Value/Cost as Cap Rate Equivalent	9.3%	8.3%	7.3%	6.3%	5.4%	4.5%
Typical Buyer Cap Rate Floor	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%

Optimal Escalator for Seller = between 3% and 3.5%



Assumptions: Rent = $1000/month
Approximate 10.5% gross yield on lease purchase before expenses
Expenses include closing costs, title, compensation estimates
Perpetual purchase term (maximize proceeds for seller)
Annual Escalations take place 6 months from date of purchase

** Similar results for 'Term' escalations of 0%, 5%, 10%, 15%, 20% and 25% respectively*

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Summary

There are many things to consider when negotiating (or re-negotiating) a wireless lease. One of the more salient economic considerations is, of course, the rate at which the lease escalates. Taking current market limitations on buyers into account and keeping in mind that for NEW towers/installations, the tenant may have numerous other options in terms of where to put their equipment while also recognizing that existing leases being re-negotiated may have few places they can go as an alternative, we feel that an optimal escalator to shoot for in a wireless lease is an annual one at a rate of 3.0 - 3.5%.

Future articles will discuss, among other things, the following additional considerations for the landlord when negotiating or re-negotiating a wireless lease:

- Compound size

- Initial term and number of renewal terms

- The importance of negotiating Rights of First Refusal out of your lease

- Property tax responsibility

- Revenue sharing provisions

We hope you found this article useful.

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Mr. DeMita's Biography