Valbridge Property Advisors

NEWS

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Fair Market Rental Value in Commercially Leased Spaces

Establishing Fair Market Rental Value is a major consideration for both landlords and tenants - understanding how that decision is made is essential!

Determining fair market rental value is critical for both landlords and tenants. This three part series will explore important issues that will help you and your clients make better choices.

Part One: What is Fair Market Rental Value and How Does It Work?

In many areas of California - and in many other rapidly developing areas across the country - real estate values are rising sharply year over year. If a space is leased for a number of years, how can both landlord and tenant ensure that it is a fair and sustainable rate? This is exactly the point that fair market rental value (FMRV) appraisals seek to answer. **In this article, we'll examine the FMRV process through a hypothetical case study**. Sometimes the concepts can seem rather abstract, but by placing them into a real-world scenario, it's easier to understand how they might impact the concerns of both landlords and tenants.

Concerns about fair market rental value arises most commonly in two scenarios. First, it comes into play when there is the option to extend a lease beyond its current terms. Should the rent go up, go down, or remain the same? A FMRV appraisal can help create a fair outcome for both parties.

FMRV appraisals are also often ordered when a new landlord inherits a building, perhaps from the terms of a will or trust. Are the rents that are currently charged fair? An FMRV appraisal can help establish that.

Meet Meredith. Let's imagine that Meredith wants to turn her small home-based bakery into a larger commercial space, converting a successful pastry line into a limited-service cafe. She envisions a comfortable, neighborhood space where customers can enjoy a cup of coffee and a delicious pastry, and where she can also feature local jams, artisanal food products, and occasional live music or cooking demonstrations. But Meredith doesn't have a lot of money, so she's looking at leasing a restaurant space in a less desirable area and hoping that, over time, she can grow with the neighborhood.

Meredith finds her ideal space - it's 1300 sq ft, available for an initial 10 year lease. Meredith signs a **modified gross lease**. That means that she pays her rent in one lump sum, which can include property taxes, insurance, and common area maintenance. In Meredith's case, trash is included but all other utilities and janitorial services are her responsibility. Modified gross leases tend to be more tenant-friendly, since they are easier to set up and manage.

This also allows Meredith to predict her expenses. If, for example, property taxes or insurance rates change, the landlord absorbs the difference and Meredith's rent stays steady. She's paying $30/sqft, or $3250/month, in 2018. Meredith and her landlord agree that she will have the option to renew her lease in 10 years, in 2028. Because neither of them want to set a specific dollar amount given the unpredictability of the California real estate market, **they agree that the renewal rate will be mutually determined in the future based on fair market rental value (FMRV) – a very standard provision in many commercial leases**.

But what does that actually mean? Here is the first critical element to understand: fair market rental value is established based on comparable leases of comparable spaces. Let's explore that concept in more depth.

Comparable leases of comparable spaces

Fair market rental values are established by looking at similar commercial spaces that are leased in the same area, in the same way that one establishes the value of a property before selling it by comparing similar properties in the area. So if Meredith is located in North Hollywood, comparable leases of comparable spaces would include commercial leases on similar square footage, for similar uses, with roughly similar features and agreements. That means that a 1500 sq ft Chinese takeout two blocks away on a 3 year modified gross lease would be a useful property to consider, while a 1300 sq ft bakery located in Santa Monica would not.

Meredith's landlord wants to charge a higher rent than he's currently getting. After all, he could (presumably) find a new tenant who would pay much more than Meredith is paying. But Meredith points out that her cafe and its success and attractiveness to customers is an integral part of why the area is more desirable than it was ten years ago. She also doesn't think that she should have to pay a higher rent because she's made improvements to the space - after all, that would be like paying for those upgrades twice!

Selecting comparable leases of comparable value is a critical part of establishing FMRV; it's easy to imagine how cherry-picking properties could lead to a fair market value that would be heavily biased in one direction or the other. It is obvious, then, that establishing an impartial appraisal is critical to an equitable FMRV.

So who chooses comparable leases of comparable spaces? That's the job of an appraiser. That appraiser can be hired by the landlord or the tenant, or negotiated between them according to a prearranged system.

In **Part Two** of this series, we'll investigate the primary methods by which an appraiser can be chosen. **Part Three** will outline other considerations that landlords and tenants should bear in mind when establishing agreements, leases, and negotiating new rental rates.

If you or your clients might need appraisal services related to fair market rental value, or any other kind of commercial real estate valuation, please email us at LA@valbridge.com or call us at (626) 486-9327.

SOURCES/FURTHER READING:

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- Herb Myers, “Determining Fair Market Rental Value,” National Real Estate Investor (November 1, 2000).
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