

THE IMPACTS OF COMMERCIAL LEASE STRUCTURES ON LANDLORD AND TENANT LEASING BEHAVIOURS AND EXPERIENCES

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ABSTRACT

The commercial property market in New Zealand is characterized by two standard but distinct lease environments. In Auckland, the commercial core of the economy, net leases dominate, whereas in Wellington, the political capital, gross leases are dominant. These different lease environments have the potential to strongly influence the nature of landlord and tenant relationships in these markets. Using in-depth interviews with key industry personnel, this study examines the perceptions, behaviours, experiences and key issues confronting landlords and tenants under net and gross leases. The paper examines how different lease structures affect the behavioural and attitudinal characteristics of landlords and tenants including: landlord/tenant perceptions of a lease, the operation and maintenance procedures, landlord-tenant relationship, and ultimately, overall satisfaction.

Keywords: alternative lease structures, property management, landlord tenant behaviours, landlord-tenant relationship.

INTRODUCTION

In order to improve business success, landlords are now looking to place more emphasis in maintaining positive relationships with their tenants. This has become particularly apparent in an economic climate where tenants have increased negotiating power (French and Jones, 2010; Rasila, 2010). However, there is evidence that this change to leasing practice is primarily only adopted by more insightful landlords and overall the requirements of tenants are not generally fully understood or provided for by landlords (French and Jones, 2010). The structure of commercial leases, specifically, has been identified as exacerbating this mismatch between tenants' lease requirements and lease clauses (Crosby *et al.*, 2003).

Theoretically, leases should be responsive to the requirements of both landlords and tenants, and with each agreement the interests of both parties should be enhanced

(Jaffe and Yang, 1997). However, there is a growing literature that suggests that many landlords attempt to enforce strongly pro-landlord lease forms by being largely inflexible towards tenant lease requirements (Crosby *et al.*, 2003; Crosby *et al.*, 2006; Dunn, 2003; Edward and Krendel, 2007; French and Jones, 2010; Lizieri *et al.*, 1997). Such lease contracts cause discontent among tenants and have long term negative effects that are detrimental to good landlord-tenant relationships and well-performing leases (Goldman, 2000b; Harris, 2004; Rothenberg and Ruddy, 2004; Saltz, 1990). In the UK, occupier satisfaction surveys (Kingsley Lipsey Morgan and IPD, 2007; Property Industry Alliance and CoreNet Global 2010) confirm a high level of frustration among tenants with the service provided to them by their landlords. The behavioural and attitudinal characteristics of landlords and tenants could have a significant impact on the operation of a lease, the strength of the landlord-tenant relationship, overall satisfaction and, ultimately, profitability for the landlord.

Recognising the significance of the behaviour of key market agents in the determination of market operations, property research in recent years has sought to understand the impact of human behaviours in property processes (Baum *et al.*, 2000; Daly *et al.*, 2003; Diaz, 2000; Diaz III, 1999; Hardin III, 1999; Leishman and Watkins, 2004; Levy and Henry 2003; Levy, 2005; Roberts and Henneberry, 2007). Although in recent times there has been increased diversity in the behavioural real estate literature, the work in this area has tended to focus on appraisal issues (Diaz III, 1999; Pfrang and Wittig, 2008; Roberts and Henneberry, 2007). Despite the growing diversity in lease structures, there is currently limited empirical research on understanding how landlords and tenants behave under different lease environments and the effect of leases on the evolution of landlord-tenant relationships and their overall experience with the lease.

As part of a wider study exploring the operation of alternative lease structures, this paper seeks to increase this understanding by investigating the perceptions, behaviours and experiences of landlords and tenants in the context of two most commonly used lease structures in the New Zealand market: gross and net leases. The study focuses on two distinct New Zealand office leasing markets; Auckland dominated by net leases and Wellington by gross leases. Using key informant interviews, the paper examines the experiences of a set of landlords that manage a total of over 875,000 sqm (9.4 million sq feet) of commercial space located in New Zealand worth in excess of NZ\$4 billion, and tenants (both public and private) that lease in excess of 300 New Zealand office locations. In particular, the following research questions are addressed:

- How do landlords and tenants perceive alternative lease structures and the ability of these leases to meet their lease requirements?
- Are there any differences in landlord and tenant leasing behaviours and experiences under different leases?
- What issues, if any, do they associate with alternative leases?

The remainder of the paper is in four parts. The next section provides an overview of the study and reviews the existing literature that highlights the importance of acquiring an in-depth understanding of the impact of different lease structures on landlord-tenant leasing behaviours. Section two outlines the research methodology and this is followed by the main findings of the study. The concluding section highlights the key findings of the research and comments of the implications of these findings for commercial leasing practice.

CONTEXT AND LITERATURE REVIEW

Traditionally within New Zealand, the office markets located in the two major urban centres of Auckland and Wellington have adopted alternative lease structures (Halvitigala *et al.*, 2011). Auckland, the country's commercial capital and largest metropolitan area comprising over 1.62 million sqm of space (Colliers International, 2010) is strongly driven by the service sector which occupies 60% of the total space (Jones Lang LaSalle, 2005). The Auckland office market is characterised by net leases and is strongly influenced by the presence of institutional investors and corporate tenants. Wellington, which operates as the centre of the government sector, is the second largest office market with a total office stock of approximately 1.46 million sqm (Bayleys, 2010). The Wellington office market where 40% of the office space is occupied by public sector tenants (CBRE, 2008) is dominated by gross leases. In addition, leases in New Zealand are relatively standard in structure and tend to follow one of two distinct formats, the Auckland District Law Society lease, and the Building Owners and Managers Association (BOMA) lease. Given these characteristics, New Zealand offers a significant empirical context for this research.

The major difference between a gross and net lease revolves around the responsibility for the payment of operating expenses (OPEX) (Mooradian and Yang, 2002; Rowland, 2002). Under a gross lease, the landlord pays for OPEX without a separate charge to the tenant (Rowland, 1996). A net lease requires the tenant to pay all, or a portion of a property's OPEX in addition to the agreed rent (Bierschenk *et al.*, 1999). Both landlords and tenants commonly prefer not to take responsibility for OPEX due to the risk of cost escalations affecting the bottom line (Adamshick, 1995; Rowland, 2000). Therefore, negotiations around landlords' and tenants' OPEX responsibilities can be a complex process (Crosby and Murdoch, 1998 as cited in Noor and Pitt, 2009). Rowland (2000) argues that it is not uncommon for landlords or tenants to surrender part of the rent if the other party accepts responsibility for these outgoings.

Many landlords have a strong preference for net leases as they guarantee a constant, predictable long term income stream (Edward and Krendel, 2007; Mattson-Teig, 2000; Rowland, 2002; Rowland, 1996). The benefits of net leases from the tenant's perspective are mainly related to their ability to control the operation procedures of

the building since they too are directly contributing to the running costs (Rowland, 1994). However, several studies have identified that many tenants are unhappy with the quality of services that are delivered by landlords and the service charges that are levied to them under net leases (Cooke, 2007 as cited in Noor and Pitt, 2009; Edward and Krendel, 2007; Noor et al., 2010, Silman, 2007). Net lease tenants often suspect that landlords overspend or manage the OPEX carelessly since they control the nature and the extent of the expenses while tenants have to pay (Edward and Krendel, 2007; Goldman, 2000a; Lewison, 1999; Noor *et al.*, 2010; Rowland, 2002; Silman, 2007). OPEX charges are solely governed by the lease contract without any legislation (Noor and Pitt, 2009; Silman, 2007) and the absence of any legislative instrument causes dissatisfaction among tenants (Noor et al., 2010). In fact, The Loughborough Report (2009), based on the UK market, found that service charges in commercial buildings were higher than necessary and many tenants were frustrated by a feeling of not being able to influence service charge costs (Calvert, 2009). As a result, RICS Code of Practice (2011) strongly encourages a continual communication between landlords and tenants where tenants can have an opportunity to challenge all services procurement and expenses.

The most significant issue with gross leases for landlords is the risk and uncertainty associated with the net return as their investment return can be eroded by OPEX escalations which are sometimes neither within their control nor of direct benefit to them (Wyldbore-Smith, 1990). However, landlord provision of services may mitigate contracting problems and reduce negative interactions and relationships among tenants in multi-tenant properties (Mooradian and Yang, 2002). The certainty associated with the total occupancy costs is of paramount importance to tenants under gross leases (Rowland, 1996). This is particularly advantageous for tenants who occupy premises with high maintenance costs (Mooradian and Yang, 2002). However, there may be an element of under-maintenance under gross leases in order to protect the landlord's net return (Rowland, 1994).

Due to the importance of commercial rents in determining the investment value of properties, the extant literature relating to property leasing has mainly been directed towards examining the financial characteristics of leases and the effect of different lease covenants on investment returns (Adair *et al.*, 1994; Hamilton *et al.*, 2006; Metawa, 1995; Turner and Thomas, 2001a; Turner and Thomas, 2001b). However, Ball *et al.* (1998) suggest that market agents' behaviours may differ from those implied by rational profit-maximization and these differences are influenced by the nature of the agents and their practices. The recent literature therefore has acknowledged the importance of examining the interactions of market agents, as "the essence of property is human behaviour" (Diaz III, 1999) and viewing property markets as the product of the market participants that operate within them (Baum *et al.*, 2000).

The nature of the interaction between landlords and tenants is mediated by the provisions of their lease. However, landlords' and tenants' different lease objectives can cause tension between the two parties. Landlords have financial objectives regarding the cash flow qualities and capital values of their investment and this gives them a different perspective from tenants, who require space to run their businesses (Crosby *et al.*, 2006). Previous studies have provided insights into tenants' dissatisfaction with their leases, as many landlords do not make commercial property available on the terms sought by tenants (Crosby *et al.*, 2003; French and Jones, 2010; RICS, 2005)

The review of the existing literature, although highlighting a number advantages and disadvantages of alternative leases from the landlord and tenant perspectives, fails to provide an in-depth understanding of the impact of the lease structure on their relationship and resultant behaviours. Research relating to lease structures has tended to focus on the effects of economic factors on the financial return of a property investment. Given the potential impact of the way the lease is structured, it is important to understand landlords' and tenants' behaviours, experiences and the key issues confronting them under different lease environments.

METHODOLOGY

The focus of this study is to explore and gain an in-depth understanding as to how landlords and tenants behave under alternative lease structures. In-depth key informant interviews with landlords and tenants were utilised as the most effective data collection method and the interviews were conducted in 2008 and 2009. Six commercial portfolio managers representing the three largest property trusts in New Zealand were interviewed. These managers between them were responsible for the management of in excess of 875,000 sqm of commercial space (approximately 30% of the total office space in the Auckland and Wellington markets) worth in excess of NZ\$4billion. In addition, eight of their major office tenants were interviewed who between them leased over 300 New Zealand office locations. Out of six landlords interviewed, four were commercial portfolio managers of the top three property trusts and the other two were commercial portfolio managers of two unlisted property funds managed by one of the top three listed property trusts. The property trusts represented in the interviews made up more than 75% of the total asset value of the commercial properties held by the New Zealand LPT sector in the year 2009 and 65% of their total value of all assets. The two unlisted property funds also owned commercial portfolios worth more than NZ\$1 billion with approximately 334,000m² of net lettable office space. All interviewees held the ultimate responsibility for leasing and other property related decisions for the entire property trust or their Auckland or Wellington portfolio. Details of the landlord interviewees are set out in Table 1.

Table 1: Profiles of the landlord interview participants

Job title	Value of the commercial	Total NLA managed	Type of commercial properties owned
National Commercial	856.17	170,968	Prime quality
Wellington Portfolio Manager	817.45	146,046	Prime quality
Auckland Portfolio Manager	751.50	106,889	Prime quality
General Manager	390.00	117,810	Prime & secondary quality
National Asset Manager	540.44	144,028	Prime & secondary quality
Asset Manager	650.13	190,598	Prime & secondary quality

The eight tenants represented both the private and public sectors and were chosen on the basis of their business sector, geographical distribution, significance in the market, and the ability to provide meaningful insights into their leasing behaviours. Among the participants, three were large public sector tenants and of the five private sector tenants, two were large international tenants, two were large national tenants and one was a large New Zealand university. Approximately 75% of the participant organisations employed more than 1000 employees and occupied more than 50,000m² of space throughout the country. All interviewees held senior managerial level positions within their respective organizations and had extensive property management and commercial leasing experience. Details of the tenant interviewees are set out in Table 2.

Table 2: Profiles of the tenant interview participants

Sector	Job title	Base of the organization	No. of office locations in NZ
Public	National Property Manager	National	200
Public	Senior Property Advisor	National	23
Public	Director, Corporate Services	National	3
Private	Senior Property Manager	International	47
Private	General Manager, Property & Operations	International	7
Private	Senior Property Manager	National	22
Private	Corporate Manager	National	3
University	Property and Project Manager	National – Auckland based	Cluster of office & educational properties in 4 locations

Landlord interview questions were designed to elicit in-depth understanding of their perceptions of gross and net leases and their leasing behaviours, preferences, experiences, satisfaction and issues under the two lease types. While the topic areas contained in landlord and tenant interviews were reasonably similar, the specific questions reflected their different perspectives. For instance, landlords were asked: “How do you describe the operation and maintenance procedures of gross and net leased buildings in your portfolio?”, while tenants were asked: “How satisfied are you with the operation and maintenance procedures of the building you are occupying?”. Table 3 sets out the main topics examined in landlord and tenant interviews.

Table 3: Main topics examined in landlord and tenant interviews

Landlord interviews	Tenant interviews
<ul style="list-style-type: none">▪ Landlords' preferred lease type vs. current lease types▪ Basis of determining the lease type to be offered▪ Tenants' influence in lease negotiations▪ Advantages and disadvantages of gross and net leases▪ Financial performance of gross and net leases in terms of net return, risk and building capital values▪ OPEX sharing procedure and associated problems▪ Operation and maintenance procedures of gross and net leased buildings▪ Landlord-tenant relationship under alternative leases▪ Landlords' overall satisfaction with gross and net lease structures	<ul style="list-style-type: none">▪ Tenants' preferred lease type versus current lease types▪ Basis of determining their preferred lease type▪ Nature of influence in lease negotiations▪ Nature of influence in the operation of the lease▪ Advantages and disadvantages of gross and net leases▪ Tenant responsibility for OPEX, problems associated with them and their level of satisfaction▪ Satisfaction with the operation and maintenance procedure of leased premises▪ Nature of relationship with the landlord▪ Overall satisfaction with the lease

RESULTS

All interviews were audio-taped with the consent of the interviewees and transcribed. The transcripts were analysed using a thematic analysis, from which a number of themes emerged and these were categorised as follows:

- Landlord and tenant perceptions towards gross and net leases
- Financial implications of leases on investment returns
- OPEX recovery process
- Property operating and maintenance process
- Landlord-tenant relationships

Landlord and tenant perceptions towards gross and net leases

Overall, landlords expressed a strong preference for triple net leases permitting them to recover all property running expenses from tenants. They perceived the net lease as a commercial imperative which aligned the objectives of landlords and tenants far more thoroughly in terms of maintaining landlords' net return and providing a high level of service to tenants. They believed that net leases were conducive to reducing financial risk and uncertainty. They argued that the increased certainty protected them

from fluctuations associated with OPEX and thus made for more stable investment portfolios. The uncertainties associated with returns, and the difficulties in matching building services with tenants' needs, were considered the most significant problems related to gross leases.

Despite landlords' strong preference for triple net leases, gross leases dominated their Wellington portfolios. The strong influence of public sector tenants in the Wellington market was the key factor preventing landlords from implementing their preferred form of net lease. Public sector tenants had a strong preference for gross leases mainly due to an aversion to cost uncertainties, a potential distrust of landlords' OPEX management processes, and a reluctance to take responsibility for any property management activities. As one public sector tenant explained, *"the simple fundamental is that we are not here to manage property, we just want to pay the rent and not have to worry about anything else"* (Public Tenant 1).

Larger tenants possess greater negotiating strength and access to information, resulting in them being more likely to negotiate lease structures that are more favourable compared to their smaller counterparts. The tenants interviewed noted that public sector tenants had, under the direction of the State Services Commission and Government Treasury, a coordinated approach to lease negotiations. This approach provides an ability to negotiate more tenant-favoured leases and to implement stronger protection mechanisms to ensure that landlords meet their lease obligations, particularly in the area of building maintenance. Conversely, the ability to control the operation and maintenance standards of the property, and the opportunity to be more involved in the management of properties, were identified as the main reasons corporate tenants prefer net leases. International tenants tended to express a stronger preference for net leases than national private sector tenants, which could be a result of their familiarity with net leases internationally. It was interesting to note that with the exception of one private sector tenant interviewee, no mention was made of the cost implications related to net leases. This suggests that large corporate tenants tend to be more concerned with the quality of their premises as opposed to their occupancy costs. To illustrate this, one international corporate tenant stated: *"If you want to be a mean and miserly government tenant who worries about every dollar you spend - the gross lease is the best answer. To me net lease is the commercial reality, [for] proactive and informed people in business"* (Private Tenant 1).

The different perceptions of public and private sector tenants regarding alternative lease structures reflects the importance that large corporate tenants place on having high quality premises, whereas public sector tenants, being more financially constrained and less market driven, are more averse to cost uncertainty. The results from these interviews strongly suggest that tenant perceptions of alternative leases structures vary with expectations and priorities, financial constraints, willingness to take part in the management of the premises, previous lease experiences and trust in

the landlord. In contrast, landlords' perceptions of lease structures are primarily focused on the financial returns.

Financial implications of leases on investment returns

Consistent with the views of the existing literature (Sirmans and Miller, 1997; Turner and Thomas, 2001a; Turner and Thomas, 2001b), all landlords interviewed emphasised that lease structures have the potential to significantly impact upon the delivery of property investment returns. When discussing leases in general, landlords strongly believed that due primarily to the uncertainty of OPEX, properties subject to gross leases were more at risk of receiving lower, and more volatile, net returns than those on net leases. It was further stressed that the returns delivered by alternative leases could differ substantially if the landlords were small scale, unsophisticated, operating in isolation and with poor OPEX purchasing powers. Landlords argued therefore that gross leases have the potential to add more uncertainties to the investment and thus have a significant negative impact on the net return and the property's capital value.

All landlords suggested however, that in their own portfolios there was *no* significant difference in the net return of their gross and net leased properties albeit their strong reservation regarding gross leases. As explained by one landlord:

“Large property funds operate both gross and net leases in a similar way, so that puts away a lot of arguments about pros and cons of different leases. But for small, less sophisticated landlords with poor OPEX purchasing power, gross leased buildings will definitely be a poorer performer” (Landlord 1)

All of the landlords interviewed maintained that their comprehensive management philosophies as large institutional investors, combined with their economies of scale, strong purchasing power over OPEX, carefully prepared budgeting exercises and long term contracts with service providers had significantly minimised the risk of OPEX price inflation. Notwithstanding their strong cost management practices, it was suggested that the impact of leases on return delivery depended on general inflation in the economy and the inflation in OPEX prices. Inflation would add to the uncertainty surrounding the net return of any gross leased property despite landlords efficient lease management procedures unless they had secured long term contracts with OPEX service providers.

The interviews with tenants identified a significant discrepancy between the perceptions of public and private sector tenants on the effect of leases on landlords' investment returns. Public sector tenants had a strong perception that landlords' returns should not be affected whether the lease is a gross or net, as gross rentals should include a fair and reasonable figure going forward to cover uncertainties. Interestingly, they expressed strong criticism of the unsophisticated analyses

undertaken by some landlords and valuers (Halvitigala, *et al.*, 2011) when determining rents under alternative leases. They commented that the gross rents set by some landlords were at a lower rate than they considered they should be, since landlords focussed only on the major OPEX items and other OPEX items are invariably undervalued or completely ignored. These comments raise questions regarding the ability of market participants to accurately ascertain the effect of lease obligations on rental levels.

The majority of private sector tenants, in contrast to the public sector interviewees, suggested that the fixed rent under gross leases had a negative impact on landlords' net return. As explained by one private sector tenant;

The return of a landlord with gross leases is degraded by the fact that he has a fixed income stream though he doesn't have a fixed expense. So the end result is that the landlord with gross leases manages down their OPEX" (Private Tenant 3).

Overall, the perceptions of the landlords and tenants indicate that even though lease structures can have an impact on the delivery of investment returns, the direction and the size of this impact would mainly be determined by the size and sophistication of the landlord. In situations where landlords are large scale, with effective management strategies, properties on alternative lease structures generate reasonably similar net returns. Notwithstanding their preference for triple net leases, institutional landlords such as listed property trusts are therefore in a position to offer different lease types and minimise any negative impact associated with such leases.

OPEX recovery procedures

In order to examine if landlords and tenants experienced any issues when interpreting, calculating and allocating the OPEX under net leases, interviewees were asked to discuss their experience with the OPEX recovery process and the problems associated with it. The landlord interviews clearly indicated that major landlords recovered almost all property running costs from their tenants on net leases. All landlords interviewed believed that it was in the tenants' best interest to pay for OPEX if they wanted to have an influence over the manner in which the building was operated. However, they were unlikely to consent to tenants taking responsibility for the OPEX management procedures, even in the circumstances where the tenant had a comparative cost advantage or expertise in building management. There was a strong desire, expressed by all of the landlords, to retain total control of the building management.

Significantly, public and private sector tenants differed in their views relating to their responsibility for OPEX. There was a strong belief amongst public sector tenants that property management should be the responsibility of the landlord and thus they did

not wish to have any responsibility for OPEX. Importantly, even though the private sector tenants were in favour of net leases, they were not totally in favour of landlords being in complete control of arranging service providers for the building. They indicated that the inability to arrange their own service providers had jeopardised their ability to match their required standard of work.

Landlords emphasised that apart from some tenant enquiries to verify OPEX calculations at the end of OPEX reconciliations, there were no significant problems associated with the OPEX recovery process. As one landlord interviewed stated, “*in OPEX wash-up time you might get 3 or 4 enquiries, but nothing of any real consequence*” (Landlord 4). This result seems to contradict the findings of previous studies that suggest that the OPEX recovery process has the potential to create problems between landlords and tenants (Goldman, 2000a; Harris, 2004; Rothenberg and Ruddy, 2004). Landlords emphasised that the OPEX recovery process would only be problematic if the lease contract was vague or if landlords tried to overcharge or pass on illegitimate expenses onto tenants. They highlighted several procedures that they had implemented to minimise the opportunities for conflicts in the OPEX recovery process for their portfolios as illustrated in Table 4.

Table 4: Steps taken by landlords to minimise the conflicts in OPEX recovery process

Well interpreted and well documented lease contracts

Proper negotiation of the landlord’s and tenants’ OPEX responsibilities at the start of the lease

Meticulous approaches in interpreting, calculating, recording, allocating and implementing OPEX

Accurate calculation of OPEX to ensure only legitimate costs are passed through

As ethical landlords they do not make any profit from their OPEX

Tenants are entitled to review landlords’ OPEX records and question or dispute the charges

Punctuality when dealing with OPEX reconciliations

In contrast, the majority of net lease tenants interviewed had experienced dissatisfaction regarding the allocation of OPEX. Three out of four net lease tenants believed that they were being overcharged, invoiced for items not legitimately considered as part of OPEX or experienced inefficiencies and delays associated with the OPEX reconciliation. As explained by two tenants:

“Our landlord would charge us for things we believe that should not be part of the OPEX” (Private Tenant 5)

“Some of our landlords are slow, so you are dealing with OPEX calculations that are 2 (even 3) years out of date” (Private Tenant 4)

All of the tenants indicated that large and/or strategically important tenants tended to have relatively less conflicts regarding the OPEX recovery process, since landlords were more prepared to resolve issues with larger tenants. One large international tenant confirmed that they receive all proposed OPEX and capital improvement budgets each year from their landlord and are given the opportunity to discuss and debate or include further items. As he explained, *“it allows us to have transparency over the OPEX, what’s spent, and to have some input into those budgets and control them” (Private Tenant 2)*. It was also suggested by this interviewee that small strategically less important tenants, with less influence, may not be offered this opportunity and that this could result in them being more dissatisfied with their OPEX payments.

Landlords and tenants expressed different views on the distinction between the OPEX and capital expenses resulting in significantly different opinions regarding which of the landlord’s costs should be recovered. The landlords interviewed revealed that they did ‘pass through’ a number of expense items which have been identified as non-recoverable expenses, such as management fees, sinking fund contributions and corporate fees (Christiansen, 1988; Hennigh, 2004; Hollyfield, 1994). Even though the use of sinking funds in leases is declining within the industry (Eccles and Holt, 2010), the majority of landlords had provisions for tenant contribution for sinking funds. The landlords’ ability to include such items in the OPEX reflects the bargaining strengths of these large-scale landlords and the quality of their building stock located in prime locations.

Net lease tenants expressed strong reservations in respect of the payment for certain types of expenses which they thought of as ownership related expenses. These included; any contribution to capital expenses, sinking fund contributions, corporate fees, ground rent, and management fees. As explained by an international tenant:

“There are a couple of things in net lease that I believe the tenant should not be responsible for. Management fees and corporate fees would be an absolute no, no as far as I am concerned. Also, there shouldn’t be any place for sinking fund contributions because it is not my job to maintain the landlord’s investment” (Private Tenant 1).

Overall, the results highlight the differences in perceptions and experiences of the OPEX recovery process between landlords and tenants. It is clear that tenants are

more dissatisfied with their OPEX responsibilities than landlords perceive they are. The main reason for this could be the differences in objectives of landlords and tenants in terms of OPEX responsibilities. Landlords try to maximise their net return by passing on OPEX to tenants, while tenants try to minimise their occupancy costs by avoiding them. These differing objectives can create conflict between the two parties from time to time. The interviews strongly suggest that this issue may be more significant for those tenants who have less influence or power over the landlord.

Property operation and maintenance (O&M) procedures

Conflicting opinions were expressed by the landlords interviewed regarding their approach to O&M under gross and net leases. Two of the landlords argued that there was a potential for under-maintenance of properties under gross leases, as landlords would be reluctant to increase the amount of OPEX unless it increases their returns substantially. This situation may be more evident when the lease provisions are vague and when the tenants are less influential. One landlord stated:

“I know for a fact that landlords who run gross leased buildings won’t spend money where they should and that is a detriment to the level of service the tenants get” (Landlord 3).

Three of the landlords interviewed indicated that they paid equal attention to the O&M standards of their properties no matter what the lease type. Justifying their decision, they explained that poorly maintained premises would have several long-term negative impacts such as; unnecessary increases in OPEX, lower rents on rent reviews and lease renewals, limited tenure choices, highly obsolete buildings, lower capital value of buildings, high tenant turnover, less influential power in lease negotiations, potential damage to landlord-tenant relationship and inefficiently operating buildings. However, even these landlords admitted that spending money on gross leased buildings would not be worthwhile if the borrowing costs for the investment are higher than the net return from the property.

Interestingly, one landlord indicated that he was inclined to pay more attention to the O&M standards of gross leased buildings as any savings made on OPEX would increase the net return between rent reviews. He stated *“We pay more attention to the gross on the basis that any savings we make on OPEX goes directly on capital which adds to the value” (Landlord 5)*. But he also acknowledged that he tended to be over-zealous in the care of net leased properties knowing that those costs were recoverable.

Tenants’ attitudes towards the O&M procedures seemed to be influenced by the type of occupier. Public sector tenants tended to have a large sphere of influence within their local market and thus had the power to ensure that their properties were operated and maintained to an acceptable standard. All public sector tenants believed they had adequate provisions in their gross leases to prevent the premises from becoming

neglected. One interviewee suggested that they would not hesitate to issue notices, or take actions, if the landlord showed little or no interest in the care of the property:

“We’ve got enough clout in our lease that if the owner doesn’t perform and we’ve given him due notice then we go ahead and do it and charge” (Public Tenant 2).

Among the private sector tenants interviewed, international organisations tended to express more concern regarding the quality standards of gross leased buildings than the New Zealand tenants. These concerns may reflect their relative unfamiliarity with gross leases and their requirement for relatively high quality business environments. As explained by an international tenant who had experience in occupying premises on both net and gross leases:

“In our net leased buildings we might say ‘we’ve got problems with the AC’, someone will be there to fix it straight away and send us the bill. But with gross leases you’re constantly trying to get them to do something because they don’t want to spend any more money” (Private Tenant 1).

Interestingly the national corporate tenants did not feel that the O&M processes associated with a net lease were more effective than the O&M processes of a building leased out on a gross basis. Some even suggested that in their opinion no major differences existed between the O&M processes under the two lease types.

Overall, the results suggest that the nature of the landlord and their management philosophy, in conjunction with the tenants’ ability to influence the landlord, the length of lease, provisions in leases to prevent premises from being neglected, and landlords’ reporting requirements towards tenants, would determine how landlords operate and manage properties under alternative leases. From the tenants’ perspective, their lease priorities, expectations of the building quality, specialist knowledge and expertise in building O&M processes, and their skills in the detection of inefficiencies in O&M procedures are some of the main factors affecting their satisfaction levels. The results highlight the nature of ongoing power dynamics between the landlord and tenant. If the tenant has significant influence over their landlord, it is more likely that the landlord will ensure that the tenant’s requirements are well catered for. Tenant dissatisfaction may be more likely in the case of tenants who have little or no ability to influence the landlord.

The landlord-tenant relationship

Both landlords and tenants perceived that the landlord-tenant relationship was affected by the lease type and this was particularly the case for tenants. Significantly, both parties perceived that the strength of the landlord-tenant relationship under gross leases tended to be stronger than that of landlords and tenants on net leases. The

landlords highlighted the benefit of the ‘simplicity’ associated with gross leases in reducing problems with tenants;

“Under net leases you get more questions about the OPEX. You may tend to have better relationships with the tenants under gross leases because you don’t have to debate or discuss potential arguments around OPEX” (Landlord 1).

Tenants identified a number of reasons for the differences in relationship strengths under gross and net leases as summarised below:

- Gross lease tenants are less likely to have to negotiate on matters relating to OPEX thus eliminating the potential for conflict
- Some net lease tenants believe that they are being overcharged or incorrectly charged
- Visibility and transparency in respect to OPEX under net leases can create conflict in the circumstances where the tenant believes that the landlord has spent money unnecessarily.

This finding is consistent with the views of Rothenberg and Ruddy (2004) who suggest that disputes over OPEX can have a negative impact on the landlord-tenant relationship. The analysis of the interviews also indicated that the ‘quality of the premises’, ‘covenants of the lease’, ‘landlords’ and tenants’ willingness to invest in a relationship’, ‘extent of trust in the relationship’, and the ‘length of occupancy’ had the potential to affect the nature of the landlord-tenant relationship. In addition, the landlord’s ‘level of responsiveness’, ‘understanding of tenants’ business needs’, ‘accessibility’ and ‘extent of professionalism in the relationship’ have a significant impact on how tenants perceive the relationship.

Despite the lease type, the majority of tenants were frustrated with the difficulties in communicating with the landlord. This frustration stemmed from landlords being ‘slow to respond to requests’, ‘not responding at all’, ‘not following up’, ‘not being available to discuss issues’ and ‘not keeping tenants informed about what was happening in the building’. This resulted in their viewing the landlord and their relationship negatively.

A common view across both landlords and tenants was that landlords tended to have a stronger relationship with their large, strategically important, tenants no matter what their lease type. All landlords emphasised that they were strongly motivated to maintain good relationships with their major tenants, since those tenants were more important in terms of revenue generation, long term image of the building and the ability to attract further high quality tenants. They clearly indicated that the time and attention they were prepared to allocate to tenants would be proportionate to the income that particular tenants generated, and thus the strongest and most desirable

tenants tended to receive more attention and higher relationship benefits. As one interviewee put it, *“timewise I am not going to spend as much time with a retailer whose rental is \$20,000 a year as opposed to someone else whose rental is \$2.5 million”*(Landlord 2).

This observation suggests that many large scale landlords are not interested in maintaining the same level of relationship with all of their tenants, but will put more effort into those tenants paying more rent and those with higher reputations. This was emphasised by the majority of landlords who described their relationship with major tenants as a ‘business partnership’ and their relationship with strategically less important tenants as more ‘adversarial in nature’. As explained by one landlord:

“As they occupy the whole building or a large portion of it we’re in a partnership, they’ve got involvements in the decisions we make about the buildings. But in a multi-tenant property, if you’re going to do a refurbishment, you just do it; whether the tenants like it or not, you don’t have to care” (Landlord 5)

This finding was strongly supported by all of the tenants interviewed who confirmed that large scale tenants experienced stronger relationships with their landlords and were treated as more valued customers than their smaller counterparts. This resulted in landlords giving these larger scale tenants preferential treatment and maintaining frequent contact with them in order to provide opportunities to discuss any issues and concerns.

These results highlight the significance of on-going power dynamics between landlords and tenants. It was apparent that the stronger the relationship and the respect the landlord had for the tenant, the greater the potential for tenants to influence the operation of a lease. This close relationship may explain why major tenants tend to be more satisfied with their accommodation and enjoy certain benefits of scale. Overall, landlords tend to adopt differentiated relationship strategies with tenants and are partial towards more desirable tenants. Thus, the strategic importance of certain tenants in a building can have a significant impact on the nature and level of their relationship with the landlord.

CONCLUSIONS

This paper examines the behaviours, perceptions, experiences and key issues confronting landlords and tenants when contracting under alternative lease structures. The study focuses on gross and net lease structures in two of New Zealand’s largest commercial centres, Auckland and Wellington.

The results highlight that the nature of the lease not only has significant financial implications for net returns, but also non-financial outcomes, including the operation

and maintenance procedures of the premises, the landlord-tenant relationship, and ultimately, overall landlord/tenant satisfaction. All landlords interviewed expressed a strong preference for triple net leases which allowed them to recover all the property running expenses from tenants. Yet, despite their strong preference for fully recoverable net leases, their leasing strategies and behaviours were affected by the prevailing dominant lease type operating in sub-markets (e.g. Auckland has net leases and Wellington has gross leases).

Major differences between the perceptions, behaviours and experiences of private and public sector organisations, as well as international and national corporate tenants, were identified. Public sector tenants in general tend to favour gross leases, while the international and national corporate tenants favour net leases. Public sector tenants indicated that their preference for gross leases was due to their aversion to cost uncertainties, together with a potential distrust of a landlord's management of recoverable expenses. On the other hand, large scale corporate tenants tend to be more concerned about the quality of their premises, as opposed to their occupancy costs. International private sector tenants tended to express a stronger preference for net leases than national private sector tenants, which may be a reflection of their familiarity with net leases.

The interviews also demonstrated the significance of the balance of power between landlords and tenants, and that leasing behaviours, perceptions and experiences were affected by on-going power relations. The interviewees clearly articulated how power dynamics affected both tenants and landlords and can have a major impact on lease negotiation, building O&M procedures and the nature of the landlord-tenant relationship. While the interviews confirmed the power of landlords to shape the leasing environment it also highlighted the power of key tenants. In contrast to accounts that posit a uniform landlord dominated environment, our study reveals a more fluid set of power asymmetries. Under certain circumstances, tenants can and do exercise considerable influence. In particular, power asymmetries in areas such as the size, sphere of influence, specialist knowledge, information availability, leasing experience and market conditions, are used by large-scale tenants to influence their landlords' leasing decisions. If a tenant has significant influence over their landlord, it is more likely that the landlord will ensure that their requirements are well catered for. The landlords tend to be more flexible towards those they classify as important tenants, but not necessarily towards those considered to be of less importance.

Given the strong preferences from landlords, and the acceptance from large corporate tenants, the interviews indicate that net leases are becoming more commonplace, particularly in new lettings. However, the interviews also suggest that both landlords and tenants do not expect significant changes in the operation of the New Zealand leasing market or their leasing strategies in the near future. In this context, both the Auckland and Wellington commercial leasing markets are characterised by persistent

path dependencies or institutional inertia. Yet, notwithstanding this inertia, it is clear that landlords and tenants are willing to be flexible in lease negotiations and management practice. In, particular, it is clear that larger tenants hold considerable sway with landlords, whether public bodies demanding gross leases or large corporates demanding services. Going forward, the need to manage large tenants will alter practices and behaviours in the market. Large tenants and landlords that espouse strong environmental and social responsibility agendas will likely promote the rise of green leases in the market. In addition, it is likely that successful landlords and tenants will increasingly seek to manage the transactional dimensions of their interactions in a mutually beneficial way. These trends point toward the need for a more sophisticated set of tenant-landlord practices and behaviours that move beyond simple adversarial rent setting negotiations, to more of an ongoing partnership.

The current research highlights the value of analysing how key market agents actively create, and consequently interact and behave, in different lease environments. The analysis offers a context for developing a deeper understanding of the operation of alternative lease structures in a national market. By focusing on the behaviour and experiences of key market actors, the findings provide useful insights into landlord-tenant dynamics in New Zealand commercial property markets. Although this research focuses on the behaviours and experiences of large scale landlords and tenants, anecdotal evidence from informal discussions with the interview participants suggests that the behaviours and experiences of small scale landlords and tenants may be significantly different. A study addressing the perceptions, behaviours and experiences of small, less sophisticated, landlords and tenants under alternative lease structures would add another dimension to the findings of this research.

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