"Blend and Extend" Transactions:

Proactive P&L Management for GAAP-Reporting Organizations

savills

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A core misconception about commercial real estate leases stems from the belief that a lease term is permanently fixed and prohibits interim action by tenants who seek to restructure real estate expenses. For any number of reasons, a tenant may come to find themselves in a situation where they are leasing space at a premium to the market. This most commonly arises after a market correction or simply due to scheduled base rent increases and accrued expense escalations. Situations like these can leave a tenant who was otherwise paying a "fair market value" for its space subject to premiums of 10%, 20% or even 30% above current market pricing.

One tactic utilized by many proactive companies is the strategic early negotiation of extension term often referred to in the industry as a "blend and extend" transaction.

This name derives from the action of extending a lease's term in exchange for the opportunity to blend down the P&L rental rate on what amounts to a new long-term lease obligation. The following example (*Figure 1*) displays a situation where "Tenant X" originally signed an 11-year lease in 2013 where the combination of term, base rent, free rent and tenant improvement allowance ("TI Allowance") resulted in a GAAP (straight-line equivalent) rent of $24.45/SF over the term of the lease. By July 1, 2021 (8 years into the lease), we assume that Tenant X has incurred operating expense and real estate tax escalations of $2.50/SF, which when added to the GAAP rent, lead to a full current P&L rent of $26.95/SF. You will note that the correlating cash expense for this lease is currently $35.50/SF due to base rent increases and expense escalations.

FIGURE 1:

Original Lease Terms

Commencement:	1/1/2013
Expiration:	12/31/2023
Term:	11 years
Free:	10 months
Starting Rent:	$30.00
Mid-Bump:	$33.00
TI Allowance:	$50.00

July 1, 2021 Lease "Vitals"

Remaining Term:	3 years
GAAP Rent (Constant):	$24.45
2020 Expense Escalations:	$2.50
Total 2020 P&L Cost*	**$26.95**
Total 2020 Cash Cost	**$35.50**

* Excludes Tenant Improvement Depreciation

FIGURE 2:
Proposed Early Extension

Added Rent Term:	5 years
New Free Rent:	5
New Expiration:	6/30/2029
Extension Term Rent:	$25.00
New TI Allowance:	$40.00
Extension GAAP Rent: (with new base years in 2024)	**$15.69**

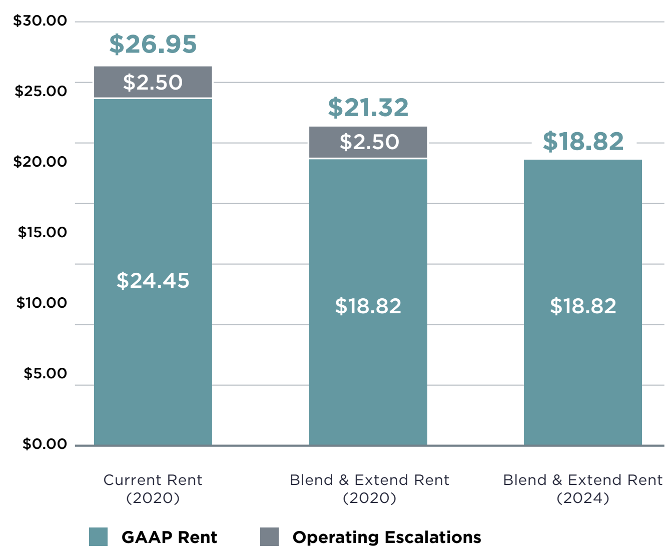
In this example, Tenant X now finds itself in a re-priced market due to macroeconomic factors. By leveraging this market dynamic and seeking to offer the Landlord the benefit of additional term during uncertain times (and mitigating future vacancy risk), Tenant X may compel its Landlord to proactively extend the term of the current lease for an additional 5 years and 5 months *(Figure 2)*. Here, it is evident that the new GAAP (straight-line equivalent) rent on the extension term is $15.69/SF due to: a) a drop in base rental rate; and b) more importantly, the amortization and deduction of the new concessions (TI and free rent) from the GAAP base rent.

Tenant X may now average its remaining lease term (3 years) at its current GAAP rent ($24.45/SF) with the 5.5 years of new extension term GAAP rent ($15.69/SF) to create a new 8.5 year obligation that equates to $18.82/SF commencing immediately ($21.32, once the current base year escalations are added back) *(Figure 3)*. By adding term at a discounted rate, Tenant X has now reduced its P&L rent expense immediately by nearly 20% without changing the Landlord's cashflow. The rent is further reduced when the new escalation base years of the extended term commence in 2024. Additionally, it may be possible for Tenant X to extend the term of its depreciation schedules on leasehold improvements and equipment, further lowering P&L costs.

Importantly, opportunities may exist to engineer the transaction to create larger immediate savings (although often at the expense of later years) via structuring the reset of expense base years in a particular way (as can be seen in Figure 3, the 2024 GAAP rent is lower than the 2020 GAAP rent). In these uncertain economic times, any blend and extend transaction should also have provisions that include additional rights and options such as those reserving the right to reduce square footage now and throughout the new lease term.

While these transactions may not provide relief to a cash-strapped tenant (although many landlords will offer to bring forward all or part of the free rent and TI allowance to today), they can provide significant benefit to any firm seeking to stabilize its long-term P&L expenses at competitive levels years ahead of a contractual lease expiration.

FIGURE 3:
P&L Rent Impact of Blend & Extend



By Matt Barlow and Nate Brzozowski

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