Northwestern Kellogg School of Management

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Tulaberry Plaza:
Leasing Decisions in Commercial Real Estate

"This isn't as easy as I thought it would be," Benedict Clarke murmured to himself. It had been only three years since Clarke had purchased a thriving retail shopping center outside of Orlando, Florida. Now, in January 2019, his anchor tenant had declared bankruptcy, and vacancies in his inline spaces had been more difficult to fill than he had anticipated, given the rise in online shopping.

The Property

Tulaberry Plaza was a 59,100-square-foot gross leasable area (GLA) neighborhood shopping center located in the Southeast Orlando submarket (**Exhibit 1**). The property contained two buildings, with 8,650 and 50,450 square feet of leasable space, respectively. Located nearby, but not part of the property, were two freestanding buildings currently occupied by banks. The property was located across the street from a Publix grocery store (**Exhibit 2**).

Clarke's initial years of ownership had been rather uneventful, but the property's anchor tenant, a nationwide electronics retailer, had recently vacated its space and ceased paying rent. Looking over the property's site plan (**Exhibit 3**) and rent roll (**Exhibit 4**), Clarke realized that he would have to address the shopping center's vacancies. He also considered that the leases of some of his existing tenants would soon expire. Wishing for an existing tenant to vacate might have seemed counterintuitive, given the changes that were undoubtedly facing the shopping center. Nevertheless, Clarke wondered whether upcoming lease expirations were an opportunity

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to change the overall tenant mix. Of course, his experience suggested that every vacated space typically took six months to fill and required potentially significant tenant-specific improvement expenditures (TIs).

Leasing Opportunities and Costs

With significant vacancy and lease renewals, Clarke realized that leasing commissions (LCs) and TIs were major costs to be considered in the operation of Tulaberry Plaza over the near term. His leasing broker, Alice Cho, charged a commission of 3% of total lease revenue (total rental payments less TIs) for new tenants, and 1.5% for renewing existing tenants. These commissions were due immediately upon the signing of a new lease.

TIs varied widely according to the type of tenant, so Clarke carefully reviewed a list of prospective anchor tenants, which Cho had put together for him, that outlined each tenant's specific lease terms, including their TI needs (**Exhibit 5**). Clarke noticed immediately that the lease terms offered by the potential anchor tenants differed not only in terms of required TIs but also in terms of base rent and term. Cho had also provided similar information for potential inline tenants (**Exhibit 6**).

Clarke understood from Cho that the most important decision he needed to make was how to fill the anchor space in the shopping center. An anchor tenant tends to drive traffic to other stores in a plaza, and as a result, is typically offered lower rent on a per-square-foot basis. An anchor's ability to drive traffic to inline stores depends crucially on the similarity of the anchor's typical customer and the demographics of the local population.[1] Thus, Clarke had to give serious thought to which tenants would be best for Tulaberry Plaza.

The Decision

Clarke understood that he needed to act quickly. Because his tenants had triple net leases, Clarke didn't personally incur any operating expenses. However, he was responsible for any capital expenditures on the property, which historically averaged around $85,000/year. He also had annual mortgage payments on the property of $750,000/year. He certainly didn't want to think about what might happen if he didn't make every mortgage payment on time. As he sat down at his desk to start crunching some numbers, the words "Skilled financial analysts can make a spreadsheet to justify anything—so think carefully about your assumptions," echoed through his head. If only he could recall where he had first heard them . . .

[1] There were currently just over 5,300 people (2,200 households) living within three miles of the shopping center, with a median age of 43, household income of $104,000, and home price of $403,000.

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