Leases, Contracts and Legal Due Diligence (Real Estate)

Interview preparation summary · RE track

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INT.EG.1.a · Leases and tenants

Explain how term, break options, rent-free periods and other incentives change the income a lease really delivers, and which protections a buyer asks for.

A lease is a bundle of promises and each one moves value. The term and the break dates decide how long income is contractually secure, and a tenant-only break is an option the landlord has written for free. Rent-free periods and capital contributions are incentives that lower the net effective rent below the headline, so the number in the tenancy schedule overstates what the tenant pays over the term. Buyers look for protection when the break is exercised: a break penalty, often sized at several months of rent, that repays the unamortised incentive; conditions on the break such as no arrears and vacant possession; and notice periods long enough to re-let. Practice varies: US leases more often use termination fees and fixed escalators, English-law leases more often use rent reviews and breaks. The interviewer is testing whether you read the clause before the yield. The usual mistake is to treat the break date as the end of income only in a downside case and to price the headline rent as if it were fully paid.

WORKED EXAMPLE: CALDER POINT: HEADLINE RENT VERSUS THE RENT A TENANT REALLY PAYS

Calder Point is an invented distribution unit let on a 10-year lease at a headline rent of 1.20m a year, with the first 12 months rent-free. The tenant has a break at the end of year 5. Calculate the net effective rent over the full term, the effective rent if the tenant breaks at year 5 with no penalty, and the penalty that would give the buyer the same effective rent as the full term. Ignore discounting and indexation.

Answer: Effective rent is 1.08m over the full term, 0.96m if the tenant breaks at year 5 with no penalty, and a 0.60m penalty (6 months) restores 1.08m. Price off the effective rent, and treat the break as an option the tenant owns.

> **Interview tip:** Say that a headline rent is not what the tenant pays, then give the effective figure and the clause that protects it. Keep the conditions on the break in view: a penalty with no security behind it is only a claim.

INT.EG.1.b · Leases and tenants

Describe repairing, service charge and alienation clauses, and say which costs and risks each leaves with the landlord.

Who pays for the building is a legal question before it is a financial one. A full repairing and insuring lease puts repair and insurance on the tenant, while an internal repairing lease leaves structure and common parts with the landlord, usually recovered through a service charge. The lease wording decides what is recoverable, whether the charge is capped or fixed, whether a sinking fund exists for big items such as lifts and roofs, and who bears the cost on vacant space. A cap or a fixed contribution turns a pass-through into a landlord leak that falls straight to net operating income. Alienation clauses control assignment, sub-letting and sharing, and a tenant who can assign freely to a weak covenant weakens the income; authorised guarantee agreements and consent conditions are the usual answer under English-law leases. At the end of the lease, dilapidations or restoration claims arise. They are often capped by the loss in value to the landlord and are only as good as the tenant covenant. The usual mistake is to assume recovery is complete.

WORKED EXAMPLE: MARLOW COURT: A SERVICE CHARGE CAP AND A DILAPIDATIONS CLAIM

Marlow Court is an invented 40,000 sq ft office. The leases cap the service charge at 1.20 per sq ft a year, but the actual cost of running the building is 1.65 per sq ft. Separately, a tenant on a 12,000 sq ft floor is leaving; the landlord's surveyor has served a dilapidations schedule of 15.00 per sq ft, and the loss in value to the landlord's interest is assessed at 110,000. Calculate the annual leak, its effect on value at a 6.0% yield, and the likely dilapidations recovery. Ignore tax.

Answer: The cap leaks 18,000 a year, worth up to 300,000 at 6.0% if permanent but nearer 54,000 if the capped leases end in 3 years. The 180,000 dilapidations schedule is likely worth no more than 110,000 and less if the tenant is weak.

Interview tip: Always ask who pays when the clause is silent and whether the figure is a claim or cash. A candidate who separates the schedule from the recovery shows they have read leases, not just yields.

INT.EG.1.c · Leases and tenants

Assess tenant covenant, guarantees, rent deposits and security of tenure in a tenancy schedule, and size the exposure if a tenant fails.

A tenancy schedule summarises the leases, and a candidate should know what it hides. The covenant is the tenant's ability to pay, and a guarantee or rent deposit only helps if the guarantor is stronger than the tenant and the document is enforceable and unconditional. Look for guarantees capped in amount or time, deposits held by the tenant's agent rather than the landlord, and rights that fall away on assignment. Security of tenure is jurisdiction-sensitive: in England and Wales, business leases are either inside the statutory renewal regime, where the tenant can usually claim a new lease on market terms, or contracted out, where it cannot; in the US renewal rights come from the lease itself. Each changes how a buyer values the reversion. To size exposure, add void, re-letting incentive and costs, then subtract what the security recovers. The interviewer wants you to compare that exposure with the price, and to say whether the covenant, not the yield, drives the discount. The usual mistake is to count a guarantee as certain cash.

WORKED EXAMPLE: FENWICK ROW: SIZING THE LOSS IF THE ANCHOR TENANT FAILS

Fenwick Row is an invented trading estate. Its largest tenant pays 1.20m a year. If it failed, assume the unit would be empty for 12 months, the next tenant would need 6 months rent-free at the same rent, and the owner would carry 0.18m of empty-property costs and 0.10m of letting and legal costs. The tenant has lodged a 3-month rent deposit. Calculate the exposure with no security, with the deposit, and the expected loss if the chance of failure over the hold is 8%. Ignore discounting.

Answer: Exposure is 2.08m with no security and 1.78m with the 3-month deposit, an expected loss of about 0.14m against 20.0m of value but a tail of nearly 9% of value. A guarantee only helps if the guarantor is stronger than the tenant.

Interview tip: Quote both the expected loss and the tail. Interviewers like the point that security is judged by who stands behind it, and that a document is not cash.

INT.EG.2.a · Buying, financing and partnering

Plan legal due diligence on title, planning, environmental and structural matters and explain how warranties, indemnities and deal structure allocate what it finds.

Legal due diligence turns unknowns into price, protection or a walk-away. A buyer reviews title (ownership, charges, easements, rights of way, restrictive covenants and boundary issues), planning and permitted use, environmental and ground condition, structural and building reports, leases, and any litigation or tax. Findings are then allocated. Price is adjusted for known defects; a specific indemnity covers a known risk that cannot be priced; warranties cover general risk and give a claim if the seller's statement was untrue. Typical limits include a de minimis threshold below which claims are ignored, a basket that must be exceeded (a tipping basket pays from the first pound once passed, a deductible pays only the excess), a cap, and a time limit; market practice varies. A share deal in a property company buys the asset with its history, often attracting lower transfer tax but taking on latent tax and liabilities, while an asset deal buys only the property. The usual mistake is to rely on warranties for a known defect, since disclosure against a warranty removes the claim.

WORKED EXAMPLE: QUARRY LANE: HOW A BASKET AND AN INDEMNITY CHANGE A CLAIM

A buyer is purchasing an invented warehouse for 36.0m. The draft sale agreement has a de minimis of 25,000 per claim, a basket of 150,000, a cap of 10% of price on warranty claims, and a separate specific indemnity for soil contamination. After completion four warranty claims of 20,000, 60,000, 90,000 and 70,000 arise, and the contamination costs 400,000. Calculate recoveries if the basket is tipping and if it is a deductible.

Answer: The buyer recovers 620,000 with a tipping basket and 470,000 with a deductible, the 150,000 gap being the basket. The 400,000 contamination is recovered through the indemnity either way, not the warranties.

Interview tip: State the four limits in order (de minimis, basket, cap, time) and say that known issues belong in price or an indemnity. That shows you know warranties are not insurance.

INT.EG.2.b · Buying, financing and partnering

Explain joint-venture agreement terms such as promote, reserved matters, deadlock, transfer rights and funding obligations, and judge which are negotiable.

A property joint venture agreement turns a partnership into rules. The economics sit in the distribution waterfall and promote: the operating partner earns a share of profit above a preferred return, and the question is whether it is paid on realised or unrealised returns and whether it can be clawed back. The control terms are reserved matters (decisions needing the investor's consent, such as budget changes, major leases, refinancing, sale and new debt), deadlock provisions (escalation, mediation, then a buy-sell or forced sale), and the key-person and removal rights if the operator underperforms. Transfers are restricted by pre-emption, drag and tag rights, and lock-ups. Funding obligations matter most in stress: if a partner fails a capital call, the usual remedies are a loan from the other partner at a punitive rate, or dilution at a penalty. Investors tend to push for control of leverage and sale; operators push for fee protection and a promote that is hard to remove. Market practice varies and every term is a trade. The usual mistake is to negotiate the promote and forget the default provisions.

WORKED EXAMPLE: WHARFSIDE JV: DILUTION WHEN A PARTNER MISSES A CAPITAL CALL

An invented joint venture is funded 12.0m by the investor (60%) and 8.0m by the local operator (40%). A cost overrun requires a further 5.0m, called pro rata: 3.0m from the investor and 2.0m from the operator. The operator does not pay. The investor funds the whole 5.0m. Calculate the ownership if the missed 2.0m is credited at par, and if the agreement credits it at 150%.

Answer: At par the operator falls from 40% to 32.0%, and at a 150% credit to 30.8%, on the same 2.0m. The default remedy is a deterrent only if it is enforceable and proportionate.

> **Interview tip:** Name the default mechanism before the promote. It shows you have thought about the stressed case, which is when the agreement is actually used.

INT.EG.2.c · Buying, financing and partnering

Outline property loan terms (security, covenants, cash trap, cure) and development contracts (building contract, forward funding, collateral warranties), and size a covenant cure.

A property loan is secured on the asset, the rents, the accounts and often the shares of the owning company. Its covenants are tests: loan to value, interest cover or debt service cover, and sometimes debt yield. Typically a tighter threshold triggers a cash trap, where surplus cash is held back instead of distributed, and a looser one is an event of default. The borrower cure rights are an equity injection, a prepayment, or cash collateral, each with limits on number and timing; the cure sum depends on the wording. Development adds contracts: the building contract (fixed-price design and build shifts cost risk to the contractor, while construction management leaves it with the owner), delay damages, retention and bonds; collateral warranties give the funder and the tenant a direct claim on the contractor and the professionals; and forward funding or forward purchase fixes the buyer's price and pays as work proceeds. The usual mistake is to cure to the covenant exactly instead of leaving headroom, and to ignore that the same cure uses cash the plan needed.

WORKED EXAMPLE: BROOKFIELD RETAIL PARK: CURING AN INTEREST COVER BREACH BY PREPAYMENT

An invented retail park has a 30.0m loan at an all-in interest rate of 6.0%. The loan has a cash trap at an interest cover of 1.75x and an event of default at 1.50x. Net operating income (NOI) falls from 2.97m to 2.55m after a tenant leaves. Calculate the cover before and after, and the prepayment needed to cure the default by exactly reaching 1.50x. Ignore fees and hedging.

Answer: Cover falls from 1.65x to 1.42x against a 1.50x default, and a prepayment of about 1.67m cures to the line. Because the cure uses cash and leaves no buffer, ask for the right to cure by equity, prepayment or cash collateral.

> **Interview tip:** Say how many times the cure can be used and whether the cured cover is tested again next quarter. A candidate who thinks about headroom, not just the line, sounds like an asset manager.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.