Overage Rent

Calculating it; and deciding what it is worth

Percentage rent above a breakpoint, paid in bands — and a second income of a different quality arriving in the same check.

THE SHORT VERSION

A retail lease often has two rents in it. One is fixed and promised: the base rent, due whether the store has a good year or a terrible one. The other is a share of the tenant's sales, paid only once those sales pass an agreed figure. That second one is overage rent, and it is also called percentage rent.

It is paid in bands, not on the whole. The lease sets a breakpoint, and sales below it produce nothing. Sales above it are divided into bands, each with its own rate, and each rate applies to its own band and to nothing else. A dollar of sales is charged once, by the band it lands in.

That is the entire mechanism. Almost every error in this topic is a rate applied to more sales than it belongs to.

WHAT THE LEASE SETS UP

Take a store paying $24,000 a year in base rent, on a lease with a fairly typical percentage clause: nothing on the first $600,000 of sales, 4% on sales from $600,000 to $900,000, and 2.5% on sales above $900,000.

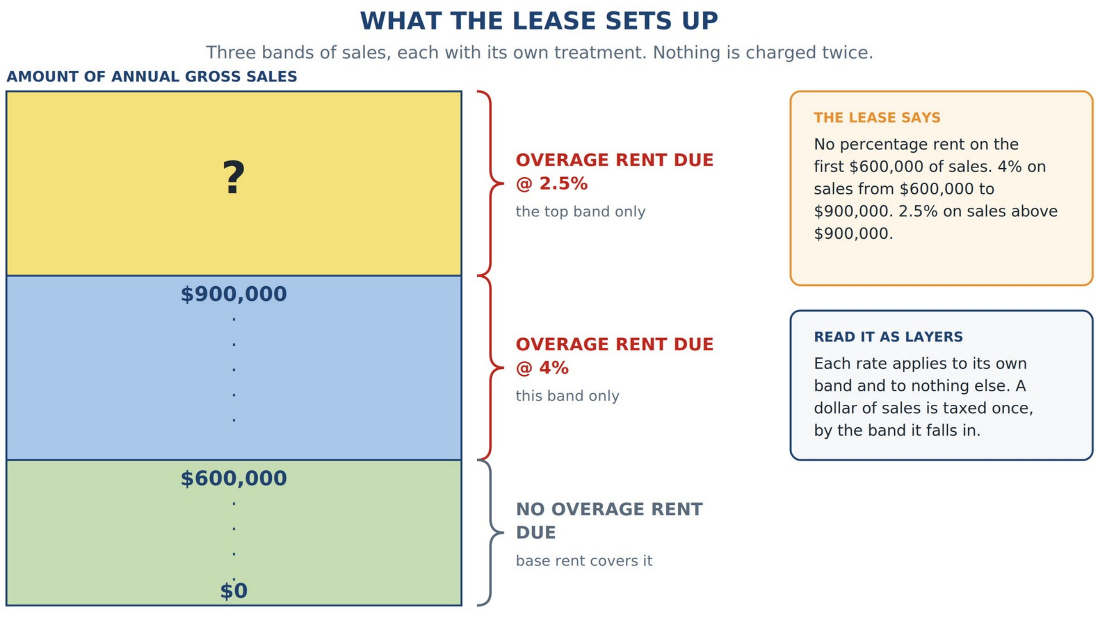

Exhibit 1 — Three bands of sales, each with its own treatment.

The question mark at the top is the point. That band has no ceiling. It is the one the landlord is interested in and the one the appraiser has the most trouble with, because nobody knows how tall it will be.

ONE YEAR, WORKED THROUGH

Say the store sells $1,200,000 in a year. Take the bands one at a time.

ONE YEAR, WORKED THROUGH

Annual gross sales of $1,200,000. Take the bands from the top down or the bottom up — same answer.

First $600,000 no percentage rent is due on this band	—	**$0**
$600,000 to $900,000 that is $300,000 of sales, at 4%	$300,000 × 4%	**$12,000**
$900,000 to $1,200,000 that is $300,000 of sales, at 2.5%	$300,000 × 2.5%	**$7,500**
OVERAGE RENT FOR THE YEAR	$12,000 + $7,500	**$19,500**

Exhibit 2 — The calculation, band by band.

Overage rent for the year is $19,500. Add the base rent and the landlord collects $43,500 — but only $24,000 of that was ever promised to him.

WHERE $600,000 CAME FROM

The first band is not a round number somebody liked. Base rent divided by the first percentage rate gives the sales figure at which that percentage would have produced the base rent on its own — the point where the landlord has been paid what he contracted for, and beyond which he shares in the upside. It is called the natural breakpoint.

WHERE $600,000 CAME FROM

The first band is not arbitrary. It is the point where the percentage has paid the base rent.

THE NATURAL BREAKPOINT

base rent ÷ the percentage

$24,000 ÷ 4% = $600,000

Below it the landlord is already being paid. Above it he shares.

A SPECIFIED BREAKPOINT

Leases are free to set any figure they like, and plenty do — higher than natural, lower, or a flat dollar amount with no arithmetic behind it at all.

Read the lease. Never assume it is natural.

WHY THE SECOND RATE IS LOWER

Once sales pass $900,000 the landlord has already collected his base rent and a healthy share above it. A tenant producing that volume has bargaining power, and the step down to 2.5% is what he bargained for. It is a negotiated term, not a rule — some leases step down twice, some never step down, and some run a single rate the whole way up.

Exhibit 3 — The natural breakpoint, and the reason it is not always the one in the lease.

Check it against the lease every time. A breakpoint is a negotiated term like any other. It can be set above natural, below it, or at a flat figure with no arithmetic behind it at all, and a lease with an unnatural breakpoint is telling you something about the bargaining that produced it. Never calculate the natural breakpoint and assume it is the one you are owed.

THREE WAYS TO GET IT WRONG

Every one of these has been seen in a real appraisal, and every one produces a figure that looks reasonable on its own.

THREE WAYS TO GET IT WRONG

Same lease, same $1,200,000 of sales. Only one of these is the rent.

2.5% × $1,200,000 — ✗ **$30,000**
The top rate applied to every dollar of sales. Off by $10,500.

4% × $1,200,000 — ✗ **$48,000**
The first rate applied to every dollar. Off by $28,500.

4% × $600,000 over the breakpoint — ✗ **$24,000**
Right idea, one band missed — the step down to 2.5% never happened. Off by $4,500.

$12,000 + $7,500 — each band at its own rate — ✓ **$19,500**
The only method the lease describes.

Overage rent works in layers, the way an income-tax table does. The top rate never touches the bottom dollar.

Exhibit 4 — Same lease, same sales, four different answers.

The comparison people find useful is an income-tax table. Nobody thinks a taxpayer who reaches a higher bracket pays that rate on every dollar he earned. Overage rent works the same way, and for the same reason — the bands are cumulative, not a single rate selected by the size of the total.

WHAT IT IS WORTH IS A SEPARATE QUESTION

Calculating the rent is arithmetic. Deciding what it is worth is appraisal, and they are not the same exercise.

THE SAME LEASE OVER FIVE YEARS

Base rent is a promise. Overage rent is a consequence of somebody else's trading.

Base rent, every year, by contract — **$24,000**
Overage rent — five-year average $7,740, but the range is $0 to $19,500 — **varies**
Two incomes of different quality, arriving in one check.

Exhibit 5 — Five years of the same lease.

Base rent and overage rent are not the same quality of income. The $24,000 is contractual: the tenant owes it whether he trades well or badly, and if he fails, a guarantor or a re-let usually still produces something like it. The overage is a consequence of somebody else's trading. Over these five years it averaged $7,740 — a figure that never once occurred. What actually arrived was nothing, then $1,600, then $11,200, then $19,500, then $6,400.

An appraiser who adds the average to the base rent and capitalizes the total at one rate has treated a volatile, tenant-dependent, uncapped stream as though it were a contract. That is not a small error of degree. It values two different things as one.

What to do about it is a matter of judgment, and there is more than one defensible answer. Capitalizing the overage separately at a higher rate is common. So is excluding it entirely and treating it as upside the buyer is not paying for. So is including only the portion supported by a long and stable sales history. What is not defensible is folding it in silently.

MISTAKES TO WATCH FOR

Applying one rate to total sales. The commonest error by a distance, and it can run in either direction depending on which rate gets picked.

Stopping at the first band. A lease with two or three steps needs all of them. Missing the top band understates the rent; forgetting the step down overstates it.

Assuming the breakpoint is natural. Read the clause. The arithmetic that would have produced a natural breakpoint tells you nothing about what the parties actually agreed.

Checking the sales figure the lease means. Gross sales is a defined term, and the definition varies — returns, online orders fulfilled from the store, sales to employees, and departments sublet to a third party may be in or out. Two leases with identical percentages can produce different rent from identical trading.

Treating one good year as the run rate. A single year above the breakpoint is not a stream. Ask for the sales history, and if it does not exist, say so in the report rather than assuming.

Read this one alongside the papers on capitalization rates. The question of what rate to apply to an uncertain income is the same question those papers ask from the other end.
