

# AMORTIZATION & DEPRECIATION

## Commercial Real Estate Concepts & Applications

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**Amortization** refers to the distribution of payments over a period of time as determined by an amortization schedule. The amortization payments, associated with a loan, would typically consist of installments of both principal and interest divided into equal amounts for the duration of the loan. In most loans, a greater portion of the payment is applied towards the interest at the beginning of the amortization period, with a greater amount of the payment applied to the principal at the end of the amortization period.

The amortization concept is also applied in accounting for the 'depreciation' of commercial real estate related assets - physical additions, replacement or improvements to structure, systems and equipment. In this case, amortization is used to 'account for' the asset over its 'useful life'. Examples include the depreciation (amortization) of a 'capital expense' such as a roof, chiller or boiler over the expected life of the asset (15 - 20 year period). In this example, the capital expense is excluded as a property operating expense and, therefore, is not treated as a tenant 'recoverable' expense. The expense is also excluded in the calculation of the property's net operating income.

AMORTIZATION SCHEDULE		CALC. PMNT:		\$1,198.04	
IN YEARS	Principle	Interest	Balance	CPLTD	
0			\$160,000.00	2,227.43	
1	178.04	1,020.00	159,821.96	2,241.32	
2	179.18	1,018.86	159,642.78	2,255.61	
3	180.32	1,017.72	159,462.46	2,269.99	
4	181.47	1,016.57	159,280.99	2,284.46	
5	182.62	1,015.42	159,098.37	2,299.02	
6	183.77	1,014.25	158,914.58	2,313.68	
7	184.92	1,013.08	158,729.62	2,328.43	
8	186.07	1,011.90	158,543.48	2,343.27	
9	187.22	1,010.71	158,356.15	2,358.21	
10	188.37	1,009.52	158,167.63	2,373.15	
11	189.52	1,008.32	157,977.91	2,388.09	
12	190.67	1,007.11	157,786.98	2,403.03	
13	191.82	1,005.89	157,594.83	2,417.97	
14	192.97	1,004.67	157,401.46	2,432.91	
15	194.12	1,003.44	157,206.85	2,447.85	

There are some exceptions that allow a landlord to recover (or partially recover) the amortization of capital expenses through the property's operating expense recovery process. This exception primarily pertains to capital expenses that are required by law or capital expenses that reduce operating expenses that would otherwise be recoverable. The landlord-tenant lease would typically stipulate the criteria to which these exception applies.

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The schedule below illustrates the amortization of a (variable frequency drive - VFD) capital expense project over a 7 year period. The amortization chart shows a representative first 12 months of the loan period. In this example, because this CAPEX project will reduce the property owner's and tenant's (electricity) operating expenses, the annual amortization can be added to the property's operating expenses as a tenant recoverable expense (subject to the terms of the tenants' leases).

PROPERTY NAME		CAPEX VFD PROJECT DEPRECIATION   AMORTIZATION				
<b>LOAN VALUES</b>		<b>LOAN SUMMARY</b>		<b>ANNUAL</b>	<b>ANNUAL RECOVERY</b>	
Loan amount	\$80,000	Monthly payment	\$1,207.41	\$14,489	Subject to the terms of the lease, \$14,489 can be added to the annual property expenses & recovered (from tenants) as an additional operating expense.	
Annual interest rate	7.00%	Number of payments	84			
Loan period in years	7	Total interest	\$21,422.81			
Start date of loan	1/1/2016	Total cost of loan	\$101,422.81			
Payment	Payment Date	Beginning Balance	Payment	Principal	Interest	Ending Balance
1	2/1/2016	\$80,000.00	\$1,207.41	\$740.75	\$466.67	\$79,259.25
2	3/1/2016	\$79,259.25	\$1,207.41	\$745.07	\$462.35	\$78,514.18
3	4/1/2016	\$78,514.18	\$1,207.41	\$749.41	\$458.00	\$77,764.77
4	5/1/2016	\$77,764.77	\$1,207.41	\$753.79	\$453.63	\$77,010.98
5	6/1/2016	\$77,010.98	\$1,207.41	\$758.18	\$449.23	\$76,252.80
6	7/1/2016	\$76,252.80	\$1,207.41	\$762.61	\$444.81	\$75,490.19
7	8/1/2016	\$75,490.19	\$1,207.41	\$767.05	\$440.36	\$74,723.14
8	9/1/2016	\$74,723.14	\$1,207.41	\$771.53	\$435.88	\$73,951.61
9	10/1/2016	\$73,951.61	\$1,207.41	\$776.03	\$431.38	\$73,175.58
10	11/1/2016	\$73,175.58	\$1,207.41	\$780.56	\$426.86	\$72,395.02
11	12/1/2016	\$72,395.02	\$1,207.41	\$785.11	\$422.30	\$71,609.91
12	1/1/2017	\$71,609.91	\$1,207.41	\$789.69	\$417.72	\$70,820.22

Another commercial real estate *amortization* application is the accounting of a property owner's capital investment associated with a tenant's transition into the property. In this example, the total '*initial landlord investment*' may be comprised of:

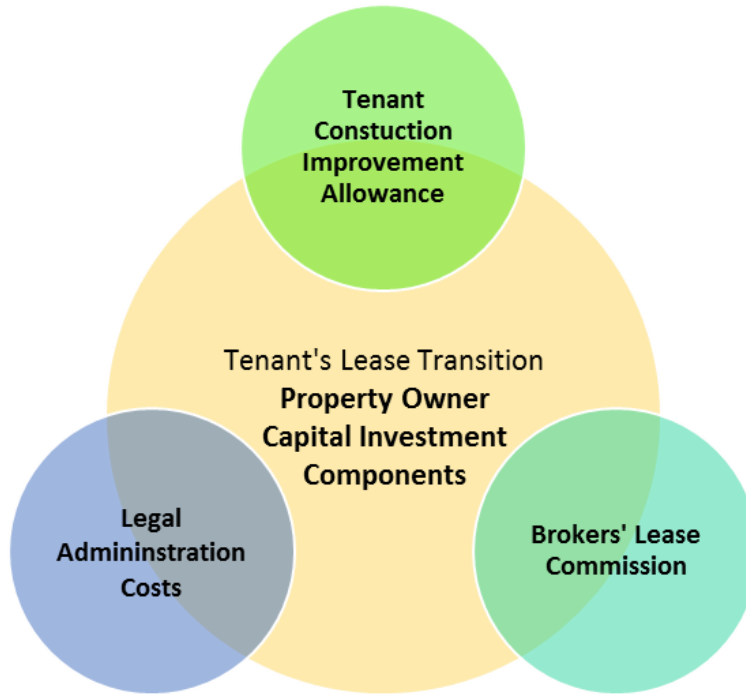
1. Landlord's contribution towards the tenant construction allowance
2. Lease commission payments to the landlord's and tenant's brokers
3. The leasing legal costs associated with the development and administration of the lease itself.

The total amortization period would typically '*parallel*' the tenant's lease period, e.g., 5 years (60 months), 7 years (84 months) or 10 years (120 months).

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It is routine practice for commercial leases to include, in the 'early lease termination clause', the tenant's repayment of the landlord's *'unamortized balance'* of the initial lease investment described on the previous page. The calculation of this unamortized balance would be based upon the total amount of the initial investment, the duration of the lease period, the date of (early) lease termination, as well as a defined interest rate. Each of these factors should be outlined in the landlord-tenant lease in order to calculate the amortization, and tenant re-payment specifics, should the lease be terminated early. The unamortized balance would be calculated by using an amortization schedule like the one shown on the previous page.

Available in BuildingsOne library of documents are several amortization schedules, including practical commercial real estate applications and supporting instructions, for the calculation of amortization and depreciation of property owners' capital expenses.