TELECOM SITE STICKER SHOCK —

HOW HIGH CAN THE RENT GO?

BY SEAN HEATH

HAVE YOU EVER PAID TOO MUCH FOR A PRODUCT OR SERVICE, BECAUSE YOU THOUGHT A CHEAPER ALTERNATIVE WASN'T AVAILABLE?

How about for an airline ticket for a flight leaving the next day? Or paid through the nose for Super Bowl or Olympics tickets, because you didn't think you could get them for less? As consumers, we will always try to seek out the best price for a product or service whenever we have the ability to make a choice. But when our choices are limited, like in the case of Super Bowl tickets or last-minute airfare, we will pay more.

BUT HOW MUCH MORE ARE WE WILLING TO PAY? IS THERE A CEILING?

When a telecom carrier negotiates a site lease with a property owner, that carrier makes some of the same consumer choices that you and I make each time we go shopping. Most of the time, carriers will negotiate rental amounts that work to their advantage relative to the market — meaning an amount which is lower than the rents from competing sites. In those cases, they would be getting a "deal" relative to the market. However, there are cases where carriers will be forced to pay more than they expected in order to cover a particular area.

In the November/December 2002 issue of *right of way* Magazine, I described the relationship between the lessor and lessee of a cell site as being much like a seesaw.

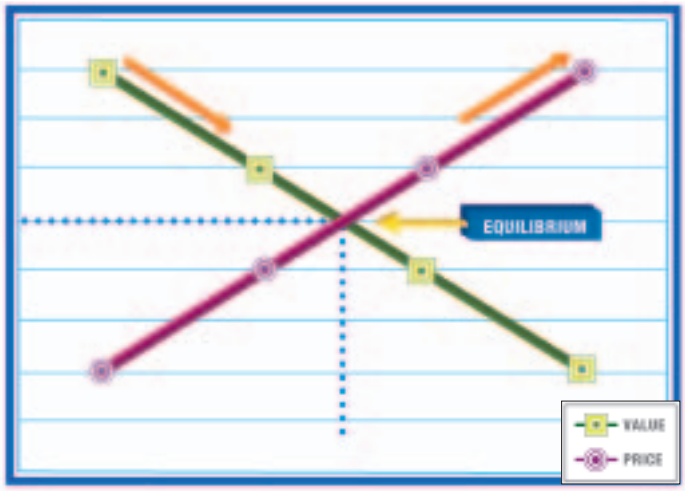
If a property owner (or lessor) has the most leverage, the wireless company (the lessee) is faced with a choice: pay an aggressively high rent, or risk not being able to serve a particular area.

SO, AGAIN, HOW HIGH IS HIGH?

If the highest rent in a particular submarket is, say $5,000 per month, could an owner ask for $10,000? Or $15,000?

Basic economic theory tells us that there is a difference between price and value. Price is usually defined as the most a buyer is willing to pay for a product or service. Value, on the other hand, is more of a relative term, and relates to an average or typical price for the same product or service in the marketplace.

If the price of an item falls below our perception of value for that item, then we think we are getting a good deal. If however, the price rises higher than our perception of value, then we often experience "sticker shock." To be more scientific about it, the point at which price and value coincide is known as equilibrium.[1]



Carrying this analogy over to cell sites, when the price (the rent) of a cell site is lower than its market value, the lessee (the carrier) would have an advantage over the lessor. If the negotiated rent is equal to market value, then neither side would have an advantage.

However, price "markups" can occur when the negotiated rent for a cell site is higher than this equilibrium point, yet *still results* in a consummated deal. In this article, we refer to this markup as an "enhancement factor" borrowing on a theory proposed by Charles Seymour, MAI.[2]

In April of 2001, Seymour gave a presentation titled "The Continuing Evolution of Corridor Appraising," as part of a two-day seminar on telecommunication corridors sponsored by the Appraisal Institute.

Seymour stated that the value of a particular corridor would be expressed by the following formula:

Value = ATF x EF

In this formula, EF (or Enhancement Factor) refers to "the ratio of the corridor sales price divided by its ATF, as of the date of sale." Another way of describing EF would be the amount of markup that a corridor buyer would be willing to pay, over and above its market value, to obtain the right to use this strip of land. Seymour then went on to say that, in his experience with corridor sales, most EFs tend to range from 1.1 to 2.0.

Although Seymour's EF was based on a survey of corridor-land sales, a similar factor could be determined for ground-leased telecommunication sites. If Seymour's corridor-value formula were to be applied to this type of situation, the ATF and EF variables would take on slightly different connotations. [*Author's Note: Since the only amount getting "enhanced" is the money paid to the lessor, the phrase "enhancement factor" might not be the most accurate term. However, to be consistent with Seymour's analogy, we have used his term interchangeably with "rental or price markups."*]

On a ground-leased basis, the ATF variable would represent the market value of the leased area as determined from recent transactions of other telecommunications-site leases. Going back to the graphs, ATF would represent the theoretical equilibrium at which price and value coincide.

However, there are cases where one ownership entity controls all of the land within a particular coverage area. Therefore, if a cellular carrier wanted to construct a site within the area controlled by this entity, they would not have the option of negotiating with anyone else. This is where an EF would come in.

So, the value of a cell site in our line graph would be its equilibrium rental value (or its rental value assuming competition exists), plus an EF. See Figure 1.

The use of this type of factor, coupled with the general relationship of leverage described before, can help appraisers better analyze cellular-site leasing data.

CONSIDER THE FOLLOWING FICTIONAL EXAMPLE.

Over the course of many years, Farmer Ted managed to acquire a sizeable chunk of land along Southern California's coastline, to the point where now, his holdings are so large that one would have to pass

FIGURE 1

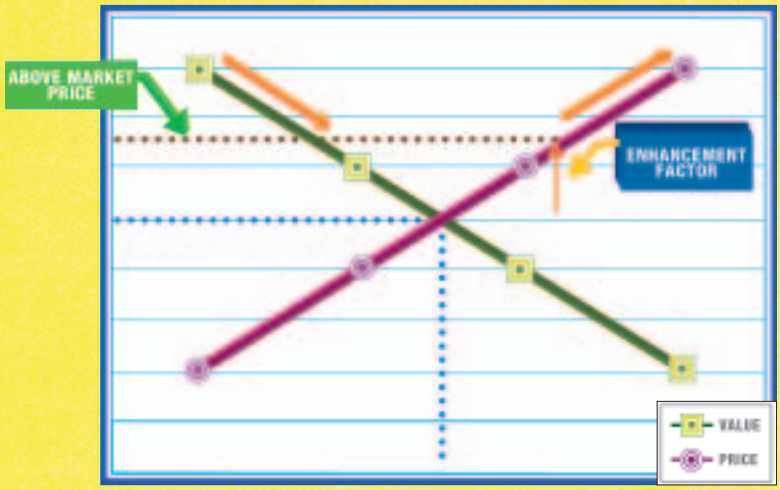
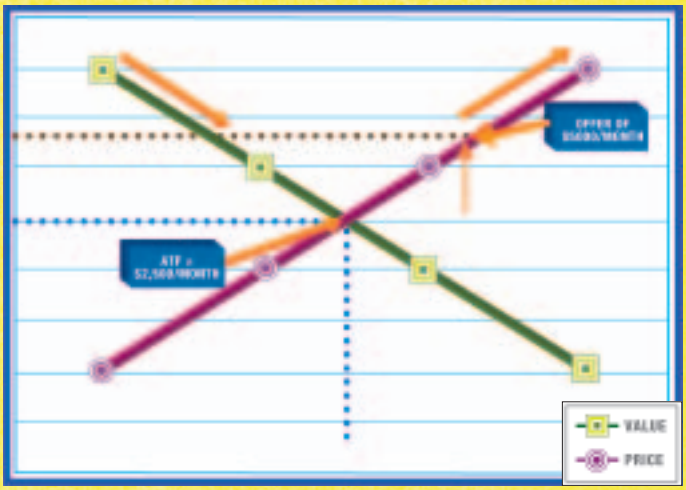


FIGURE 2



through his property just to get to the Mexico border. An interstate runs through Farmer Ted's ranch, and he has been approached from time to time by various telecom carriers. Farmer Ted knows that cell phones won't work along the segment of interstate that passes through his ranch, but that reception gets better as one reaches the northern or southern borders — where there are other towns with existing antenna sites. Telecom carriers have approached him inquiring about the possibility of building antenna sites in the middle of his ranch, so Farmer Ted, savvy guy that he is, issues a counter-offer.

"You know what," he says to one of the interested carriers, "It seems to me that you don't have much of a choice if you're looking for land around here, since I'm the only game in town. I'll charge you $5,000 a month."

After he said this, he listened calmly to the carrier's representative complain that the most they had ever paid for sites in this region was $2,500 a month, and that his asking amount was way too high.

In this situation, the market value of a site on Farmer Ted's ranch, as perceived by the carrier, was $2,500 a month — since that was what they had paid in other areas where competition exists.

Therefore, if the carrier accepts Farmer Ted's offer, the rental markup (or according to Seymour's EF) would be 2.0. See Figure 2.

As most appraisers can attest to, for this type of relationship to be expressed through market data, there should be true "apples to apples" comparisons. This means that the data used to establish the ATF should be based on current lease transactions, or adjusted for market conditions between the date of the lease and the date of analysis. Also, rents used to establish ATF should reflect typical lease terms for a market area. Lease terms that could influence the ATF would include a short lease period, insurance clauses, or high-risk indemnity — again, if not common for a particular locale.

Our theoretical ATF value also assumes that the associated utility costs for a site (power and telephone), are reasonable and typical. If utility connections have to be extended a long distance to a site, then the rent charged to the tenant may differ substantially.

A REAL-LIFE EXAMPLE OF FARMER TED'S RANCH CAN, IN FACT, BE FOUND IN SOUTHERN CALIFORNIA.

Tejon Ranch (see maps) covers 270,000 acres within a natural mountain pass between the Sierra Madre and Tehachapi Mountains in Southern California, and is the largest contiguous expense of land under single ownership. The Ranch starts just south of the Los Angeles County line near Interstate 5 and Highway 138 and extends north 40 miles and east to west for 26 miles in Kern County.[3]

If, for example, a fiber optic company wanted to build a fiber route connecting Sacramento or San Francisco with Los Angeles, the most direct path would be through Tejon Ranch. While other routes might be considered, the majority would involve a climb up through the mountains, and would be significantly more expensive to build.

Consequently, the exclusivity provided by Tejon Ranch's size and location has enabled its land-use managers to set their own lease rates. According to Vice President and General Counsel Dennis Mullins of

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the Tejon Ranch Company, the average rate for a telecommunications corridor that passes through the ranch (as of 2001) was $2 per linear foot per year. In comparison, the average corridor lease rate for Southern California during the same period of time was approximately $1.50 per linear foot per year, and the average rate quoted from the Los Angeles Department of Water and Power was $0.68 per linear foot per year. This data would indicate the following EFs.[4]

AGENCY	RENTAL RATE	EF
Tejon Ranch	$2.00 per LF per year	—
Southern California avg.	$1.50 per LF per year	1.33
LA Dept. of Water and Power	$0.68 per LF per year	2.94

In certain instances, price markups can be determined from a comparison of telecommunications-site leases within a given metropolitan area. This is particularly evident when considering privately owned properties (like high-rises) in very desirable locations.

LET'S TAKE ANOTHER FICTIONAL EXAMPLE.[5]

Farmer Ted, being something of a land tycoon, also owns a downtown high-rise with a prime location along a busy freeway. On the roof of this high-rise are a couple of telecommunications tenants, one of whom is up for renewal. This tenant, Urban Telecom, had been paying Farmer Ted approximately $2,000 per month, and was more than a little surprised when the owner informed him that the new rate would be $3,000 per month. Urban Telecom tried to point out to Farmer Ted that $3,000 would be too large of an increase, and that they were currently paying an average rate of $1,800 to $2,000 per month for a handful of other sites in the surrounding area.

In the end, it comes down to the old real-estate axiom: "location, location, location." Since Farmer Ted controls the rooftop, he can set his own price, just like he did on his ranch.

So, let's return to the earlier question. If the highest rent in Farmer Ted's neighborhood is, say $5,000 per month, could he ask for $10,000? Or $15,000?

To answer this question, we revert to Seymour's observation that price markups tended, in his experience, to range from 1.1 to 2.0. This indicates that there is a market-based ceiling, above which consumers will not go.

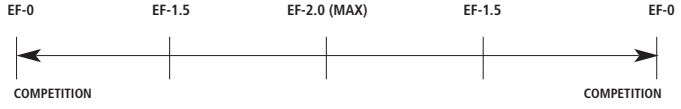
In Urban Telecom's case, they would have to make a business decision whether to pay a marked-up rent or not. They may consider whether this marked-up rent (as a portion of the operating cost of the site) still provides them with a sufficient margin of profit. Nevertheless, if Urban Telecom agreed to pay $3,000 — for whatever reason — then their consent would constitute market-based support for this price increase. If the tenant declined, then their refusal would also represent market-based support that the price increase was too high.

SO WHEN SHOULD AN APPRAISER CONSIDER RENTAL MARKUPS?

Let's go back to Farmer Ted's ranch. For sake of discussion, let's assume the following line represents the length of his ranch, with each endpoint representing an area of multiple properties, and multiple property owners — in other words, potential competition.

If a carrier wants to build a cell site anywhere near the midpoint of this line, in an area where there are little to no other competitive choice of properties, then they would have to deal only with Farmer Ted. As he puts it, he's "the only game in town." Therefore, the rent charged in this situation would also include the maximum rental markup justified by the market.

As a carrier moves away from the center of the ranch, closer to competition, the EF should decrease, as follows.



The length of this line between sources of competition can be hundreds of miles (like Tejon Ranch) or as compact as a high-rise building rooftop.

SO WHEN SHOULD AN APPRAISER CONSIDER RENTAL MARKUPS?

USE OF RENTAL MARKUP IS DETERMINED BY:

1.) **Location**. No matter how big or small, if the site in question is in the best location within a given coverage area, this exclusivity would give the lessor more leverage.

2.) **Distance from competing sites**. If a carrier is negotiating site rent in an area where there are other potential sites, there is a greater likelihood that the rent agreed upon by both parties will be closer to the equilibrium market value described earlier. If the carrier thought the rent was too high, he could move to an alternate site.

3.) **Areas controlled by a single ownership entity**. Appraisers run into the issue of price markups — or sticker shock — almost every day. Indeed, the entire concept of market value is based on what a willing buyer would pay, given a choice and assuming that he is not under duress.

In fact, telecom carriers (like AT&T, Sprint and T-Mobile, to name a few) are consumers themselves, just as much as we are consumers of their communication services. Telecom carriers are consumers in the sense that they have to negotiate leases, and pay rent, for each antenna site within their cellular network.

It all comes back to the adage of "what the market will bear." If the price is too high, consumers will walk away. The product can be a telecom site, airline tickets or widgets — the principle is the same.❖

REFERENCES

[1] Line graphs based on basic supply/demand graphs used as part of an Introductory Economics online course, at www.bized.ac.us/stafsup/options/notes/econ207.htm.

[2] Seymour presented his Enhancement Factor theory as part of a two-day seminar in April of 2001 in Sacramento, Calif. The seminar (Law and Value: Communication Corridors, Tower Sites, and Property Rights) was sponsored by the Sacramento chapter of the Appraisal Institute.

[3] Maps courtesy of www.tejonranch.com/RanchNews/Maps.

[4] These figures were cited by Mullins as part of a presentation titled "A Large Land Owner's Perspective of Issues and Trends" during the same April 2001 seminar. Mullins can be reached at (661) 248-3000.

[5] The following fictional examples are based on data collected from actual case studies. Where applicable, the specifics have been changed to protect the confidentiality of the client.