Negotiating a commercial lease

Jerry Merola

Merola is back with tips and principles to keep in mind when obtaining space for your FEC.

As the uptick in new entertainment center development continues to take hold throughout most quadrants of North America, the availability of commercial retail space has taken center stage.

Those of you that are presently developing new centers know that family entertainment centers (FECs) gobble up real estate at an alarming pace, often requiring 20,000 to 40,000 square feet to properly house a suitable portfolio of attractions and games. With this in mind, the carrying cost of real estate typically becomes the second greatest expense of the business, rivaled only by the cost of labor.

More importantly, rent, or "occupancy cost" as I like to refer to it, is generally fixed in nature, unlike labor or marketing, which can be tailored to actual revenue volumes. This single condition often positions occupancy cost as the most important variable in the development process, and one that requires a clear understanding of its current and future impacts on the business model.

For most new developers today, leasing an existing structure makes sound business sense. For starters, a project can often launch much quicker, as the structure and associated site improvements are already in place.

In addition, many existing commercial boxes are already suitably located on well-traveled roadways, and may possess the added benefit of being positioned among other established retailers.

Finally, total development costs are almost always considerably less, as a tenant does not have to bear the costs (and associated financing hurdles) of design, permitting, construction, and certification.

Instead, a typical tenant will sign an agreement to occupy a retail bay for a stated number of years at a predefined rent rate. On the surface, this might sound like a fairly simple transaction, but in practice, commercial leasing is far more complicated. Below are some elements to consider before signing on the line.

KNOW ALL COSTS

Often times, the rent rate is merely the baseline of a tenant's true cost of occupancy. During the heyday portion of the last decade (2003-2006), savvy landlords began layering additional tenant expenses into their lease agreements in an effort to pass-through typical landlord operating expenses.

These expenses may include: real estate taxes, common area maintenance charges, administration expenses, healthcare costs for landlord's administrative staff, infrastructure repair or replacement of HVAC, roofing, parking lot lighting, and audit expenses associated with a review of tenant's financials (for percentage rent provisions).

In essence then, a base rent of $10 per foot might easily become $20 per foot if the charges noted above remain unchallenged by the tenant.

"As with everything in life, if a transaction is not fair, one party will ultimately walk away unhappy."

BE CAREFUL OF TENANT OBLIGATIONS

As with everything in life, if a transaction is not fair, one party will ultimately walk away unhappy. When it comes to commercial lease agreements, it's critical that the document be reviewed very carefully, as most examples are easily 15-20 page manuscripts containing 50 or more sections.

Legal representation is a must; however, don't rely upon your attorney to determine what's best for you. Provisions that might be deemed

acceptable for a "light" tenant user, may have devastating effects on a tenant that's more closely defined as a "heavy" user.

For instance, while a "percentage rent" provision might work acceptably for an apparel retailer, it may be completely unsuitable for an entertainment tenant. In the same sense, a lease that requires the tenant to "maintain the existing HVAC system" may quickly prove to be more than the tenant bargained for, particularly if the system is already more than seven years in age.

If one was to sign a 10-year lease today on such a structure, it's quite probable that the HVAC system would have to be replaced eight years into the term at the tenant's expense (most HVAC systems will last 15 years).

IMPROVEMENT ALLOWANCES/ FREE RENT OFFERS

In recent years, more and more landlords have been offering tenant improvement allowances as an inducement for tenants to accept second-generation space (i.e. space that has been occupied previously). In theory, the improvement allowances are provided to permit a tenant to make modifications to a space to improve its effectiveness or appearance.

Generally speaking, the larger the allowance, the more worthwhile the deal is for the tenant, as improvement allowances often offset costs already present within an entertainment developer's capital budget. The problem arises when a landlord opts to offer "free rent" instead of an improvement allowance.

These two elements are not the same, and have very different impacts on a project. While a tenant improvement allowance helps to reduce the total project budget, free rent has no impact on the project budget. Free rent merely reduces operating costs once the facility is open.

That means that the developer would still need to borrow the maximum amount of funds to complete necessary improvements at the site, as the landlord would essentially have no stake in the construction transaction. Given the challenges with financing today, it's highly recommended that a tenant push hard to obtain an improvement allowance instead of a free rent period.

LANDLORD SPONSORED FIT-OUT CONSIDERATIONS

There are many instances whereby a landlord will agree to provide a specific level of improvement for a tenant in exchange for an increase in the base rent rate. This commonly occurs with elements such as restrooms, kitchen stubbing, electrical panel upgrades and distribution, and storefront remodeling.

As an example, a landlord might provide $250,000 in fit-out enhancements for a 20,000-square-foot structure, and in turn ask for an increase in rent of $2.50 per foot.

While this might be seen as a fair deal, it only remains fair provided the rent rate reduces by $2.50 at the start of the sixth rental year, as the "loan" for improvements would have been paid back in full by the tenant at that point.

Most landlords seem to forget about this simple provision and instead look to increase the then-current rent rate using the Consumer Price Index rate or a specific percentage rate. In essence, the landlord has served as your banker for the past five years, but now that you've repaid the borrowed amount, your rent rate should be reduced accordingly.

CHOOSING THE LEASE TERM

Sometimes, the signing of a longer lease term will encourage a landlord to offer improvement funds, as they'd essentially be making a long-term investment in the tenant relationship. A long-term lease by today's standards is commonly 10 years.

While you might be inclined to believe that you'll stay in the space forever, it is often unwise to commit or obligate yourself or your organization to a longer term. Instead, you can request "option periods" which will give the tenant the right to extend the lease if they choose to.

Commonly a 10-year lease might be initiated, with a tenant being provided with two five-year option periods, which would ultimately extend the lease to a full 20 years. If business is great, a tenant might initiate the option period. If not, the lease can terminate without further obligation to the tenant.

LEASE NEGOTIATIONS TAKE TIME

Signing a lease is a big commitment, often with very specific obligations on the tenant's part. It's important to not rush through the process, as the best space in the world can prove to be a nightmare if the terms of the transaction can't be supported by the business operation.

Don't be afraid to play the "eye for an eye" game when negotiating the lease, whereby each party's wish list is identified and a suitable median solution is reached.

Landlords want tenants, and tenants want space; the only thing that separates them is the language within the lease agreement. Once it's signed, it becomes a document to live by, so please take your time. Chances are, the space will still be there tomorrow. ▲

Jerry Merola is the CFO of Amusement Entertainment Management (AEM) LLC, a subsidiary of Alpha-Omega Amusements. He has conducted feasibility studies in almost all regions of the United States and Canada. He can be reached at (732)254-3773; fax (732)254-6223; e-mail (profit wizz@aol.com).