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Lease Negotiation

INTRODUCTION

The lease document is an important component in establishing the value of the property, so it must be carefully negotiated to get the best rents and terms for the property owner, while allowing the tenant to make a profit as well. The well-negotiated lease establishes the rights and obligations for both parties and should minimize misunderstandings and disputes.

Each lease provision has a specific purpose, and negotiated provisions must be carefully considered to determine their impact on the property's operations, income, and value on a short- and long-term basis. The property manager should have a working knowledge of the lease, understand the purpose of each provision, and know the affect it has on the operation of the property. For the property manager to refer to a provision of the lease as the authority for whatever is done is not enough; the manager must fully understand why the lease provision exists.

NEGOTIATING THE LEASE

Preparing to negotiate a lease involves several steps. Each step requires analyzing factors that prepare the property manager to negotiate the lease while informing the property manager of his or her negotiating strengths and weaknesses.

Lease Negotiation Steps

To prepare for a successful lease negotiation, a property manager follows several steps.

Analyze the Market. The first step in preparing to negotiate a lease is to study the market conditions. A property manager who is active in the market has a good understanding of the market conditions. The manager must know not only the “asking” rates of competing buildings but also the “deal-making” rates and their concessions.

While surveying the market, the property manager should determine the number of available spaces that can accommodate the prospective tenant’s needs. The primary concern of an office building tenant may be the size of the premises. An industrial tenant may have additional concerns, such as access to transportation, e.g., highways, rail, the port, while a retail tenant for a shopping center is most concerned with location, the anchor tenants, tenant mix, and competing uses in nearby centers. The analysis of the market includes not only which vacant spaces meet the size requirements of prospective tenants but also which buildings or locations meet their other needs.

Assess the Property. After analyzing the market, the property manager assesses the subject property. What is the current occupancy and vacancy status of the property? Which spaces will become vacant or are likely to become vacant? Which tenants’ leases are expiring, and which are likely or unlikely to renew their leases? After developing the inventory of the available and soon-to-become available space, the property manager prices each space, based on the market survey. Seldom do all the spaces in a building have the same value; each space must be priced for its size, dimensions, location, and special amenities.

Other factors to consider when analyzing the property are the financial condition of the property and the property ownership’s goals and objectives. If the property has cash flow problems, the rent from another tenant may have a significant impact on the financial operations of the property. If the property is flush with cash, the negotiating position of the property owner will probably be different than if the property is cash poor. Does the property owner need this tenant to increase the property value in order to sell or refinance it?

Assess the Prospective Tenant. Next, the property manager must know the tenant. What is the tenant’s financial condition? Credit-worthy tenants are more desirable than start-up businesses. A credit-worthy tenant will drive a harder bargain than the typical small business. The manager should attempt to find out what other space options, if any, the prospective tenant

is considering. If the tenant has other potential locations, the property manager must try to find out the tenant's negotiating style. Is the prospective tenant a deal maker, or is it attempting to negotiate a "big win-little win" deal or, worse, a "win-lose" deal? Is the tenant's business successful? If the prospective tenant is a retailer, what are its sales in its other locations and what are the projected sales for this location? Of course, the manager must inquire of the prospective tenant's interest in the specific use of the premises. The more the manager can find out about the tenant, the better he or she will understand the tenant's negotiating position and the manager's own position.

Understand the Property Owner. The fourth step in preparing to negotiate is to understand the property owner and the decision-making process. A developer will probably provide an immediate response to a deal, while an institutional owner may need the approval of several people. Is the property owner aware of the market condition? Does the owner understand the property's position in the market and have a realistic understanding of its rental rate? In other words, does the property owner expect to achieve a much higher rental rate than the building justifies? What is the property owner's negotiating style? What role will the owner play in the negotiations?

Determine Tenant Importance to Property. Next, determine how important this tenant is to the property. If the property is a shopping center, is the prospect important to its tenant mix and draw? Is the prospect interested in a space that has long been vacant and is difficult to lease? Is the prospect important to the sale or refinancing of the property? What other value does the prospect bring to the property? If this deal is not made, what are the prospects of making an equivalent or better deal in the future?

Learn the Lease Provisions. The final step is to learn the lease provisions. The commercial lease is not a complicated document. With the help of an experienced property manager or an attorney, a novice property manager can develop an understanding of each lease provision and how each provision impacts the value and operations of the property. This chapter discusses most of the provisions in shopping center, office building, medical office building, and industrial property leases.

Who Is Involved?

Many players are involved in a lease negotiation, often referred to as a "deal." Some players—such as the property manager, the property's leasing agent, and the tenant's representative—are often directly involved in the entire negotiation. The property owner and the tenant may not be directly

involved in the negotiations, but they decide whether to accept or reject the lease terms and provisions. Attorneys may be involved in negotiating the lease provisions, available for consultation on specific provisions and issues, or not involved in the deal at all. Seldom is an attorney involved in negotiating the deal's business terms, e.g., rent and possible concessions.

One responsibility of the person in charge of leasing a property is to keep all the players involved in the deal. A deal that appears to be proceeding to closure can come to a complete standstill. The longer completing a deal takes, the greater the chance it may collapse. Each player in the deal must recognize his or her role and be willing to take the deal to completion while respecting the other parties' roles.

Property Owner. The property owner's role is to analyze the terms of the potential deal, the use of the space, and the negotiated lease provisions and to make the final decision as to whether to accept or reject the lease. The decision may take many turns while the lease terms and provisions are negotiated. Each party submits offers and counter-offers. The property owner should rely on the property manager or leasing agent's advice as to the market rental rate for the property and the space under negotiation.

Property owners and especially developers sometimes become emotionally involved with the property and perceive it to have a higher value than the market perceives it to have. This is one reason the asking rate for some buildings is significantly above market value. The property owner should also be responsive to all lease proposals and counter-offers. Everyone in the deal must have a sense of urgency in completing the deal to avoid the other party losing interest in it or finding another alternative. However, at times a delay in responding to an offer or a counter-offer is part of the lease negotiation strategy.

Prospective Tenant. The prospective tenant also has final authority to accept or reject an offer or counter-offer. The role of the prospect is similar to that of the property owner. The prospect must rely on the advice of his or her representative regarding the market rental rate for the property and space under consideration. Unlike the property owner, who is likely to be actively involved in real estate, prospective tenants are not real estate professionals, and they may have only a vague understanding of the market. The prospect is more likely to have an attorney review the lease document.

Property Managers and Leasing Agents. Property managers and leasing agents are highly motivated to "do deals." The leasing agent typically earns all of his or her income from commissions. This person may be the only party to the leasing team who is not paid if the deal falls apart. The opportunity to earn a commission keeps the leasing agent motivated to keep the deal in play.

The property manager and leasing agent must not let the chance to earn a commission be the driving force behind doing deals. These parties have fiduciary responsibilities to their clients and must always act in the clients' best interests. This may include telling a client that a proposed deal is not in the client's best interest. The leasing agent representing the prospective tenant must keep the client aware of market conditions, alternative space, and the comparison of each deal to the rental rates in other buildings. The leasing agent is the confidant of his or her client and must understand the motivations of each party to keep the deal in play as long as it is in the client's best interests.

The property manager is responsible to the property owner either in the role of leasing agent for the building or in supporting the building's leasing agent. The property manager's role includes keeping the property owner educated on the market and the building's rental rates. If the property manager is also responsible for leasing, the role discussed for the leasing agent above also applies to the property manager. If the property manager serves in a support role, he or she should review negotiated lease provisions and evaluate their impact on the operations of the property.

Attorneys. Attorneys are charged with protecting their client's interests. A good attorney recognizes a client's need to make a deal while providing advice on negotiating lease provisions.

Each player in the deal must be aware of the dynamics involved in completing a deal with multiple parties. Each party brings a different perspective to the deal. There are more opportunities to kill a deal than to facilitate and complete one. If each party understands its role and acts in the best interests of its client, and if the property owner and the prospective tenant are realistic as to the value of the space, the probability is high that a deal will be completed.

With this understanding, property managers will know the property owner's position in negotiating lease provisions and concessions. The market conditions, the need for a tenant, and the tenant itself also determine whether lease provisions need to be negotiated and whether concessions must be granted. In soft markets and in properties with high vacancies, concessions may be given that otherwise might not be necessary to make the deal. Very desirable tenants, major tenants, and national tenants generally require the negotiation of lease provisions. The independent and local tenant is seldom in a strong negotiating position to command many, if any, lease provision concessions. Disputes are more likely to occur with independent tenants than with national tenants. The property owner should maintain more protection in the lease with local and independent tenants. An independent tenant is more likely to have lease defaults.

It is important to assess the relative negotiating positions of all parties before starting the negotiations. Does the building need the tenant more

than the tenant needs the building? What alternative locations are available and what are their features? The market survey discussed in Chapter 6 provides information about the relative strength of a building in the market. All of these factors determine the strengths and weaknesses of the property manager's negotiating position.

COMMON COMMERCIAL LEASE PROVISIONS

Many business issues are common to all commercial leases. These issues should be considered for every leasing opportunity; they should be handled in accordance with the type of building, the nature of the tenants, and the probability the particular issue will become a problem.

The Parties

The property owner and the property manager must know exactly who the tenant is. Is it a corporation, partnership, a Limited Liability Corporation (LLC), a married couple, or an individual? In most states, a minor may void a lease at his or her option, so it is important to proceed cautiously if the prospect's age is in question. The property owner may not have this option. If the lease is with a general partnership, all of the partners should sign the lease. The property owner or the property manager should obtain the advice of an attorney regarding a husband and wife's obligations when only one of the spouses signs the lease.

Late Charges

The lease states both the date the rent is due and the date it is considered delinquent if it is not paid on time. Normally, all rents are due on the first of the month and delinquent on the fifth of the month. Penalties for late payment must be reasonable and clearly stated in the lease. Some leases require the property owner to give the tenant a notice that rent has not been received before a late charge can be assessed. The tenant then has three additional days to pay the rent before being assessed a late charge. Other leases state that if rent is not received by a specific date—usually the third or fifth of the month—a late charge may automatically be assessed.

Some tenants will negotiate for a written notice before a late charge may be assessed. If this provision must be negotiated, the property owner may provide for advance notice before assessing a late charge the first time the tenant's rent is late, but not for future late payments. Late charges and/or penalties should be in line with what the local courts view as reasonable, or they are not likely to be upheld in a dispute.