THE EXPERTS

COMMERCIAL REAL ESTATE

Importance of reviewing lease can't be understated

I have been working with tenants and landlords for over 40 years, helping them negotiate fair and equitable leases. The lease expense is normally a company's second largest cost (personnel being the first).

The annual lease review process is a smart endeavor that should help a company's executives formulate an ongoing strategy to keep the lease expense at a reasonable level.

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The annual review date is usually the anniversary date of the lease. If the review falls within the last year of the term, the review process should be treated as an immediate action item. This process only takes a few minutes for a professional to accomplish, but if done properly, it has the potential of saving your company thousands of dollars depending on the size of the space being leased.

Negotiating the lease renewal takes time but will give a positive result. Waiting to the last minute limits your negotiating ability with your existing landlord because the landlord knows that with the cost and preparation it takes to move your company to a more desirable or affordable location, he has a captive audience.

If improving the bottom line of your company is important to you, you need to recognize your ability to properly negotiate on your own behalf is like a lawyer representing himself in court. It's not a good idea. You need a commercial real estate broker who understands the market, building operations, construction and the lease document itself.

The first step in the lease renewal process is to understand the rent per square foot. This may seem simple, but the true rental rate is sometimes hidden. It has been my experience that most CEOs and, most of the time their agents, know approximately what they are paying per square foot, but if they have a full-service lease they do not know what the tenant paid to satisfy his increases in operating expenses charged to him annually after the first year.

This is primarily an accounting function that doesn't necessarily transform itself into part of the rate per square foot, but in order to have a realistic picture, this annual fee must be factored into the rent being charged.

These overage expenses are normal and customary in a full-service office lease and are billed to the tenant. This fee is usually based on increases of operating expenses over a base year to operate the property. Because these fees are unknown at lease signing, they are not reflected in the rate per square foot you negotiate with your landlord.

Most agents like the renewal process rather than generating a new lease because many renewals only take a page or two and a laborious legal review is minimal. Many times the end of the renewal addendum will specify that, other than what is written in the addendum, all other terms and conditions of the lease will apply.

If you have not reset the base year, the base operating expenses established perhaps five years ago remain the same and those years of annual increases keep getting billed as additional rent even though you negotiated what you thought was the market rental rate.

The annual rate per square foot is the annual rent divided by the rentable area and is expressed in a number such as $18 per square foot. This number is relevant because it gives you your current rent in a format that you can compare with what is being offered in the surrounding office area.

It is important that when comparing spaces you use comparable buildings with similar lease types. Class A, multistory buildings normally utilize full-service leases which include janitorial, electricity, maintenance, taxes and insurance as part of the rent.

Office warehouse and retail buildings generally use some sort of a net lease where the tenant pays rent, but also pays his pro rata share of taxes, insurance and any other expenses (operations).

Understanding the true rate per square foot, making sure to include any pass-through of operating expenses, is your first step in knowing if lowering the existing rent is an issue that you need to negotiate. This is the first step in understanding the scope of the negotiating issues you should be addressing prior to your lease renewal.

As noted earlier, it is customary for the increases in operating expenses to be passed through to the tenant. The clause is put in the lease to keep the landlord current with the actual expenses he is accruing on the tenant's behalf. This seems fair, but many times there is an annual escalation in addition to the expense pass-through that is paid on the rent including that part of the rent that is earmarked for operating expenses.

If the tenant has a large lease, the part of the rent earmarked as expenses is escalated twice. Quite often this can be negotiated out of the lease if the impact of the combined escalations increases your rent faster than the market.

Other issues that should be considered other than the annual escalation rate are whether or not your lease has a gross-up provision relating to limiting operating expense increases due to nonleasing activity, tenant improvement requirements and the ability of the landlord to fund those improvements, incentives that might be available, and any options that may be needed in order for the company to remain flexible.

Finally, you should also understand the availability of other property in your submarket. If there is product available, landlords are more likely to negotiate rent. If there is little or no product available, landlords are looking to increase their investment and rents will increase.

This market and product knowledge, along with the help of a knowledgeable broker, will help you negotiate a fair and equitable lease agreement.

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