

## How the Landlord Makes or Breaks the Deal and the Requirements for a Good Tenants Lease

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I have found over the years that the biggest obstacle in getting a deal done is the landlord. The landlord either makes the sale and/or lease of the business possible or prevents the transaction from moving forward. In recent years after the great recession and the booming economy in many parts of California landlords have become greedier. They want top rent for their space whether it makes economic sense or not for a food and/or beverage tenant.

Consequently, I am seeing many tenants vacate their spaces at the end of their lease term. It doesn't matter that their business is profitable as they won't be able to continue running a profitable business with the proposed increased new rent and the new rent makes it prohibitive for them to sell their business to another food and beverage operator. I am seeing many spaces that were formerly food and/or beverage operations being converted to other uses who can afford to pay the increased rent. Some cities are restricting landlords to convert ground floor retail space to office space where office space is scarce such as in downtown Palo Alto as they want to preserve the retail activity of the downtown. Nonetheless prime downtown rents are extremely high and most food and beverage operators cannot afford the rent like downtown Palo Alto.

If you are a restaurant buyer or lessee one of the first things you need to do as part of your due diligence is determine if the occupancy costs are going to be acceptable to you. These include the following: a. base rent, b. additional occupancy costs, if applicable, c. yearly rent increases and d. option periods and rent during option periods, etc. These latter mentioned items as well as additional items will be discussed in detail later in this article.

I have a client in San Francisco who is doing \$4.5 million in sales and has been a tenant in their space for 17 years and they are now not making money due to their high operating costs. Their lease expires the end of this year and they can't afford to pay the 33% rent increase and are moving out.

On the other hand a landlord can work with a tenant to make a lease mutually beneficial. I have a restaurant tenant who has been my tenant in San Francisco for ten years and the base term recently ended and he had a fair market rent option. Due to increased operating costs, he could not afford to pay the increased market rent so in order to keep him in the space we actually reduced his rent for the next five-year period as he is a good tenant. If we had to go to the market to lease the 5,000-square foot space it could cost us approximately \$300,000 between free rent, landlord leasehold contributions for tenant improvements and the leasing commission so we felt it made more sense to

lose approximately \$100,000 in rent over 5 years rather than losing approximately \$300,000 per the above mentioned costs up front to obtain a new tenant. Additionally, in San Francisco there is a Formula Chain Ordinance which means in many quasi-residential areas a business that has ten locations anywhere in the US cannot go into that location and our location falls under this category. Needless to say, it is much riskier for us to lease the space to independent operator versus a chain operator which our current tenant is.

I currently have a well-established bar listing in San Francisco which are in high demand. My clients want to retire and immediately after listing the business the landlord sold the building which is an old run-down apartment building. The buyer is a developer who plans to tear down the building and build a new multi-unit residential and/or condo building and my clients fair market rent option which kicks in approximately 5 years will be prohibitive for the buyer as the developer wants to tear down the building and eliminate the bar. Consequently, the sales price of my client's business will be reduced by 50% to provide a buyer the ability to get his investment back as well as getting a good return on his investment so the investment makes economic sense. Making sure to have enough time left on a lease is important to maximizing or making a sale. Here you really need to Not Wait Until it is too Late.

We have a franchise listing in Southern Cal and although initially we were told that the landlord would offer an option with the remaining five years on the base term we recently learned after being in escrow that the landlord has changed his mind regarding offering an extension and the seller has only five years left on his lease. Consequently, the sales price is being reduced by 50% so the buyer will be able to get his investment back as well as get a good return on his investment. In both of the immediate examples above in order to make it worthwhile for the buyer to be spending four to five years of his life building a business and then have it taken away by the landlord due to no lease extension the buyer needs to get an outstanding return on this investment in order for him to justify this risk.

## The Requirements for a Good

### Tenant's Lease

The basic requirements for a buyer or lessee for either a new lease to be negotiated or an existing lease to be assigned to the buyer/lessee are indicated below.

Minimum Base Term of five (5) years.

Yearly Rent Adjustments not to exceed three (3%) per year.

Options - A minimum of one (1) five (5) year option and preferably two (2) or more five (5) year options. The rent for the first year of the first option and subsequent years of the first five (5) year option should be a continuation of the yearly increases spelled out in the base term above (i.e. not to exceed 3% yearly). In subsequent options try to negotiate the first years rent of the option tied to a formula such as the base rent in the second or third five (5) year option in the most recent prior years rent is not to exceed somewhere between ten (10%) to fifteen (15%). Subsequent yearly increases in each option again should not exceed three (3%) per year. By having a set formula and not being subject to the landlord's fair market rent adjustment at the beginning of each option you will be able to keep your rent at a reasonable level which will hopefully give you the ability to stay in the space for many years. If you have to accept a fair market rent adjustment make sure it only becomes applicable in a second option and not in the first option. Also make sure that there is an objective formula to determine the fair market rent such as the brokers method or appraisal method and try to stay away from arbitration for determining fair market rent. In any case make sure that the formula is tied to ninety (90%) of the fair market rent.

Additional Occupancy Costs. In some leases, and in particular retail spaces in shopping centers and office buildings, landlords will require tenants to pay additional costs such as property taxes, building insurance and common area expenses (CAM expenses). These expenses are charged based on a pro-rata share of the common area costs such as landscaping, security, parking lot maintenance, utilities and other repair and maintenance items (i.e. if you occupy ten (10%) percent of the building you'll be charged ten (10%) of the CAM costs). Capping Real Estate Taxes – Try to negotiate language in your lease to protect you should the building be sold or transferred and the building is reassessed and you are responsible for paying a pro-rata share of the increased real estate which could result in a significant increase in your occupancy costs. This language (capping your real estate tax liability) will result in your real estate tax liability being limited only to the assessed value of the building at the time you executed the lease with yearly increases being limited to normal yearly real estate tax increases. I must add however, that most landlords will not cap the real estate taxes as it negatively affects the value of their building.

Assignment and Subleasing – Make sure you have language in the lease which gives you the right to assign and/or sublease the lease to qualified third parties who are interested in either buying the business and/or subleasing the business. Make sure there is language in the lease that states the landlord will not unreasonably withhold consent to a buyer for an assignment of the lease. Also in the case of a sublease try to negotiate language whereby any rent spread (increased rent you receive versus the rent you are paying the landlord) goes to you and does not have to be split with the landlord. In most cases the landlord is going to want either 50% of the spread or 100% of the spread.

Use Clause – This is the section of the lease that spells out specifically what type of use you are allowed in the space. I suggest having as broad a use clause as possible such as a "restaurant serving alcoholic beverages". This give you the flexibility to change the restaurant use if the current concept is not working. In buildings where there are multiple food service tenants this will be difficult to obtain as landlords want a very specific use clause so there won't be any head on competition with their other food service tenants and they want complimentary tenants that will be synergistic for the other tenants in the building.

First Right of Refusal or The Right of First Offer – The First Right of Refusal means that if the landlord puts the property on the market to sell and receives an offer the landlord is then legally obligated to let the tenant match or increase the offer being made. Most landlords will not agree to the first right of

refusal as it clouds their ability to fully market the building to third parties as a certain percent of buyers will not be interested in making offers if they know they can be out bid by the existing tenant. However, a good compromise in negotiating your lease with the landlord is The Right of First Offer. This means that if the landlord decides to put the building on the market for sale he is legally obligated to offer it first to the tenant. If the tenant is not interested in purchasing the building at the price and terms requested by the landlord the landlord can then put it on the market and has no further legal obligation to deal with the tenant regarding the purchase of the building.

**Guarantor** – For most leases the landlord will require a personal guarantee of the lease by the tenant. This means that although the lease can be in the name of the owner's partnership, corporation or limited liability company the landlord will want the lease personally guaranteed by an individual that owns a reasonable amount of assets and preferably owns real estate. The reason for this is that if the tenant fails the landlord can take legal action against the guarantor to recover the monies he is owed by going after the guarantor and obtain a judgement against the tenant which can be attached on the guarantor's real property. I recommend that you try to negotiate a removal of the personal guarantee after a certain period of time (3 to 5 years from the start date of the lease) once you have a proven track record with the landlord in meeting the terms of the lease

**Landlord Contributions for Tenant Improvements and/or Free Rent** – If you are buying a business and the seller is in good standing with the landlord it is not likely that the landlord will agree to give you monetary contributions for tenant improvements and/or free rent. However, if the seller is a problem tenant and the landlord wants to get rid of the seller as a tenant he may contribute monetary contributions for tenant improvements and/or free rent for short period of time until you are open for business. Also, if the space is a shell (an empty space not built out as a restaurant) and the tenant has to build out the space then the landlord may consider contributing so many dollars per square foot and/or free rent (usually a certain number of months before the tenant is open for business). In some cases, the landlord wants the tenant improvement contributions he made paid back to him through increased rent until the improvement money is fully paid back.

**Non-Disturbance Clause** – This is a clause which protects the tenant should the landlord be foreclosed on and lose the property and will enable the tenants lease to survive the foreclosure. If this clause is not included in your lease your lease can be wiped out if the landlord loses the property.

The above items are only some of the major points that should be included in your lease. If you would like further information regarding the above material, other lease items and/or would like consultation regarding negotiating a lease please contact [steve@restaurantrealty.com](mailto:steve@restaurantrealty.com).

## ABOUT THE AUTHOR

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Steve is the Founder, Principal Broker and Chief Executive Officer of Restaurant Realty Company. Steve has personally sold/leased over 900 restaurant, bar or club businesses, sold many commercial buildings and completed over 3,000 restaurant valuations since 1996. His real estate experience also

includes sales, acquisitions, management and ownership of numerous properties throughout California including restaurants, hotels, apartment buildings, single family houses, an office building and a multi-use retail building. Steve is also the author of Restaurant Dealmaker – An Insider's Trade Secrets for Buying a Restaurant, Bar or Club available on Amazon. Prior to starting Restaurant Realty Company Steve had over 20 years of restaurant experience and was President and Chief Executive officer of Zim's Restaurants, which was one of the largest privately owned restaurant chains in the San Francisco Bay Area.



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