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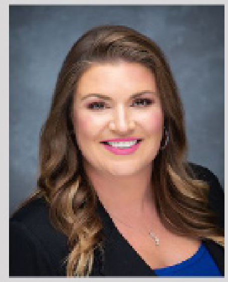
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Different Choices Of Rental Plans

When there are vacancies in commercial buildings, tenants may feel that they are in a good position to seek concessions from landlords on new leases or in exchange for extending or renewing existing leases. Landlords are apt to make deals for two reasons: (1) The landlord may be facing high vacancy rates, and (2) The landlord also recognizes that tenants may also be suffering from declining business during a recession and are less able to pay the high rentals.

The landlord will be looking for a formula or concession that will give the tenant an economic break, but at the same time allowing the owner to show a scheduled (on paper) rent roll that is sufficient to satisfy a banker who is providing financing for the property.

Alternative Idea In Rentals

There can be a variation in the typical retail rent formula that calls for a fixed minimum rental plus a percentage of gross sales over a specified minimum sales volume. Here are some possibilities:

- **Graduated rent.** Most people starting in business are short of money. If the negotiation establishes a graduated minimum rental that will give them a rent break in the early years, while producing the overall rental needed by the owner over the lease term, both might be happy. (Be sure and check with your tax advisor, as consideration should be given to IRC Sec. 467, which may require the rent to be "leveled" for tax purposes.)
- **Rent differentials.** There is no reason that the landlord must charge the same square footage rental for the entire leased premises. The rent charged for the showroom area and sales area may be higher than that charged for stock rooms or storage areas. In exchange for charging a lower rent for the non-sales area, the landlord may want the percentage rental on the sales area to kick in at a lower level or be at a higher rate.
- **Base year rent.** The parties might agree to a straight percentage rent for the first year instead of setting a minimum fixed rental for the first and subsequent years. Then that rent will become the base for all future years. This will allow the tenant to be assured that a slow start-up will not be a business-breaker because of the need to pay a high minimum rent. For the owner's protection, he may have the right to cancel the lease if low sales in the early months or years result in a too low rental.
- **Rent deferral.** Deferral or free rent is the worst example of graduated rents. In extreme cases, a l0-year lease could offer free rent for the first year. (It might be better for both parties if the period of free rent could come somewhere in the middle of the lease term. This can assist the landlord to "amortize" the loss over the earlier years during which rent has been paid.)

(continued)

Other Concessions

Don't just limit the negotiations to dollar amounts of the monthly rent. There are other things that can be just as important to both sides:

1. Recapture provisions. When the tenant incurs significant costs for leasehold improvements, the owner may agree that the tenant may recoup a portion of the cost from future percentage rents (but not minimum rents).

2. Turnkey deal. The owner might agree to make all leasehold improvements to the premises so that it is ready for the tenant to move in and begin fixturing.

3. Kickout clause. A performance kickout clause included in the lease may reduce the minimum fixed rental if sales do not achieve the level mutually agreed on.

4. Percentage rents. The point at which gross sales trigger the payment of percentage rents may be raised during a portion of the lease term or during the entire term

5. Escalation clause. In the typical lease, the tenant must pay a proportionate share of increases and operating costs as well as a percentage rental. There are adjustments that can be made here. A cap could be put on the maximum amount of escalation costs each year or on the maximum increase each year. Another way might allow the tenant to deduct a percentage of escalation costs from percentage rents; this could be an excellent negotiation for a tenant who expects to show significant increases in sales volume over a period of years. ❑

Agreement Between Owner And Developer

The acquisition and improvement of land is a large-scale operation and requires large amounts of capital. This has created methods of land acquisition that gives the developer access to and control over a large enough tract to make development economical without requiring an initial outlay of all of the capital necessary to acquire such a tract.

From the point of view of the landowner, the disposal of a large tract at a good price may require a formula that will encourage the developer to commit improvement and development money for part of the tract that will build future value into the entire tract.

This may be accomplished by the following:

- The developer sets up a master plan that sets forth the general scheme of development and submits it for the approval of the owner.
- The developer and owner enter into an agreement setting forth the acreage prices for the entire property.
- Owner and developer agree on the number of years over which the full development is to be completed.
- To protect the owner against freezing of his property, the developer firmly commits to buy a predetermined number of acres each year.
- If the developer fails to meet this schedule, the owner is released from his commitment.

A Development Agreement

Another way of handling the problem is for the developer to share the net profits from the land development with the landowner. This can be done by a "land development agreement" in which the developer agrees to perform the platting, the laying out, the installation of lot improvements, and the promotion of the subdivision. The landowner agrees to accept a percentage of the sales price of each lot, with a fixed minimum guaranteed. For example, the developer agrees to pay net to the landowner 25% of the sales price of each lot sold, with a minimum of $50,000 per lot.

With this kind of arrangement, it is important to protect the landowner from finding his land cluttered up with liens left by a subdivider who became insolvent. The landowner should consider confining the developer or subdivider to a small tract of land at a time and give him "rolling options" to acquire additional parcels at intervals over a period of time. Failure to keep up with this purchase program results in loss of future options. The land that has been optioned but not purchased is not subject to liens against the developer.

A Liability for Not Proceeding

In one case, a jury found that a village breached its contract with a real estate developer calling for the village to acquire property and convey it to the developer for construction of apartment houses and a shopping center, all conditioned on obtaining financing from HUD. The village repudiated its explicit undertakings, to acquire and convey property to the developers. HUD had granted the main application and was in the process of considering the other grants involved, so the village could not back out of its promise. [Heritage Commons Partners v. Village of Summit, 730 F.Supp 821, (ND Ill. 1990)] ❑

Refurbish For Future Profits

When you want an increased return on an older property it may be time to refurbish the property. When you look around a community, you will usually find a number of properties that need to be upgraded. Some existing owners do not recognize the increased return that they could get or do not want to make the necessary investment. Often these buildings can be acquired at a price that reflects the return based on the current condition and income.

When you set out to modernize an older building, you will encounter physical deterioration, which starts immediately after the building is completed and continues throughout its entire life, unless it is handled along the way with proper maintenance and repair. Functional obsolescence then happens when the property loses its usefulness as a result of changes in styles or in the needs of tenants. Economic obsolescence is a change in value that is caused by circumstances that are not directly related to the property. Often this is a change in the area from residential to commercial or industrial. When a building is quite old, structural changes may be needed for safety reasons. Before you purchase the building, a professional engineer should make an inspection.

The building can be partially redesigned with architectural changes during the modernization. If a building has very distinctive architectural features these might make the building more desirable and be retained.

Functional changes and mechanical replacements can reduce costs in an old building and increase efficiency. Wiring will usually need to be replaced to provide safety for modern electrical and computer equipment. Old heating systems will usually be inefficient and cause high maintenance costs, and should be replaced.

Aesthetic improvements are the sprucing up of the property and can usually be done at a relatively little cost. When an investor is looking for a quick resale, this type of improvement may be done rather than some of the others. Cleaning up the property, inside and outside, installing new lighting and repainting the building can be enough sometimes to make a quick, small profit.

Modernize For Profit

When an investor is looking for the proper investment, older apartment or commercial buildings in good neighborhoods often look better for a long-term commitment than new construction. When a property is upgraded, rents can be raised substantially and, if the work can be done without disturbing the existing tenants, the investor will not have the expense of carrying the property as he would in new construction. The investor would also hope that most of the existing tenants would stay and pay the increased rents, so the costs related to acquiring new tenants, as would be needed with a new construction, would be avoided.

Finally, the overall costs may be less. Although the price of the property may be high in relation to the current rents, the final cost after modernization may be far less than the cost of new construction. With this lower cost, the investor may be able to charge lower rents than new buildings nearby, putting him into a very competitive position.

Converting To New Use

Unproductive properties can present opportunities for big profits. When a building is bringing in little or no income because obsolescence or because of changes in the neighborhood that have made the location unsuitable for the original use of the building, converting to a new use can make a new profitable income stream.

Don't overlook properties that are still productive, but may have a much greater potential after a conversion. A chocolate factory was converted to a shopping center on the west coast. Movie theatres have been converted to supermarkets. Garages have been converted to condominium parking buildings. Seeing potential profits in older buildings takes imagination.

Give our office a call if you see a building that has potential for another use. ❏

Communication Between Management And Owner

For success in achieving the owner's objectives, there must be open communication between the owner and the management company. The process must be continuing from the onset of the management plan based on the owner's objectives to the dissemination of monthly and annual financial reports for the owner's records.

Meetings between the owner and the management company should be set up on a regular basis. In these meetings, topics such as major repairs, personnel problems and rent collection can be reviewed. In-between meeting, managers must communicate serious problems with the owner immediately, so they can be addressed in a timely and cost-effective manner. Constant communication is essential to the process of management. ❏

The Need For Both Asset And Property Managers

When owners of large portfolios of investment properties need to make strategic business decisions involving management of these properties, they will usually call on asset managers. Areas of concern are overall leasing strategy involving rental rates and tenant concessions, in addition to repositioning or redevelopment, tenant mix, managing bulk service contracts.

The Asset Manager

There will be owner oversight to the manager's actions, but the asset manager usually controls such matters as contracts, leases, and capital improvements for portfolio properties and is directly involved in implementing strategies involving financing and tax or litigation-related issues. The asset manager will also be responsible for maintaining communication with lenders and equity partners with respect to financial reporting, debt negotiations, and significant operational issues.

The asset manager also can be expected to provide basic administrative services, including information systems support, in-house legal counsel, financial accounting, coordination of required appraisal, and preparation of annual operating budgets. The asset manager also may plan and coordinate exit strategies–sale and disposition of real estate. Finally, the asset manager will be responsible for overseeing property management personnel.

The Property Manager

Property management responsibilities differ from those of the asset manager. The property manager has a more tactical focus, dealing with the day-to-day operation of individual properties. These responsibilities include: overseeing repairs and maintenance, security, and cleaning operations.

Finance-related responsibilities of the property manager include tenant billings and collections at individual properties; lease negotiations; vendor contracts; cost control for property operations; and maintaining appropriate insurance coverage. They also handle tenant relations and deal with on-site issues such as space and leasing requirements. Finally, the property manager maintains accounting records and performs necessary inspections.

Property managers also may be called on to handle legal matters relating to building and tenant interests and to ensure compliance with local laws and ordinances. Finally, the property manager is the conduit by which information about each property and its operations passes to the asset manager. ❑

CCIM Institute
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A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.