

Foremark



Foremark provides strategic planning, real estate site selection and project management services for restaurant companies nationwide.

The Pendulum Swings In Tenant's Favor

THROUGH UPFRONT DEAL NEGOTIATIONS, A GROWING RESTAURANT COMPANY CAN GET TERMS THAT AFFORD FLEXIBILITY AND TENANT PROTECTIONS

In a difficult economy, restaurateurs need all the flexibility they can get. For example, if a concept has run its course, you want the ability to change concepts. The contract most likely to prevent you from doing so is your lease. Now is the best opportunity in many years to negotiate tenant friendly lease terms. And, the best way to successfully negotiate these deal points is upfront in the real estate negotiation by the site selection team. Restaurant companies that do so will be best positioned to succeed in the years ahead.

For many years, landlords were in the driver's seat. Developments in desirable trade areas around the country were inundated with potential tenants, especially eager restaurateurs. One result: landlords got used to dictating lease terms to their retail tenants. And, those tenants who dared to question the terms of a lease were reminded, not always gently, that it was a landlord's market.

To illustrate the point, 20 years ago I was negotiating a pad site deal for Grady's American Grill in Johnson City, Tennessee. Grady's was a small regional chain of 8 units at the time. The other party to the negotiation was Toys R Us, the largest toy retailer in the USA. Toys R Us had some excess property adjacent to one of its stores. In trying to finalize a Letter of Intent, a fairly amicable negotiation turned heated. What I thought was a reasonable request on my part (in representing the small regional chain) was deemed overreach by the negotiator for the powerful, national retailer. He responded, "that would be like the ant eating the ant eater!"

It was a landlord's market. The Toys R Us negotiator wanted our side of the table to be clear about that. Demand outpaced the supply of desirable retail space. Like it or leave it. So it goes during boom times.

No matter what the economy is doing, or whether your retail operation is regional or national in scope, a set of risks needs to be addressed in assessing the viability of a long-term investment. On behalf of our clients, we do our utmost to identify and minimize those risks. And, we do that in any kind of economic environment. On that day, it just happened to be a more challenging proposition, given the robust economy.

Today's Oversupply of Retail Space

What a contrast to today's economic uncertainty! Now, there is an oversupply of retail space in many markets. Some landlords have lost retail tenants during the economic downturn, and those who have are nervous about the prospect of losing more.

The economic uncertainty presents extraordinary challenges. The credit crunch that began in 2008 is still with us. For companies large and small, the need for financial and operating flexibility has never been greater.

In real estate, the pendulum has swung in favor of tenants. Good tenants are in high demand. For them, today's economic uncertainty presents an opportunity to take advantage of the lower demand for desirable restaurant sites. It's a chance for bold restaurateurs to improve their positions, if they've got the financial flexibility to do so.

One of the first things Foremark recommends to a new or prospective client is creation of a Letter of Intent template that addresses most of the significant business points that will ultimately end up getting incorporated into the lease. It starts with the basics, like rent, landlord build-out allowances and term of lease. We also consider important non-financial business points, which will be written to the landlord's advantage unless they are addressed and negotiated. The best time to successfully negotiate these terms is not between the attorneys during the lease negotiations, but upfront between the site selection team and their counterparts on the other side of the table.

Some of these issues include:

LEASE GUARANTEE

When signing a lease, the tenant is liable for the entire rental stream of the lease term – whether the location succeeds or not. Some risk can be mitigated by forming an entity to limit personal or corporate exposure, but, in many instances, landlords require full corporate (or even personal) guarantees. To what extent should a tenant be at risk? For the full amount of the rental stream owed for the entire term? Or, for the amount of the unamortized tenant improvement allowance? And, for what period of time? The entire primary term? Or, say, one that “burns off” over the first half of the primary term of the lease? The point is this: these terms are negotiable. Through negotiation, it is possible to reduce your exposure. If your primary lease term is 10 years, perhaps your personal or corporate guarantee need not cover all 10. In today's environment, every dollar of exposure is important.

USE AND CONTINUOUS OPERATION

Concepts go in and out of favor, and desirable trade areas change over time. Landlords typically ask tenants to operate as the original concept for the entire length of the primary term of the lease. In these uncertain economic times, the ability to re-concept a location, or to assign or sublease to another tenant is imperative – without the landlord being able to unreasonably withhold its consent. Having that flexibility on each location may be the difference between a company thriving and struggling to survive. Along the same lines, an operator needs the leeway to cease operations while continuing to pay rent – if it is in their best interest to do so. Is it reasonable for a landlord to require a restaurant to stay open when they desire to close? In my opinion, no. Is it reasonable for a landlord to require a restaurant to commit to staying open any length of time – whether it be one day or two years in order to give the location a fair try? Probably so. The landlord has a need to limit his operational exposure too.

We have successfully negotiated on behalf of tenants who wanted to try another concept within the same price range. In other words, it may be possible to move from one upscale dining concept to another. However, moving from upscale dining to a mid-range menu may pose problems for other tenants. In any event, realize that it's easier to negotiate such a change on the front end of the deal. That's when you have the greatest leverage.

COMMON AREA MAINTENANCE

Most restaurant leases are structured as triple net leases, meaning the landlord passes through to the tenant the costs of taxes, insurance and common area maintenance (CAM). If not well managed by the landlord and appropriately controlled by the tenant, these costs can increase over time and significantly affect profitability. The ideal scenario for a restaurant is to opt out of CAM and pay for the maintenance of a defined area.

However, sometimes it is possible to realize economies of scale by sharing these expenses with surrounding tenants. Any sharing arrangement that is based on the square footage of leased premises is beneficial to restaurants, as restaurants typically utilize more of these services than straight retail operations. Another important point is to negotiate a cap on how much the landlord can increase CAM charges during the lease term. Be forewarned: landlords fight caps tooth and nail, but it is feasible to achieve, at a minimum, caps on controllable items such as trash removal and landscaping.

In our experience, it is fairly common for landlords to estimate CAM charges during the lease-up phase of development. Those estimates sometimes understate actual costs by a significant amount. When it happens, the tenant's existing ROI analysis is rendered useless. How can a tenant agree to an open-ended expense? Prospective tenants must address the issue in the form of a first year cap – before signing a lease. After the fact, you have no recourse.

Most standard shopping center leases are written by a landlord's attorney to protect the landlord's interests. But, tenants have interests that ought to be considered too. By agreeing to a lease term of 10 or 20 years, a tenant's financial commitment to the landlord is quite substantial. It's not unreasonable for a tenant to seek provisions that protect its interests.

EXCLUSIVE USE

A tenant's best interests are served by assuring that the landlord will not rent space in the same shopping center to a direct competitor. If your restaurant is a burger concept, it's reasonable to suggest that it be the only burger concept in the center. That is the purpose of an exclusive use clause. Landlords sometimes bristle at the notion that a tenant should dictate how the landlord's space will be used. It's an idea that violates historical norms in most U.S. real estate markets, so prepare to meet with resistance.

PROHIBITED USE

This clause restricts a landlord from renting space to another business that is fundamentally incompatible with your business. For example, if you operate a family-oriented restaurant, you might reasonably seek to prohibit the landlord from renting space to an adult entertainment establishment.

LANDLORD DELIVERY OBLIGATIONS

For any property, there should be a list of landlord deliverables. Make sure the list is written, and everything agreed to verbally is on the list. If the landlord tells you the property is equipped for a restaurant and ready to go, you want to see a deliverables list that includes water, sewer, electrical and HVAC systems, etc. Typically, these deliverables are found in the Representations and Warranties clause of the lease. A tenant ought to specify what the remedy will be in the event the landlord does not deliver as promised. Ideally, the tenant would like the right to cure the problem and get reimbursed through rent offsets. Putting specific remedies in the lease is far more effective than failing to do so, and later seeking redress through the courts. Suing is costly and time consuming.

PARKING RIGHTS

Most restaurants earn a majority of their profits during a relatively short period during the week. For some, it's the two-hour breakfast period on weekdays. For others, it's Friday and Saturday nights. During your peak times, you don't want customers competing for parking space with another tenant's customers. You might reasonably require the landlord to ensure ample parking for your customers during your peak times. The number of spaces is just one issue.



The designated parking area should be close enough to your door that patrons won't be discouraged from using it. And, it should have appropriate lighting. In most cases, there is no such a thing as too much signage. The one sign you never have to want to install is a neon "Seating Available" sign. It's only necessary when a full parking lot discourages customers from coming in the door.

Many other points like these can be addressed and successfully negotiated with potential landlords, if tenants get advice from an experienced real estate team. While the Foremark team has been involved in over 800 restaurant transactions, we also advise clients to have leases reviewed by experienced real estate attorneys. This complement of talent on your side can allow the "ants" of this great industry to at least avoid getting eaten by the "anteater" landlords we might face in securing new locations for growing restaurant operators, and put us on an equal level of the real estate food chain.

Doug Alcott is a principal at Foremark Real Estate Services, a Dallas-based real estate firm specializing in strategic planning, site selection, acquisition and development services for growing restaurant companies. You can reach Doug at alcott@foremark.com.