LEASING COMMERCIAL SPACE

Two major expenses of any small business are the buying or leasing of property in which to conduct business and the on-going expense of operating that space.

Business owners must consider several issues when leasing a business location. The following list can be used to compare and contrast several different location options.

- **Is the lease a "net" or "gross" lease?**

A "net lease" means you will be responsible for at least one additional expense beyond the base rent. A "gross lease" means that other costs above the base rent are included in the total rent and are the responsibility of the landlord. A true gross lease is rare because most tenants pay at least one or two expenses associated with leasing the space.

Some leases may be referred to as "triple net", "modified gross", "gross plus utilities," "net, net," or even "net, net, net." The reality, however, is that a lease is either "net" or "gross."

Some leases are known as "percentage rent" leases. This means that all or part of the rent is calculated on a percentage of sales at that location. "Percentage rent" arrangements are based on the idea that the location of the space is integral to the potential sales that might occur there, such as in a shopping mall. In "percentage rent" arrangements, it is important for the two parties to agree on the definition of *sales revenue* and what is and isn't included in the calculation.

- **Lease Terms**

It is always advisable to ask an attorney knowledgeable in real estate law to review any lease you are considering. You may also consider using a real estate broker to represent you.

Every item in a lease is negotiable. Some items will be of economical value to the landlord and some to you, the business owner and tenant. For example, it may be important for you to have designated parking for your employees because it will save them money, while parking costs may not be important to a landlord.

- **Common lease terminology**

Common area factor: This defines commonly shared, public space within buildings (usually office buildings) and can include hallways, vestibules, rest rooms, lobbies and atriums. The factor is usually described as a percentage and should be accounted for in your space allocation. For example, you may be using 1,500 usable square feet, but if the common area factor is 15 percent, then your rent may be based on 1,725 square feet.

Common area maintenance: The cost of maintaining the exterior and/or the shared interior areas of a property may be passed on to you as the tenant. These might include snowplowing, rubbish removal, parking lot lighting, restroom cleaning, property management, taxes and other costs. Your lease must specify which and how much of these expenses are included in your rent and which ones may increase or decrease over time.

Escalations, graduations, indexes and adjustments: Your lease may use these terms to describe others ways your rent may change over time. For example, your lease may state that your rent will go up by a certain dollar amount on a given date, or by a defined percentage raise. It may state that future rent increases will be tied to the Consumer Price Index or other measure. As a tenant, you will need to understand and then agree to these conditions before signing the lease.

BUYING COMMERCIAL REAL ESTATE

As a business owner, you'll consider buying real estate based on price, value, location, size and utility. You'll also need to determine real estate value when you prepare a Business Plan to obtain financing for your business.

Real estate financing is directly linked to the property's appraised value, not necessarily how valuable the location appears to be to you, the business owner. The appraised value will be determined by an independent third party. Typically, a conventional lender will lend up to approximately 75 to 80 percent of the appraised value of the property. You, as the business owner, would have to finance the remaining 20 to 25 percent, plus the closing costs and other out-of-pocket costs in buying the property. These additional costs may be deposits, down payments, bank fees and points, legal fees, appraisal costs, environmental studies, retrofitting or renovations, construction costs, brokerage fees and deed transfer taxes and recording fees.

Determining Value

Appraisers consider real estate value using three valuation methods: *comparable sales method, income approach* and *cost approach*.

The ***comparable sales method*** determines an approximate value based upon sales of similar properties within a reasonable, recent period of time. Similarities include type of property, age, location, size and other tangible criteria. Adjustments are made based on whether the past properties were in better or worse shape than the one being considered.

The ***income approach*** determines an estimate of total real estate value based upon the rate of return from potential net operating income from the property (assuming it was leased to a third party). In this method, an appraiser estimates an annual income rate for the property based upon similar properties occupied by similar users. For example, the appraiser might determine that a retail store will lease or rent for **$9 per square foot** per year. This rate should be comparable to other retail spaces in the vicinity, and the appraiser will document this in his/her assessment.

Once this lease rate is determined, the property's value is estimated using a type of multiplier known as a *capitalization rate* or *cap rate*. Historically, cap rates are subject to several factors including the strength of the type of tenant, the level of landlord involvement, economic conditions and type of industry. However, for illustrative purposes, a property with a good tenant in a good location might command a **cap rate of 12 percent** in a good market.

The value of the real estate is then determined by multiplying the net rental rate by the reciprocal of the cap rate. In the example given, the value would be calculated by multiplying $9 per square foot by 8.3 (100 percent divided by a 12 percent cap rate). This would mean that the investment value of the real estate would be equal to $74.40 per square foot.

Often, these figures are further adjusted to consider other variables such as vacancy rates, property management costs and other investor related factors.

The ***cost approach*** evaluates the replacement value of the property by analyzing the cost component of the specific land and building. The variables involved in estimating value are location, geographic region of the country, labor and material costs.

Factors considered include costs for land acquisitions, site preparation, utilities, types of building materials, tenant improvements and soft costs (architectural and engineering costs, legal and brokerage fees and other similar related costs).

Reconciliation of the three methods

After conducting the three analyses described above, an appraiser will summarize and compare them to analyze their relative values.

In a perfect business environment, the three variations of value would likely produce relatively similar results. Quite often, however, each method may produce somewhat different values from one another. This occurs because all real estate is unique, general economic conditions may vary by region, and market information is not readily available to buyers, sellers, landlords and tenants in the real estate market.

All that means that the valuation of commercial real estate is an educated estimate based on the collective experience and expertise of the appraiser, available and relevant information in the market, the willingness of the lender to accept the estimates and the ultimate agreement of the buyer and the seller on the property's price and terms.