

GIVE AND TAKE

Commercial Landlords Must Know How to Give Rent Concessions Without Conceding Too Much

By Steven P. Heller, Esq.

A challenging lease market may force a landlord to offer concessions to attract a more selective tenant. A prudent landlord will choose will choose the most advantageous type of concession(s) and concede only what is necessary to lure the tenant to its building. Landlords, who have a range of options in offering lease concessions, should offer only the type and mix of concessions that leave them in the best possible position to retain the benefits of the lease transaction.

The boundaries of an inducement package are limited only by the requirements and creativity of the landlord and the tenant. Some inducements decrease a tenant's launch costs for move-in and initial construction of the new space as well as related freight elevator charges. Other packages may provide amenities related to parking, health club memberships, on-site daycare or even free storage. The more common rent concessions simply reduce the amount the tenant must pay for base rent, operating expenses, taxes or percentage rent during a prescribed lease period. In any scenario, the landlord should carefully consider the alternatives and offer the mix of concessions most appropriate for its specific set of circumstances and priorities.

Rent Concessions and Construction Allowances

Typically, lease transactions involving concessions take the direct approach, with landlords providing a cash allowance for the tenant's construction of its initial space improvements and/or granting a rent credit to reduce the tenant's rental costs during the start of the lease term. Although representing a construction investment of sorts into the

landlord's building, a construction allowance is also up-front, out-of-pocket cash the landlord must pay to the new tenant. While a rent credit interrupts the flow of the landlord's initial revenue during the lease term, it does not require the landlord to come out-of-pocket. Some tenants simply prefer free rent because it offsets other cash outlays the tenant may have to make at the beginning of the lease term.

Rent Credit Advantages and Disadvantages

A tenant naturally appreciates having lower rent costs while starting up or relocating its business and perhaps paying the last months of rent for the overlapping term of its previous lease. The drawback for the landlord is obvious – it gets the rent money later than it otherwise would. In addition, free rent undercuts the tenant's financial and symbolic investment in the space, deprives the landlord of immediate revenue to show for the occupied space, concerns the landlord's lender and investors and causes the landlord to wait longer for the tenant to show itself capable of meeting the routine rent payment obligations. Further, the landlord may have tax liability for the effective rent deemed to be earned during the free rent periods when the landlord receives no actual revenue.

Despite these factors, the landlord should also recognize the relative advantages of the rent credit. If the landlord leases up space in a weak market to a tenant that may be shopping for space in multiple buildings, the effective rental rate over the entire term does not change and the face rental rate for the lease transaction increases. This higher "pro forma" rent setup attracts buyers, facilitates

refinancing and strengthens the landlord's rental rate position when the next potential tenant comes along.

Free rent, the informal term for a rent credit, is never really free. A rent credit does not allow a tenant to avoid paying any rent; instead, it is just a mechanism for creatively structuring the payment of rent in a lease transaction. Typically, the tenant pays no rent at the beginning of the term while the face rental rate increases for the rest of the term. This equates to the tenant giving up the lower face rental rate for the entire term that it would have had. For example, consider a 10-year lease with an effective annual rental rate of \$18 per square foot. Instead of insisting on a face rental rate of \$18 per square foot for the entire 10 years, the landlord agrees to grant the tenant 1 year of free rent while increasing the face rental rate to \$20 per square foot for the remaining 9 years.

In drafting free rent lease provisions, a landlord that wants to maximize control over its grant should pay attention to the manner in which the credit is structured in the lease document by considering the following steps:

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Push Back Free Rent Periods

The entire free rent period need not occur at the beginning of the lease term. Apply some of the credit to the base rent due at the end of lease term or spread it out in alternating months so that the landlord can sooner collect at least some revenue for the leased space. The landlord reduces its risk by recovering its costs for the initial delivery of the space and having some cash to show for the lease if the tenant quickly defaults or goes bankrupt. Meanwhile, the tenant invests in the space from the beginning of the term and

proves itself capable of making routine rent payments at the face rate.

Limit and Clearly Specify What is Free

Resist the tenant's request to expand the free rent to operating expenses and taxes or other charges that represent actual occupancy costs caused by the tenant's use of the space (unless the landlord determines that such a credit is in its interest). Spell out the charges to which the credit does and does not apply. Consider reducing, rather than eliminating, the tenant's rent obligation during the free rent period.

Condition Credit Upon the Tenant Not Defaulting

Free rent is not a free ride – the landlord gives it away in return for the tenant's meeting the other terms of the lease. Characterize free rent as a rent credit conditionally paid by the landlord, and provide that the landlord does not need to pay the tenant if the tenant has not first paid all of the rent it owes under the lease or otherwise defaults.

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