Navigating Your Commercial Lease Agreement During Inflation

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OVERVIEW

- Commercial Lease: An agreement that grants a business tenant the right to occupy certain space for its business.
- Commercial leases are typically intended to last for several years.
- Common consideration: Landlords and tenants need to not only consider the business implications of the lease terms for right now, but also for the future.
- It is important to understand all financial aspects of a lease agreement to better manage expenses and business impact.

Rent and Additional Rent

- <u>Base Rent</u>: The agreed upon amount that tenant must pay for the right to continue to occupy the premises.
  - Usually quoted in terms of "per square foot" (psf) as dictated by the market.
  - Fixed amount per year with gradual agreed-upon increases.
  - Increases can be annual or every few years.
  - Annual increases typically range between 2.5%-4%. Can also be 10% every 5 years.

- <u>Common Charges</u>: Amounts that commercial tenants pay to reimburse landlord for operating and other expenses incurred in connection with operating the property. Referred to in the lease as "additional rent."
  - Insurance; Taxes
  - Operating Expenses – landscaping, maintenance, snow removal, repairs, cleaning and other services.
  - Usually shared by multiple tenants occupying the space, based on percentage of space occupied.
  - Increases depend on landlord's actual costs. Vary year to year. Tenant can negotiate for caps on increases (may be limited to "controlled expenses").

- Important to understand how all amounts are calculated and when they are charged.

Construction Buildout

- Landlords and Tenants negotiate the condition of the space when it is delivered to tenant.
- To incentivize tenants to lease a commercial space, landlords are often willing to invest in constructing the space to tenant's needs. This involves negotiating tenant's needs and expectations for the space and how much landlord is willing to spend to construct the space.
- Improvement Allowance – Instead of constructing the space to tenant's specifications, some landlords and tenants prefer for tenant to construct the space and be reimbursed for some or all of tenant's expenses.
  - Typically quoted as per psf.
  - Can be paid upon completion or at construction milestones.

Renewals

- Term and Renewals: Commercial leases often provide tenant options to renew the term of the lease on terms agreed to in advance.

- Renewal Rent:
  - May be fixed where rent is negotiated at the onset of the lease and are based upon an agreed increase. Can be consistent with past increases. Can be a stepped up increase greater than typical annual increases.
  - May be tied to economic metrics where base rent is reset at then-current economic metrics, such as the Consumer Price Index.
  - May be determined by using third party appraisers, taking market conditions into account.
  - May be determined by landlord using building market rates.
  - My be determined by combination of factors and methods.

Negotiating Your Commercial Lease Agreement

- For commercial landlords, protecting property interests and maintaining consistent profitability are two focal points when drafting and negotiating a commercial lease agreement.
- For commercial tenants, managing risk and expense (as well as future increases) is a vital part of negotiating a commercial lease agreement.
- Inflation and rent escalation clauses go hand in hand – when inflation rises, rents rise along with it.
- While inflation is not a new economic concept, rising inflation at unusual rates does create unanticipated results.

Negotiating Your Commercial Lease Agreement (continued)

- Clarity on rent and rent increase is an integral part of any lease. Most commonly, commercial leases provide for annual rent increases at a fixed rate. Sometimes, these increases are not annual, but every few years. Where things become more complex is when increases are tied to economic metrics.

- Since the commercial real estate market relies on certain market equilibrium, unexpected or unanticipated increases in rent impacted by rising inflation may have unintended disruptive market consequences. Focusing on these issues now will help minimize disputes and non-payment for commercial landlords and business risk for commercial tenants.

Inflation

- Inflation: Rate of increase of prices over time.
- Inflation rates last 10 years (source: worlddata.info; macrotrends.net):
  - 2022: 8.5% for 12 months ending July 2022
  - 2021: 4.70%
  - 2020: 1.23%
  - 2019: 1.81%
  - 2018: 2.44%
  - 2017: 2.13%
  - 2016: 1.26%
  - 2015: 0.12%
  - 2014: 1.62%
  - 2013: 1.46%
  - 2012: 2.07%
- Rising inflation is influencing virtually every aspect of life. For commercial landlords and tenants alike, it is more important than ever to focus on escalation provisions in your commercial lease agreement.

Inflation

- Higher inflation rates tend to increase the value of commercial real estate for many reasons, most notably, being that the cost of money and the cost of new real estate development being higher.
    - Lower supply, higher demand for existing properties.

- Since supply of commercial space becomes limited, landlords are able to charge higher rent.
- During times of high inflation, tenants prefer longer-term leases to have more control over rent increases. Conversely, landlords prefer shorter term leases to allow for adjustment for market conditions to charge higher rent.

Economic Environment

- For existing leases that have rent escalations tied to inflation risk, it is critical to understand how the current economic environment will impact future rent.
- A common issue is whether a commercial tenant should exercise a right it may have in the lease to renew. Often, tenant renewal options provide for rent to be calculated using market metrics.
- Conceptually, this generally works well where the economic environment is stable and inflation is low. In such cases, the formulaic rent escalations adjust the rent to where the market suggests it should be and mostly everyone is satisfied.
- However, in situations where the economic market is unstable and inflation is especially high, the formulaic rent escalations could adjust the rent to extreme amounts not expected by landlords or tenants.
- For <u>tenants</u>, this could create an increase in rental expenses beyond what may been budgeted or sustainable by the business.
- For <u>landlords</u>, this could create scenarios where multiple tenants are unable to afford the drastically increased rent, leading to higher rate of default.

Managing Lease Market Risk

- Understand the local real estate market and rates. Engage real estate professionals to guide you along the way. Control what you can control.

- Do not hesitate to ask, negotiate and discuss. Maintain ongoing dialogue. A reasonable commercial landlord would often welcome reasonable dialogue to find common ground to address the unintended and unexpected impact of present economic conditions.

- Find additional value.
    - Improvements.
    - Term extensions.
    - Additional Renewal options.
    - Expansion.
    - Other benefits and services.
    - Barter.

- Negotiate for caps on increases.

Understanding Lease Exit

- At times of high inflation and economic turbulence, there is an increase in tenant default.

- It is important to understand and lease and legal framework for when the lease expires or when commercial tenants are unable to continue operating its business.

- Understanding landlord's rights upon default.
  - Terminating the lease.
  - Summary proceedings for possession.
  - Costs and expenses.
  - No obligation to mitigate.

- Condition of the space at expiration – making repairs, removing alterations.

Personal Guaranty

- Many commercial landlords require commercial tenants to personally guaranty lease obligations. This prevents tenants from simply closing up shop and walking away.

- This practice provides landlords with additional protection in the event that a business tenant is unable to pay rent or fails to perform lease responsibilities. This is typical, especially for new businesses that do not have a proven track record of performance and success.

- <u>Good guy guaranty</u>: Allows a guarantor to be released of its obligations when the business tenant vacates the space and returns possession back to the landlord. Derived from the concept where tenant is being a “good guy” by returning the space since it is not paying rent. Business tenant remains responsible while landlord retains control of the space to mitigate its damages by seeking a replacement tenant.

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