Commercial Real Estate

Issues Facing Restaurant Franchisees and Small Chains

By Stephen A. Cross, CCIM

COMPETING FOR SITES against large chains that have internal real estate departments and unlimited budgets can be a daunting task. So, where do you start the process? Should you lease or buy? Who should you trust? Here are some practical guidelines and disclosures intended to address these questions and the critical issues facing Franchisees, single unit operators and small chains…and some strategies to protect your interests.

Never pay the asking price. 'Asking price' is to commercial real estate what 'sticker price' is to automobiles…merely the negotiation's starting point. Because neither property owner nor agent expects to receive the asking price, the real questions become: 'How low can the price go?' and 'What incentives and concessions can the tenant or buyer reasonably negotiate?'

Cast a wide net. Making fully-informed decisions begins with knowledge about every suitable space available, regardless of who lists them - and which property owners have the most urgent needs to sell or lease. Resist the temptation to be influenced by agents who limit your choices to just their listings and those purporting to be friends with the developer or listing agent. ***Strategy:*** Seek objective representation and advice. Agents that list properties seek to protect the interests of their clients…property owners. As a result, they seldom make tenacious advocates for tenants or buyers.

Evaluate sites carefully. Hard corners, with good street visibility, are more desirable than interior locations; free-standing buildings can be better choices than in-line space. ***Strategies:*** 1. Obtain detailed demographic data for every intersection under consideration. These reports are invaluable and should be made available free of charge from your real estate advisor. 2. Visit the sites at different times…verifying activity and traffic patterns for yourself.

Protect your use. It is reasonable to require 'Exclusive Use' protection for your type of cuisine or concept within the center. ***Strategy:*** Write the 'Use Clause' broad enough to clearly describe those things that make your concept unique. Also, make certain the 'Permitted Uses' cover your ancillary activities.

Resist percentage rents. Percentage rents are additional sums due the landlord and are based on the natural 'breakpoint' of your base rent. Calculate this number by dividing your annual base rent by the proposed percentage rent figure. Once your gross sales hit the 'breakpoint' you will owe additional rents. ***Strategies:*** 1. Eliminate the percentage rent clause. 2. Exclude pick-up and delivery sales from Gross Sales. 3. Establish an artificially high breakpoint…high enough to ensure the percentage rent does not kick in.

Get enough HVAC. Air conditioning is expressed in terms of 'tons'. Retailers typically need 1 ton for every 300 SF of floor space. Restaurants can require 3 to 4 times that amount, or 1 ton per every 75 SF to 100 SF. Discuss this early-on in the negotiation.

Be the 'Second Man' in. If there is intense competition for a property, and prices no longer make sense for your budget, let a 'deep pocket' operator pay the high rental rate and improve the space**.** The property may come back on the market, this time with the essential improvements. You may also find the landlord is more negotiable when faced with a vacant building on their hands.

Negotiate a reasonable fixturization period. Restaurants generally require 90 to 120 days to build out, including the time it takes to draw the plans and obtain the necessary approvals. ***Strategy:*** Negotiate 120 days free of Base Rent *and* NNN expenses. Also, insist on being able to open for business during this period at no cost. If your construction is finished early, this could get you an additional 30+ days of free rent.

Negotiate the shortest term possible...with options to extend. Concessions are generally a function of term and are used to encourage tenants to lease space for the longest term possible. At some point however, longer terms yield no additional concessions. ***Strategy:*** Determine the minimum term with the maximum concessions. Then, negotiate renewal options with fixed, or maximum, rental escalations. At renewal time the savvy operator may be able to negotiate additional concessions.

Mums the word. Refrain from discussing your real estate needs and the properties being considered with anyone not directly involved in your decision-making group. The less landlords and their agents know about your circumstances and any other sites under consideration the better off you will be at the bargaining table.
Strategy: Because the goals of property owners are opposite of yours, the entire negotiation should be considered what it is: an adversarial process.

Beware of undisclosed conflicts-of-interest and kickbacks. Many agents do their best to persuade tenants and buyers that one agent, or multiple agents from the same company, can effectively represent the interests of both parties in the same transaction. This practice is known as a 'dual agency' and *always* favors the property owner…and ultimately the self-dealing agent, who collects the entire commission. ***Strategies:*** 1. Never hire a listing agent to represent your interests. 2. Query those suggesting referrals to determine if they stand to receive any form of a referral fee (a 'kickback'). Written disclosures should be mandatory. 3. Treat referrals as 'preferred suppliers', but always obtain competitive prices for products and services.

Choose your advisor carefully. Your choice of advisors determines which properties you are shown and how much you will pay. Agents for property owners are generally qualified only in sales, and focus on getting the highest prices possible (that's how they obtain and keep listings). *But your goal is to pay the least amount possible.* ***Strategy:*** Seek out an expert with significant experience in solving *your* problems. And make certain your selection holds the CCIM designation, the gold standard of certifications in the commercial real estate industry. No other designation requires the level of competency, experience, education, and ethical standards of a CCIM.

Closing observations. Leasing or buying commercial real estate can be hazardous to your *wealth*…so plan ahead, stay within your budget, make objective decisions, ask questions until you have a thorough understanding of all ramifications, and hire an advisor who will protect your interests and those of your business. At the end of the day, your decisions should be based on the combination of location, demographics, condition, concessions, comparables, and overall cost.

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