Insights for Food and Beverage Proprietors

Whether it's the size of the salad or the amount of liquor in a drink, restaurateurs and night club owners pay careful attention to controlling portions. But controlling the costs of occupancy can have an even larger impact on profitability. This article focuses on considerations facing food and beverage proprietors…and some strategies to protect their interests when leasing commercial real estate.

Location is key. While menu and ambiance serve to make a restaurant or night club distinctive and welcoming, choosing the best possible location is the most critical decision a hospitality provider will face. *Strategies:* 1. Obtain detailed demographic data for every intersection under consideration. These reports should be made available free of charge from your real estate advisor. 2. Visit potential sites at different times, and verify activity and traffic patterns for yourself. 3. Prominent placement on a monument sign can help make up for lack of street visibility. 4. Be aware of natural barriers that may adversely affect patronage. For example, locating in a predominantly office, medical, or industrial district that is separated from residential neighborhoods by a freeway will likely be excellent for breakfast and lunch business but disappointing for dinner and late night activity.

New or used (and improved)? Property owners are least likely to negotiate discounts and incentives during the construction phase of shopping center development. That's because they are generally flush with money, have budgeted for a reasonable lease up period, and have lofty expectations which have not yet been challenged by the marketplace. *Strategies:* 1. Be patient – you may find landlords are easier to deal with when they have vacant space on their hands. 2. Be the "second man" in – let another operator lease and improve new space. The property may come back on the market, this time with many essential improvements (those "below the slab and above the grid") already paid for.

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Confirm total rental costs. There are three components to the amount tenants pay to landlords: base rental rate, percentage rent, and operating expenses – the first two are negotiable, while the third can be managed.

• *Base rental rate:* The published base rental rate (or asking price) is typically expressed in terms of dollars per square foot per year ($/SF/Year), and is merely the negotiation's starting point. Because neither property owner nor agent expects to receive the asking price, the real question is: "How low can the price go, and for how long?" *Strategy:* Target a rental rate ten to fifteen percent below the asking price that remains level for as long as possible. Limit the amount of any increases and their frequency.

• *Percentage rent:* Many restaurant and bar leases call for the payment of percentage rent, which is additional rent based on the natural "breakpoint" of your lease. Calculate the breakpoint by dividing your *annualized* base rent by the proposed percentage rate (leasable area *x* base rental rate ÷ percentage rate = breakpoint). Once gross sales reach this amount you will owe additional rents equal to the percentage rate times any amount *above* the breakpoint. *Strategies:* 1. Eliminate the percentage rent clause. 2. Negotiate a lower percentage rate. 3. Exclude pick-up and delivery sales from gross sales. 4. Establish an artificially high breakpoint…high enough to ensure the percentage rent does not kick in.

• *Operating expenses*: Commonly

referred to as "NNN" (Triple Net) expenses, operating expenses consist of the tenant's pro-rata share of three things: property tax, casualty insurance and common area maintenance (CAM) costs. *Strategy:* Cap any increases in *controllable* operating expenses at no more than 3 percent per year. Also, in newly completed centers confirm whether the property has been fully assessed. If not, expect *and budget* for a sizeable increase in total NNN costs in the next year. Note that CAM costs are a component of NNN expenses - and the terms are not interchangeable.

Rental concessions. Rental concessions (reduced rent, free rent, tenant improvement allowance, and the like) are generally a function of the lease term and are used to induce tenants to lease space for the longest term possible. At some point however, longer terms yield no additional concessions. *Strategy:* Determine the minimum term that yields 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.

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 to complete the fixturization process. 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.

Protect your use(s). It is reasonable to require "Exclusive Use" protection for your type of cuisine or concept within the center. *Strategies:* Make certain the "Use Clause" clearly describes those things that make your concept unique. Also, ensure the "Permitted Uses" cover your ancillary activities and offerings, such as games, television viewing, live entertainment and patron dancing. Note that because many shopping centers are a patchwork of adjoining parcels with different owners, exclusive uses are protected for your parcel only.

Heating and cooling. Restaurants and bars typically require three to four times the heating and cooling capacity of retail stores. Your architect should calculate your needs, which will likely be one ton of air conditioning for every 75 to 125 square feet of leasable area. *Strategies:* 1. If you are leasing previously occupied space with used air conditioners, request that the landlord *expressly* warrant them for the entire lease term. That failing, cap your annual out-of-pocket expenses for the repair or replacement of the units. 2. Units older than 10 years are nearing the end of their useful lives, and are probably not very efficient. Require the landlord replace them *with new units* before the lease commences. 3. If a unit were to need major repairs or replacement near the end of the lease, pro-rate your share of any costs based on the useful life of the new unit.

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Transferability: A substantial portion of the value of your business is vested in the buyer's ability to continue operating in the same location and under the same terms and conditions. *Strategies:* Make certain your lease and any options to extend are fully transferable to a qualified buyer of the business; and that the landlord cannot cancel the lease if you wish to assign it to another party.

There's no free lunch. Real estate transactions typically generate commissions that are shared between the agents or advisors representing each party. Even though the property owner writes the commission check, *it's the tenant that ultimately pays the tab*. How much are we talking about? On retail leases the total commission generally ranges from $4 to $6 per square foot. That works out to between $12,000 and $18,000 on a 3,000 square foot lease. If you represent yourself the entire commission is paid to the listing agent(s). *Strategy:* Make certain you receive value from your "side" of the commission by selecting an experienced, competent and unbiased representative who works exclusively on your behalf. After, all you're paying for it.

Closing thoughts. As with most business expenses, your costs of occupancy can be managed...but you must be proactive. 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 continue to protect your interests long after the lease has been signed. ■

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