Commercial Real Estate

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Space Considerations and Hidden Costs

Businesses that lease property should be continually seeking ways to lower and/or control their costs of occupancy. This can be partially achieved by improving space utilization, and partially by anticipating direct and indirect leasing expenses. The intent of this article is to help the cost-conscious business owner, healthcare practitioner or facility executive identify wasteful practices and recognize hidden or undisclosed costs, and offer strategies to minimize the various expenses associated with leasing commercial space.

SPACE CONSIDERATIONS

Commercial space is generally leased by the square foot. For this reason, property owners are continually on the lookout for ways to artificially "grow" their buildings. Note that this reference to square feet does not mean that you pay for just the area that you walk on. Consider the following:

RENTABLE VERSUS USABLE. In most full service office buildings (where the rent includes all of the operating expenses), tenants pay for the area in which they have exclusive use *plus* their pro-rata share of the common areas of the building. The difference between the rentable and usable area is called the "load factor," and consists of public hallways, elevator shafts and stairways, the lobby, and rooms that contain equipment that serves the entire building. As a general rule, the common area load factor should never exceed 15 percent of the area you occupy. *Strategy:* Insist on knowing what elements are included in the load factor calculations…and get it in writing. Other things being equal, buildings with smaller load factors are better values than those with larger load factors.

DRIP LINES. In warehouse and retail properties, some landlords charge for the area outside of the exterior walls, i.e., the "drip line." This is the area under an eave, where the water drips off the roof. *Strategy:* Pay only for the area that you use, plus the thickness of front and back walls, and fifty percent of the thickness of any common walls.

RIGHT SIZING. An efficient space plan can reduce the size needed to operate your business by 10 to 30 percent. Also, over time, many companies get used to storing unneeded or obsolete materials. *Strategies:* Routinely (at least annually) evaluate what's important and what can be discarded. At lease renewal time, request that your landlord, and all prospective landlords, provide a professional space plan to determine the optimal size your business needs to operate efficiently. Once you understand how much space is needed, you can purposefully negotiate lease terms.

FRUGAL OR FRIVOLOUS. Resist the temptation to lease space with more curb appeal than necessary. *Strategy:* Ask your employees which they would rather have: a fancy address, or health insurance and regular raises? Also, look at your business from the eyes of your clients, patients or customers. Would they resent subsidizing what could be perceived as opulent offices, or is this an expectation of your clientele, and therefore a requirement? After all, one man's frugality is another man's extravagance.

GO UP, NOT OUT. The size of an industrial space is generally based on the square footage of the floor area, not on the cubic square feet contained in the entire warehouse. *Strategy:* Racking is generally less expensive than floor area. So, if you can store inventory vertically rather than horizontally, the rentable area and the associated

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expenses can be reduced significantly (less the cost of the racking and a fork lift.)

PAY AS YOU GROW. Relocating to larger quarters can be expensive and disruptive. *Strategy:* If your business will require additional space at regular intervals, consider leasing a larger space than is currently needed and paying for the additional space per a pre-determined schedule. For example, on a five year lease offer to pay for 50 percent of the total space in year one, increasing by 25 percent in years two and three. *Caution:* Make certain that you are required to pay for only the appropriate portion of the pass-through expenses during the reduced rent period.

HIDDEN COSTS

I have written extensively about hidden and undisclosed costs (see the "Articles" section at www.crossrealty.com). Here, I wish to highlight some that are routinely overlooked.

PROPERTY TAXES. Until buildings are fully assessed, the property taxes are understated - and can be expected to increase substantially. Because it takes a year or more for newly-constructed buildings to be assessed as improved property, I suggest budgeting for the increase even before the tax bill arrives. This is especially important for retailers, restaurateurs, and any one signing a triple net lease in a newly developed area.

EXPENSE STOP OR BASE YEAR. In full service leases, the maximum amount the landlord is obligated to contribute towards the operating expenses of the building is tied to either an "expense stop" or a "base year," with the remaining expenses paid by the tenants. *Strategies:* When using an expense stop, make every effort to confirm that the landlord's estimated operating costs are *lower* than the expense stop. Where a base year determines the amount of any pass-through expenses, use either the year occupancy occurs or, if occupancy occurs late in the year, the subsequent year. In both, verify that the property has been fully assessed.

BASE YEAR ADJUSTMENT. When renewing a full service or modified gross lease, be certain to reset the base year to the first year of the renewal period. As operating expenses can be reasonably expected to increase by three to five percent per year and are cumulative, failing to make this adjustment can cost a tenant substantial sums.

POORLY DEFINED PASS-THROUGH EXPENSES. Make certain that capital expense items are clearly defined in the lease, and specifically excluded from the list of expenses to be passed through as additional rent.

MANAGEMENT FEES. Many landlords are attempting increase revenues by assessing tenants a 12 to 15 percent property management fee. A five percent management fee is reasonable. In the event extensive tenant improvements are being performed by the landlord, cap the construction management fee at two percent.

HVAC EXPENSES. Make every effort to have the landlord warranty the heating, ventilation and air conditioning systems for the entire term. This is especially important for triple net leases in buildings older than five years, where the manufacturers' warranty on the compressor has expired. If a full warranty is not obtainable, limit the tenants' out-of-pocket expenses for the repair or replacement of the air conditioning units to $300 to $500 per *year* (not per *occurrence*).

PERCENTAGE RENTS. Many retail leases contain a clause requiring the tenant to pay additional rent once a threshold of gross sales has been achieved. *Strategies:* Specifically exclude both take-out and online sales from the gross sales figure. A method to effectively eliminate percentage rent obligations is to negotiate an artificial breakpoint, one that is substantially higher than the natural breakpoint.

AFTER-HOURS ELECTRICAL USAGE. On full service leases, discuss normal building hours and make certain you do not end up subsidizing tenants that consume electrical services outside of these hours.

COVERED PARKING CHARGES. Limit the landlord's ability to increase the charge for covered/reserved parking spaces during the initial lease term and any exercised option periods.

FREE RENT PERIOD. Make certain all costs of occupancy (including triple net expenses) are abated during the fixturization and free rent periods.

HOLDOVER PENALTIES. Limit the amount the landlord can increase your rent in the event you remain in the premises after the lease has expired. If the landlord has consented to the holdover, or if you are in the process of negotiating renewal terms, I suggest no penalty be imposed. Otherwise, limit the penalty to a 25 percent increase over the last amount due under the lease.

OPTION PRICING. When crafting rental rate language for any option periods, I suggest using the asking rates for similar buildings (the "market rate"), *less* the leasing commissions, rental abatements and tenant improvement allowances generally available to new tenants in an arm's length transaction.

CLOSING COMMENTS. When it comes to controlling the costs of occupancy, savvy decision-makers anticipate where economies can be achieved and pay attention to the smallest of details. If you do not know as much about the leasing process as the landlord, or its agents, brokers and property managers, retain an experienced real estate advisor to protect your interests. In the final analysis, the best way to make smart leasing decisions is to ask the right questions at the right time… *which is before the lease is signed.* ■

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