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Tips for the Office Landlord Doing a Retail Lease

As an owner or manager of office buildings, you may well be a brilliant negotiator and crafter of office leases and know your market inside and out. But when it comes to attracting and putting deals together for retail tenants, you may be treading beyond your core competencies, which could cause business headaches and, worse yet, cost you money down the road.

Matthew Weinstein

Matthew I. Weinstein, Cozen O'Connor, Philadelphia, PA, an attorney who works with both landlords and tenants on retail leases, said: "Office landlords tend to be very sophisticated so it is not a lack of understanding of what goes into a lease. The problem is that warehouse, office and retail leasing are all a little different with regard to what tenants care about, how they approach the lease and exit strategies."

Weinstein offered these tips and cautions for the office landlord who needs to put occasional retail deals together.

The amenity vs. the profit center—The office landlord needs to first determine if the retail space is an amenity for office tenants or an actual profit center for the business. At the suburban office park, the retail—a newspaper stand for example—may well be an amenity and the landlord's aim may be to break even on the space. In a city environment with a lot of street foot traffic, that retail will be more of a profit center. Weinstein asserted that landlords in the city environment may short-change themselves if they merely look at that retail as an amenity for the tenants in the building. "Many times," he said, "they are charging rents well below what they could be charging for that city retail space. Sometimes this is just the opposite in suburban environments where the landlord will demand high retail rents for space that is really an amenity." In those cases, the high rent charges may well scare off a building amenity that the tenants sorely need.

Connection to retail industry—The landlord of a new office building may have good connections to the retail industry at the start of leasing. If it is first-generation space, the landlord may well be working with retail specialists to rent the new space. After five to seven years, some of those tenants will move out and need to be replaced, especially today when so many retail tenants are electing not to renew space. Five to seven years down the road, the office landlord is typically focused on keeping office space full and may not have connections with the Starbucks and McDonalds of the world. This is the time when landlords need to engage people with strong connections to retail, according to Weinstein.

Tenant mix—In the typical office building, the landlord might draw similar types of businesses, such as life sciences, software companies or financial firms because these companies like to be near each other. It is just the opposite in retail, Weinstein warned. "McDonalds does not want to be next to Burger King." Because of this, landlords will often agree to exclusive uses and potentially get burned because they do not understand how powerful an exclusive use can be. Understand what you are giving away, *before* you give it away.

Visibility—Sometimes, more than the rent, retail tenants are most concerned about *visibility*. Office landlords will often put into the lease that they will not impair the retailer's visibility only to find that the retail wants to extract something if the landlord puts up scaffolding to do exterior work. This issue needs to be dealt with in the lease.

Dealing with CAM—Another big issue is how CAM (common area maintenance) is calculated. In the typical retail center, it is easy to calculate CAM because the retailer has probably signed a triple net lease. It is simple math, with X amount of space in the center, Y amount of space for the tenant. Office space mixed with retail is different. Weinstein said there could be triple-net leases, gross leases, double-net leases; triple-net leases with structure; triple-net leases without structure; gross plus electric, to name just a few. One of the best ways to deal with this issue is to condominiumize the building with an office condo and a retail condo, Weinstein suggested. "This way, you can have your net lease charges that are very traditional to retail real estate and on the upper floors, you deal with the more complex rental amounts."

Guarantors—Because many retail tenants are national, office landlords find that they have a lot less negotiating power. In fact, often, these national tenants will demand to use their own lease forms. Another issue with retail leases is who are you actually dealing with. In the typical office lease, you are dealing with the parent company. In retail, are you dealing with the national retailer or a franchisee? Franchisees come with risk. Even in some rather large stores, franchisees only need to have a net worth of $150,000 to $200,000, which does not cover much in the way of retail rent. So who is guaranteeing this lease?

Net lease vs. gross lease—There is a big difference between net lease and gross lease and typically retail will very rarely deal with a gross lease, although they would *love* to have them. If a landlord were to give a gross lease to a Starbucks or another high water user, the office landlord would get a rude financial awakening.

Base year—Retail leases typically work differently from office leases when it comes to the concept of "base year." Landlords need to be sensitive to those differences.

Signage—Signage goes to the visibility issue. Retailers want people to know that they are in the office project and this means being on the office project sign--this needs to be negotiated up front. If it is an amenity type of retailer, it may not deserve a spot on the office park sign. If it is a profit center retailer, the office landlord would probably want it on the sign.

Assignment and sublet—Assignment and sublet must be dealt with differently than in an office context. According to Weinstein, the biggest concern here is with franchisees because the franchisor will want the ability to step in if the franchisee is no longer in compliance with the franchise group. While this arrangement may be okay with the office landlord, that landlord still needs to have a check and balance on the franchisor when that franchisor wants to reassign the space to a new franchisee. The landlord needs the right to approve the new franchisee.

SNDAs—The SNDA (Subordination, Non-Disturbance and Attornment Agreement) is a major issue. With retail tenants, the SNDA needs to be negotiated up front so it doesn't become a problem later on. Retail tenants often have their own SNDA form that they use and it would be wise for landlords to show this form to their lenders to ensure that they are comfortable with the form. "I have never had a deal die because of an SNDA," said Weinstein, "but it has gotten to the threshold. It is always in the retail context and never in the office context." ■