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**Understanding commercial leases**

**Quick Study Guide**

What space are you leasing? A commercial lease should clearly define the space the tenant will lease, also known as the “demised premises.” Leases typically include both a street address and site plan showing the demised premises and set the square footage of the demised premises. Make sure the lease clearly defines the demised premises and that the demised premises described in the lease matches the demised premises you expect to receive. Make sure, too, your demised premises has sufficient parking spaces and sign rights to allow you to operate your business.

Is this a gross lease or triple net lease? A commercial lease should tell you what’s included in the rental amount you pay the landlord. Most leases are gross leases or triple net leases or fall somewhere in between. Unfortunately, not all leases state explicitly into which category they fall, so you need to read the lease carefully. A gross lease typically is all-inclusive, meaning the tenant pays the landlord one sum and the landlord is responsible for payment of real estate taxes, insurance and maintenance expenses. In a triple net lease, the tenant pays a set rental amount to the landlord, but also pays a share of the landlord’s real estate taxes, insurance, maintenance expenses and building utilities. Understanding the difference between a gross and triple net lease is particularly important when comparing multiple spaces.

How is my rental rate determined? A commercial lease should clearly define what your rental rate will be for the entire term of the lease. In most leases, the annual rental rate increases from year to year by what’s known as an “escalator percentage.”

What can you do in your demised premises? A commercial lease likely will tell you what you can and can’t do in your demised premises. Office leases often state the space may  be used for general office use and no other purpose. Retail spaces often get more specific.

If it breaks, who fixes it? A commercial lease should clearly define who’s responsible for repairs of the premises, the building, the parking lot and such core systems as plumbing, electrical and HVAC. Keep in mind the question here is not who pays for the repairs, but who’s responsible for making sure the repairs are made in the first place.

Will there be tenant improvements and, if so, who pays for it? Commercial space tends to be rather generic and could require modifications — or “tenant improvements” — for use by a particular tenant. Accordingly, a commercial lease often states whether the landlord or tenant will make improvements to the premises to get ready for the tenant’s occupancy. When the landlord pays for the improvements, the amount spent is called an “allowance.” If improvements are contemplated, the lease must clearly state what improvements will be made, who will complete the improvements, when the improvements will be complete and the amount of any allowance. This can also be an expense to be paid back to the landlord over a period of time.

Be sure to take your time while looking for commercial space. Factor in everything that’s important for your business and the area in which you’d like to see your business grow. A lease is a legal document with potentially far-reaching consequences. We always recommend that leases be reviewed and approved by competent legal counsel.

* Fewer consumer protection laws. Commercial leases are not subject to most consumer protection laws that govern residential leases -- for example, there are no caps on security deposits or rules protecting a tenant's privacy.
* No standard forms. Many commercial leases are not based on a standard form or agreement; each commercial lease is customized to the landlord's needs. As a result, you need to carefully examine every commercial lease agreement offered to you.
* Long-term and binding. You cannot easily break or change a commercial lease. It is a legally binding contract, and a good deal of money is usually at stake.
* Negotiability and flexibility. Commercial leases are generally subject to much more negotiation between the business owners and the landlord, since businesses often need special features in their spaces, and landlords are often eager for tenants and willing to extend special offers.

**Critical Lease Terms**

The following list includes many items that are often addressed in commercial leases. Pay attention to terms regarding:

* the length of lease (also called the lease term), when it begins and whether there are renewal options
* rent, including allowable increases (also called escalations) and how they will be computed
* whether the rent you pay includes insurance, property taxes, and maintenance costs (called a gross lease); or whether you will be charged for these items separately (called a net lease)
* the security deposit and conditions for its return
* exactly what space you are renting (including common areas such as hallways, rest rooms, and elevators) and how the landlord measures the space (some measurement practices include the thickness of the walls)
* whether there will be improvements, modifications (called build outs when new space is being finished to your specifications), or fixtures added to the space; who will pay for them, and who will own them after the lease ends (generally, the landlord does)
* specifications for signs, including where you may put them
* who will maintain and repair the premises, including the heating and air conditioning systems
* whether the lease may be assigned or subleased to another tenant
* whether there's an option to renew the lease or expand the space you are renting
* if and how the lease may be terminated, including notice requirements, and whether there are penalties for early termination, and
* whether disputes must be mediated or arbitrated as an alternative to court.

**Base Rent**

Base rent-is the predetermined amount of rent the tenant must pay, regardless of what operating expenses or revenue was in any month. This rate is often quoted on a square foot per year basis, meaning that a 10,000-sf tenant paying a base rate of $20/sf will be paying $200,000 a year in base rent. While this may seem simple at first, it does get more complicated when you start to really look at the details.

Rentable Square Feet vs. Usable Square Feet

In commercial buildings, there is a difference between rentable square feet and usable square feet, and this difference has to be clear for you to truly understand what base rent is.

Usable square feet is the actual amount of square feet the tenant will occupy to conduct business. If you think of an empty office, everywhere you can walk in that space falls under usable square feet. This includes offices, shared work areas, kitchens, and restrooms located within the space itself. However, this square footage is not the number you should use to calculate your rent.

Rentable square feet includes the total usable square feet, plus a pro-rata share of the building’s common areas. To calculate how much of the common areas should be included in a tenant’s rentable square feet, the landlord first finds the load (or add-on) factor of the building. The load factor is calculated by taking the building’s total rentable square feet and dividing it by the building’s usable square feet.

Load Factor = Total Rentable SF / Total Usable SF

This load factor is then multiplied by the tenant’s usable square feet to find the rentable square feet for the space.

Rentable SF = Tenant’s Usable SF x Load Factor

Rentable square feet is the number used to calculate rental costs. In Austin, most landlords market space by the RSF. For example, if our previous 10,000-sf tenant was leasing in a building with a load factor of 1.15, their rentable square feet would be 10,000 while their usable square feet would be 8,695.

As you can see, a lot more goes into the base rate than you might first assume, and the intricacies of commercial leases do not stop there.

**Escalations**

The longer the lease, the more a landlord is exposed to inflation and rising rental rates in the market. If a tenant has signed a lease for $20/sf, but 5 years later the market average is $30/sf, what can the landlord do to keep rates close to market level without having to renegotiate leases every year?

Many landlords require base rent escalations in their leases to help account for this issue. Escalations are used as a way for the landlord to incrementally increase the base rent annually to keep up with inflating market rates.

Tenants can also benefit from escalations because it allows them to pay a lower base rent in the beginning years of the lease. Without escalations, the landlord would likely charge a high rate for the entire lease.

There are a few different types of escalations, and they each have their own unique provisions.

**Amount**

In this type of escalation, a predetermined increase in base rent is agreed upon by both parties in the negotiation process. Each year, the base rent will increase by this set amount, and will continue to do so until the term of the lease is over. In Austin, these types of escalations are usually between $0.50 to $1.00 per square foot.

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| --- | --- | --- | --- | --- |
| $20/sf Example with $0.50 Annual Escalations |  |  |  |  |
| Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| $20.00/sf | $20.50/sf | $21.00/sf | $21.50/sf | $22.00/sf |

***Percent***

Similar to a specific amount of escalation, a percent escalation is a predetermined percentage increase in base rent. Each year, the current base rent will be increased by the percentage agreed upon by both parties. Most percentage escalations in Austin are generally between 2% to 3% annually.

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| --- | --- | --- | --- | --- |
| $20/sf Example with 2% Annual Escalations |  |  |  |  |
| Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| $20.00/sf | $20.40/sf | $20.81/sf | $21.22/sf | $22.65/sf |

***Indexed***

Indexed escalations introduce a little more variability into a tenant’s rental rate because they do not increase by a predetermined amount. Instead, the escalation follows an index (usually the Consumer Price Index) and increases based on the amount of the index.

Interestingly, indexed escalations can also lead to lower rent if the index being used sees a decrease from one year to the next. Typically, this type of escalation is only used in large and complicated leases, so the specific terms will vary case by case.

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| --- | --- | --- | --- | --- |
| $20/sf Example with CPI Year-Over-Year Changes (Based on a lease signed in 2013) |  |  |  |  |
| Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|  | +1.7% | +0.2% | +1.1% | +1.9% |
| $20.00/sf | $20.34/sf | $20.38/sf | $20.60/sf | $21.00/sf |

**Operating Expenses**

Owning and operating a building is not cheap, which is why landlords often choose to pass at least some of the expense on to their tenants. As we mentioned above, different types of leases treat op/ex in different ways, but, regardless of the lease structure, op/ex is always something worth giving attention because it can be a significant portion of your overall cost.

As with base rent, op/ex is calculated based on a tenant’s pro-rata share of the building’s rentable square feet. Like base rates, op/ex is quoted on a square foot per year basis, meaning that our 10,000-rentable square foot tenant would be paying $150,000 per year if operating expenses were $15/sf.

To learn more about what operating expenses are and what’s included in them, read our article What are commercial real estate operating expenses?

Expense Stops

Things start to get complicated when expense stops, also known as base years, come into play. In a gross lease, since the landlord is responsible for the operating expenses of the building, they prefer some insurance to protect against rising taxes or a tenant using an abnormal amount of utilities. To do this, they implement a bass year stop, that will stay in effect for the life of the lease.

After the first year of the tenant’s lease, the landlord will record what operating expenses were and inform the tenant of the costs they incurred. Over the rest of the lease, the tenant becomes responsible for any operating expenses in excess of the level set in the base year.

For example, say the base year’s op/ex is set at $10/sf. In the following year, if op/ex reaches $15/sf, the tenant is obligated to pay for the $5/sf difference per the terms of their lease, on top of their gross rent. This arrangement protects the landlord from having to pay unexpected large increases in op/ex, and allows the tenant to only pay op/ex if they exceed the base year stop.

As we mentioned above, including an expense stop in a gross lease makes it very similar to what can be achieved with a NNN lease. Market conditions will dictate which of these is more common.

**Tenant Improvements**

Do you want to renovate your new office space to better suit your company’s culture, but don’t want to have to pay for the entire cost out-of-pocket? That is where negotiating a tenant improvement allowance can come into play.

Tenant improvements  are a predetermined construction allowance given by the landlord to the tenant, usually quoted on a per square foot basis. This allowance is used by the tenant to make improvements to their newly-leased space or to an existing space where the tenant has extended their lease term, whether it be something as simple as new paint, to something as complex as a complete remodel.

For the tenant, TI really can be a great way to make the space perfectly fit their needs without having to completely pay for it out of their own pockets. However, as with many things in commercial real estate, TI is not as straightforward as it seems.

TI is something that must be negotiated into a lease, which can sometimes be a challenge depending on the market. When demand is high and landlords are having no trouble filling vacant spaces, it may be harder to negotiate TI into your lease. The landlord also typically gets a say in what you can use your TI allowance on, so it will likely not cover all of your renovation expenses.

In a market with low demand, a landlord with a lot of vacant space may prefer to agree to a hefty TI allowance to incentivize tenants to lease space rather than leaving the space vacant.

In addition, some landlords offer large TI allowances even in markets with high demand in exchange for tenants signing longer term leases. While it may be a large out-of-pocket initial expense, being able to sign a tenant in to a long-term lease at favorable rates can end up being better for the landlord in the long run and allow the tenant to minimize their upfront costs.

Other factors that can influence how much TI a tenant receives include:

* Other concessions negotiated
* Desirability or creditworthiness of the tenant
* Condition of space

If you are considering making improvements to your new space, it is well worth your time to get an estimate of what the improvements are likely to cost before going too far in the negotiation process. Hiring a project manager can be a big benefit in this process, and typically the cost savings they bring to a project far exceed the cost to hire a project manager