Exercising Your Lease Option —A Two-Tiered Approach

By Gerald King

Back in 1993 the new store opening was one of the strongest in memory. The strip center's anchors produced great traffic and the store's five-year lease had two five-year options. Fast forward to 1998 and it's time to decide whether or not to exercise the next five-year option.

For many retailers this decision process is called "good store/bad store". If it's a good store we exercise the option and if it's a bad store we do not. A simple analysis of the next five year's projected sales against the option rent is all that is really needed. If the store can make money at the option rent then why not leave well enough alone?

This simplistic approach fails to take into account the profit potential of the retail chain's leasehold interest in its various locations. A more prudent approach is to separate the exercise/no exercise decision into two separate components; operational and real estate. Question one is an operational one; **"Do we want to continue to operate this location?"**

Question two is a real estate one; **"What is the Fair Market Value of the premises and is the proposed option rent relevant by today's standards?"** If you do not wish to continue to operate this location, then the second question does not need to be answered at all. If you do, then a determination of the real value of the market rent for the premises must be made. By doing this, the real estate department makes a direct contribution to the company's bottom line, as does the operations department by operating the store. Management can then measure the relative contributions of both.

Many retailers make the mistake of inserting the lease renewal

decision into the operational decision. Real Estate Directors who operate under this approach find themselves negotiating lease renewals on "What we can afford", not what the space is really worth. The negotiation process degenerates into a test of wills between landlord and tenant. Injecting the issue of the tenant's ability to pay into the renewal process makes the landlord a partner in the operation of the tenant's business. Retailers who would never agree to pay their employees based on the amount of the employee's monthly home mortgage payment or grocery bill, now find themselves arguing with the landlord that they are entitled to lower rent, based on their stores diminished sales.

A two-tiered renewal process takes into account the need of both the store operations division and the real estate department. Each makes a distinct contribution to the bottom line of the company. While the store's continued existence is determined by the store operations department, the issue of occupancy cost is determined by the real estate department. Once the decision is made to remain in a current location, the real estate department need only reach agreement with the landlord on what the market value of the property is. The tenant's credit rating, drawing power, and attractiveness of use are certainly part of the equation, but the manner in which they operate their business is not. A retailer may agree to accept less than fair market value for his products based on the credit buying habits of his customers – we call that a trade discount. The landlord may also agree to offer similar discounts to his most credit worthy or multiple location tenants – we call that a below

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The real estate department must resolve, as a matter of corporate policy, not to exercise any option that provides for a rent above the market value for the space. An effective corporate renewal policy might therefore read;

1. **Widget Corporation understands that superior retail locations will result in higher sales of Widgets.**

2. **We believe our landlords are entitled to fair market value for their retail space, and that we should not be forced to pay more than fair market value for any retail space.**

3. **We will not and can not, as a matter of corporate policy, extend any lease or exercise any option that does not reflect the fair market value of its demised premises.**

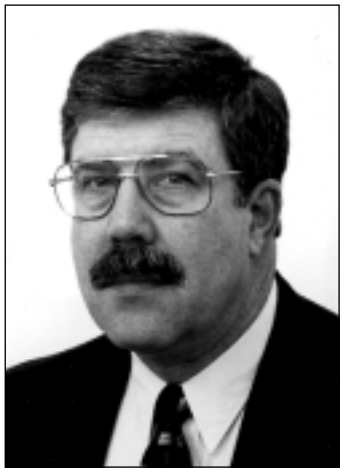
market rent! The real estate department must then determine what the market value of the retail space is. This process is complex and requires the analysis of a great many variables concerning both the subject landlord and the market in general (a subject for another column).

When the option rent is greater than the market value of the premises, the retailer should refuse to exercise the option and enter into negotiations with the landlord for a rent that reflects the market value of the space. Just as retailers expect to be paid fair market value for their products and services, they must be willing to pay fair market value for the landlord's product; his retail space. While the market value of both the retailers' products and the landlord's product will change over time to reflect their respective markets, they nevertheless can be quantified at any point in time.

Vacancy rates, new retail construction, infrastructure changes, and the individual landlord's financing position…all affect rent levels just as demographics, competition, inventory levels, and product delivery problems affect the price of the retailers products. Though neither can be predicted at a future date with certainty, both can be determined today quite precisely.

A corporate lease renewal policy based only on fair market value of the subject space serves as the anchor of a sound two-tiered lease renewal program. If enforced across the board, landlords will come to expect that you will treat them fairly and know that you expect the same. Most landlords will willingly engage in a frank discussion of the market value of their space, knowing that they are not likely to get more than that amount from a replacement tenant. The real estate department can then become the profit center it needs to be.

About the Author



Gerald King is Principal and Founder of Rent Research Consultants, Inc., an option review and tenant representation firm with offices in St. Louis, Boston, San Francisco, and New Hampshire. E-mail: rentcons@gis.net