

## **How Franchisees can Negotiate Lower Rents**

The current recession has opened a window of opportunity for tenant-franchisees to restructure their leases, including lower rents. This is by no means to say all tenants will be successful in doing so. Achieving a rent adjustment is dependent upon a myriad of factors. By following the process as outlined below, tenant-franchisees can greatly increase the likelihood of achieving rent reductions from their landlords.

So why is the environment ripe today for rent relief and how much longer will the “tenant market” last? When does a rent reduction make sense for both the tenant and the landlord? And, what steps should tenant-franchisees take in approaching their respective landlords? This article attempts to answer these questions. The article also makes the case that successful rent restructures not only inure to the benefit of tenants, but also to landlords and their lenders as stronger, viable businesses preserve tenancies and values of retail centers for the long term.

### **Why now and how much longer will the window of opportunity remain open?**

Consumers, tenants and landlords alike have been greatly affected by the credit crunch and recession. While the story has become quite familiar, nevertheless it's worth repeating (in an abbreviated manner) as the events have had an outsized impact on retail businesses and the ability of tenants to pay existing rents.

In the years leading up to the recession, many financial companies took on excessive financial leverage (30:1 in the case of some investment banking institutions). While this financial leverage fueled growth, questions ultimately arose as to the value of the assets underlying the debt issued. The concerns culminated in the credit markets seizing up, the virtual lack of any additional capital for financings and a steep contraction in the economy. Employers have cut jobs by hundreds of thousands a month (more than 5 million jobs have been lost since the recession began in December 2007). Consumers have turned into savers hoarding any remaining cash as they fear for job security and as they witness substantial declines in their financial nest eggs.

Since much of our economy is based on consumption, the decline in discretionary spending is having enormous ramifications on retail businesses. Retail businesses are seeing their sales erode as consumers cut back on spending, and thus, are having difficulty in covering operating expenses. Tenant-franchisees which rented space during the most recent growth cycle face a double hit -- they have to pay higher rents to cover the inflated land prices and construction costs (again caused by the excessive financial leverage which fueled artificial demand for product and capacity). Previously, tenant-franchisees could turn to alternative sources of capital to weather an economic downturn (e.g. business and home credit facilities, and retirement funds). Because of restrictive lending or declining asset values, these sources of capital no longer exist or if available are significantly diminished. As a result, tenant-franchisees face enormous pressure to reduce occupancy costs, including rents.

Landlords too face immense challenges as national retail chains curb growth and close stores. Store vacancies are increasing at an alarming rate and it is virtually impossible for landlords to

find new tenants to re-let space. Landlords are reluctant to allow occupancies to fall below certain levels for fear of triggering co-tenancies clauses or otherwise allowing the center to become increasingly dark with limited prospects for recovery. If the landlord can retain a tenant at a lower rent, the reduction in rent may be a relative bargain as compared to having to re-let the space (if even possible) with the associated tenant improvement and commission costs. Accordingly, tenant retention is paramount in the eyes of the landlord to the extent that landlords are now prioritizing maintaining occupancy over rental rate. To enable tenants to stay in their spaces, landlords are adjusting rent schedules to give tenants the necessary breathing room to ride out the economic storm.

At present, many economic and business experts are projecting a protracted L-shaped recovery (after the downturn has bottomed out which has yet to occur). In my opinion, tenants and landlords should work together to reset rents to sustainable levels to enable viable retail businesses to emerge from this difficult and hopefully transitory period. Indeed, this could be the best option for all interested parties (including lenders) so as to protect long term value and mitigate or stem current losses. Over time, banks will heal, the economy will improve, job losses will slow and the consumer will once again return. When this occurs, the landlords which helped tenants stay in business and in their leaseholds will surely reap the benefits.

**Which situations are ripe for reductions? What are you willing to exchange for a rent reduction? How does your landlord view you as a tenant and operator?**

As many tenants are already approaching their landlords and asking for rent reductions, it's very important that you prepare an appropriate strategy that relates to your circumstances. This will help you best attract the landlord's attention and gain the priority you deserve. Many landlords are becoming increasingly inundated with rent reduction requests, and thus, are identifying and prioritizing requests made by tenants deserving of a rent reduction from the ones which are not.

The following line of discovery will deepen your understanding of your circumstances and possibly enable you to structure a more favorable outcome.

**Sales Performance:** With respect to financial performance, tenants should be prepared to demonstrate that while their revenues have suffered due to the recession they have appropriate recovery and marketing plans in place. On the other hand, landlords may be reticent to make rent adjustments for businesses that remain profitable or were not otherwise affected by the recession or for tenants which threaten landlords with imminent bankruptcy (as they do not want to throw good money after bad). That said, strong profitable tenants may also achieve rent savings where the terms of the lease permit the tenants to exit and other space alternatives exist in the market.

**Lease Terms:** Read and understand your lease so you will know your rights and obligations and how they play into your business negotiation. When is the lease up for renewal or set to expire? The closer you are to renewal or expiration the more likely the landlord will be open to enter into negotiations and possibly lower your rents to market where market rents are lower than scheduled rents. If you are early in your lease term, check to see if the lease provides for "kick-out" or co-tenancy clauses that may allow you to exit the lease without penalty.

**Your Retail Center and Market:** Knowing what’s going on in the center and market will assist you in your discussions and raise your credibility in the eyes of the landlord. Have any anchor or other tenants moved out of your center (and, if so, did this decrease traffic and impact sales results)? What are the prevailing market rents and how do these rates compare to your existing rents and renewal rate? If you want to remain in this space for a term longer than your current term, it may behoove you to take advantage of today’s lower market rents and extend the lease early. Has other space become available in the center or elsewhere in the market that is preferable to your present space?

**What are you willing to give to the landlord:** Almost all successful negotiations are the result of parties exchanging something of benefit. If you know you want to be in this space for a longer period of time, then to extend the lease for a year or two may be worth considering. Also, some landlords may want to see tenants recycle savings into marketing efforts. Another way to entice the landlord to give you a break today is if you offer to “pay him back” if your business improves over certain pre-set levels before a specified time.

**How does your landlord view you as an operator:** Is your store clean, merchandised well and full of inventory? Do you draw traffic to the center and do these customers shop at the other stores? Are you current on your rent? If the answers to these questions are yes it is more likely your landlord will listen to you request for a rent restructure. If not, then you probably will have to first work to change the perception of how you do business. Obviously, what you want is for the landlord to want you – as if you were a prospective tenant the landlord was trying to draw to the center with all the carrots he might offer you today.

With this background information you are now ready to approach your landlord.

**Should you do this yourself or use a third party? What steps should you take?**

A tenant-franchisee may choose to approach a landlord directly or may opt to use a third party. By engaging a third party, the tenant-franchisee can offload the heavy lifting and time consuming requirements of seeking a rent reduction and instead concentrate on operating and improving the performance of the business. The third party not only brings immediate expertise to the process, but may charge a fee on a contingent basis – that is the fee is only earned if the third party is successful in achieving a rent reduction (this is particularly helpful to businesses facing cash challenges).

Whether you choose to seek a rent reduction yourself or use a third party, I suggest you take the steps below. If you do so, I am confident you will increase the chances of success and the magnitude of savings. Landlords are more likely to adjust the rent schedule if they understand your situation and believe in your plan and recover efforts.

- 1) Establish Open and Constructive Dialogue with Your Landlord
- 2) Submit Information to Your Landlord (to contain the following)
  - a. Issues and Causes
  - b. Financial Information

- c. Plan for Recovery
- d. Proposal
- 3) Contact Landlord to Discuss and Negotiate Proposal
- 4) Document Revised Rent Schedule

### Establish Open and Constructive Dialogue with Your Landlord

When you first contact your landlord about a rent reduction, it's important to establish a rapport. If you can get the landlord to participate in the process, then there is a greater chance he will cooperate which is essential for a lease restructure. On the other hand, some tenants take the path of least resistance. They simply ask for rent reduction before engaging and educating the landlord. While you still might get some rent relief by taking this approach, it may only be for a small amount, short lived and be your "only bite of the apple".

The preferred approach is to initiate open and constructive dialogue with your landlord before asking for a rent reduction. By fully engaging and educating the landlord about your business, he will gain confidence in you as a tenant and your recovery plans. As a result, he will more likely support your efforts which should increase the amount and duration of your rent reduction (to truly help your business for the long term).

Be open about what's going on with your business. If it is struggling financially, tell the landlord what you are doing to grow sales and manage your expenses (including addressing all costs). Tell him that you are confident your sales will improve, but this will take time, especially because of the issues created by the recession. Inform the landlord that you have prepared a package of information detailing your circumstances you intend to send to him (package to include your sales histories, profit and loss statement, marketing activities and recovery plan).

Suggest to the landlord that a rent restructure will go a long way to helping you implement your marketing and recovery plans to get you through the next critical 12-24 months. Tell the landlord you are sensitive to his needs with respect to CAM, taxes and insurance and you are only talking about base rent. If you want to remain in the space past the lease expiration date, say that you are open to discussing an extension of the lease in exchange for a current reduction. Reiterate to the landlord that you want him to review your package so he can fully understand your situation before any decisions are made (and you are not looking for any decisions today).

### Submit your Information to the Landlord with a Proposal

The package you prepare and send to your landlord should provide the landlord with pertinent information to fully explain 1) your current situation, 2) financial performance, 3) your marketing and recovery plans, and, 4) existing and proposed rent schedule. The idea is to provide the landlord with enough pertinent information so he can gain the confidence to make an appropriate (and hopefully favorable) response to your proposal.

In your cover letter, as in your prior phone conversations with the landlord, it's important to strike the appropriate balance between what you want and what you might be willing to give achieve a win-win outcome. For example, if you prefer to remain in the space, then the purpose

of your request is to adjust the rent structure to a sustainable level (so that you can be in business when the economy improves). In exchange you are open to extending your lease or possibly recycling some of the savings into your marketing efforts.

**Describe Your Situation:** Clearly define your issues – why are you struggling. What changed in the market that derailed you from operating as anticipated or according to plan? Was it the sharp drop in consumer discretionary spending? Is the overall traffic down in your retail center? Did an anchor or other tenants vacate the center recently? For new centers, did the center stall in its leasing activity? Did the surrounding area not develop out as quickly as you and others had projected?

What you want to convey is that what happened (the downturn in consumer spending, loss of co-tenancies etc.), was external to you and not reflective of your business practices. And, that these external factors are temporary albeit they could last another 12-24 months. When the market turns up, you will be the first to lead the recovery. If you are currently outperforming your competitors in the immediate area, point this out as well. Your aim is to put yourself in the position to be in business when the economy rebounds so that you can be a stronger, more viable long term tenant for the landlord. The rent restructure will go a long way to helping you do this.

Despite your present struggles, reiterate to the landlord that you are and expect to be a great retail business. Reference the positive feedback received from customers and any awards or recognitions received from your franchisor. Point out that you draw customers to the center, including the amount of traffic. List the various marketing activities you engage in. Say that you operate a clean store, that is well merchandised and meets or exceeds the franchisor's standards of operations.

**How have these factors affected your financial performance and bottom line:** Before making any decisions, your landlord is going to want to see how you are performing. Provide the landlord with your monthly sales histories and profit and loss statements. The financials should fully reflect all expenses attributable to the business. If you are working at your business, do you charge your time against the business and is this expense reflected in the income statement? One of the key metrics in understanding the performance of your business relative to your peer group, is the rent charges to sales ratio. If you don't know the ratio for your business category, ask your franchisor or a third party tenant representative. You can also find this information in real estate publications such as the ULI publication Dollars & Cents of Shopping Centers. The rent charges to sales ratio tells you and your landlord if you are running below, above or in line with industry standards. If your ratio is higher than industry standards then either the rent charges need to come down or sales must go up (or a combination of the two).

**Marketing and Recovery Plans:** You should demonstrate that you are continuing your marketing efforts and have prepared a recovery plan. Provide the landlord with a list of your current and planned sales and marketing activities. Also, share the efforts and changes you are making to store operations, including controlling operating expenses. Show examples of what you and your franchisor are doing to build and strengthen your business be it in the areas of marketing, operations, training or purchasing. When do you anticipate an increase in sales

results taking into account seasonality etc.? Using this information, prepare a financial forecast showing how the business will perform (and return to profitability as the case may be) during the next 12-24 months.

**Your Proposal:** Now it's time to make a proposal to the landlord. This can be done as part of your initial package or perhaps a subsequent package or phone call. The proposal should relate to your current and forecasted financial situation. Think about how much time it's going to take to get you through the current downturn (which could last for another 12 to 24 months as unemployment is expected to continue to rise and possibly to double digits). And, what are the appropriate rent amounts to reduce or eliminate operating deficits and to more closely align your rent charges to sales ratio with industry standards. When submitting the proposed revised rent schedule, remind the landlord you are asking for a reduction in base rent only and not looking for any changes to CAM, taxes and insurance.

Once you get an agreement with your landlord on a revised rent structure, this new rent schedule will need to be documented in a lease modification agreement. Again, a third party can help you accomplish this.

### Summary

The current economic environment -- the worst most of us have ever seen -- presents an opportunity for tenants and landlords to relook at their leases and where appropriate reset rents to sustainable levels. This adjustment in rent should help enable many tenant-franchisees weather the recession so that when the market recovers they can emerge as viable and strong tenants for the landlord for many years ahead. In exchange for rent relief, tenants should be prepared to provide landlords with alternative benefits such as extended lease terms or possibly recycling some savings into marketing activities. These efforts can stem current losses and preserve long term tenancies and protect the value of retail centers for landlords and lenders.

Dan Berman is a franchise development and real estate professional and is a member of the Southeast Franchise Forum. Mr. Berman has partnered with Billy Bauman of Bauman & Company, LLC, a real estate advisory firm, to provide lease restructuring and rent reduction services for the current and prior economic downturns (before such services were in vogue).

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