5 Strings Attached to the Tenant Allowance Trap

Restaurateurs, and their real estate representatives, often take great pride in how much tenant allowance money they extract from a landlord as part of a lease transaction. While it's true that landlord funded tenant build out can potentially preserve cash reserves and limit the need the need to draw down on that line of credit, be careful, these deals often come with strings attached that are not apparent until after the lease is signed or the restaurant is open for business.

There are several reasons that a landlord will offer tenant allowance funding in excess of market conditions. Typically, the pitch begins with how badly they want your concept as part of their project, how unique it is, how it consistently exceeds expectations and dwarfs the competition. Sometimes this is true, especially for highly desirable concepts that have a history of great press, are able to drive customer traffic, provide an invaluable project amenity, or anchor co-tenancy by attracting other desirable tenants. But before you buy into the flattery, sign the lease, and begin to celebrate your next location, be sure to ask the following questions.

1. **What is the landlord's motivation?** All too often, excess tenant allowance is offered as an inducement for tenants to overcome objections, obvious and hidden, to the site location or logistics. This is often the case, for instance, in growth market developments that lack a reliable history of sustained, restaurant sales performance, as well as in locations that have consistently proven to underperform. Ask yourself if the location under study would be worthy of consideration were the tenant allowance money NOT being offered as part of the deal. And, how long has the property been on the market? What other concepts have considered it and why did they elect not to take the bait? With or without tenant allowance funding, a failed or underperforming restaurant will inhibit opportunities for future growth and burn valuable resources earmarked for alternative projects.

2. **What is the "delivered" condition of base building infrastructure for Premises?** Put this question at the top of your list for vetting, before you even begin a discussion about rent. Failing to understand the condition of delivery is consistently the single biggest mistake restaurants make during lease negotiations. There is a distinction between tenant improvements which are proprietary, or unique to the concept itself, and those that are "restaurant generic," or add value to, and remain with the premises for use by a successor tenant AFTER the original tenant vacates. In my experience most restaurant operators do not grasp this distinction and too late in the process realize that the cost to upgrade landlord's cold dark shell work letter to "restaurant ready condition" can run between $50-100 per square foot. Your tenant allowance prize money can very rapidly expire improving the landlord's base building before you ever spend a dime on tenant specialty finishes you had budgeted those funds to cover.

   More than likely the landlord's lease proposal will include a single page work letter outlining the condition in which the space will be constructed. These work letters typically offer to provide a structurally compliant, cold dark shell, sometimes exclusive of tenant storefront. Rarely does the landlord work letter include the necessary, and costly infrastructure requirements to operate a restaurant such as, MEP (mechanical, electrical, plumbing) functions, properly sized utilities, access features for ADA compliance, trash loading, etc.

The least costly, and most efficient way to pro-actively address this challenge is to prepare, and submit to the landlord, a tenant work letter prepared in collaboration with your architect, general contractor and real estate representative, that outlines in detail any and all base building improvements that you expect the landlord to make BEFORE you accept possession of the space. Make it clear that these specifications are not "tenant improvements," but rather base building requirements. It should include all restaurant generic improvements that add value to the base building. Any tenant allowance funding should be above and beyond this condition of delivery, to be applied toward tenant construction and finishes.

3. **Are there any "hidden costs" associated with the location and transaction?** Hidden transaction costs can cripple a transaction. The cost of acquiring a liquor license, permitting fees, sewer and water tap fees, parking requirements and other impact fees, levied by the local jurisdictions can vary dramatically from location to location, and can be significant. Don't rely on the Landlord to reveal them. Invest in due diligence to vet hidden costs because, once again, tenant allowance money can rapidly evaporate once these costs are revealed.

4. **What long term impact will tenant allowance funding have on base rent?** While the relationship between base rent and amortized tenant allowance funding is rarely dollar for dollar, it is best to understand what cost capital the landlord is building into his base rent proposal for the cash contribution being offered. In other words, what would the base rent be if there were no tenant allowance funding, or if the tenant allowance were more in line with comparable market transactions? Remember, once base rent is agreed upon in year one, it will continue to escalate throughout the term of the lease and any option periods, long after the tenant allowance has been fully amortized and paid back. Consider instead, negotiating above market, amortized tenant allowance as a separate, "additional rent," line item, that burns off after a finite period of time.

5. **What type of guaranty will be required to secure the allowance?** Finally, while it would seem that accepting tenant allowance funding is a way to increase leverage and reduce investment risk, keep in mind that the landlord will typically seek corporate or personal guarantees to secure his investment. This portion of the guaranty is likely to be above and beyond whatever guaranty may be required on the lease itself. This could impact your ability to borrow funds for other purposes and negate the attraction behind using the Landlord's money, instead of your own. Limit said guaranty to funds that are offered at "above market" conditions only, with an expectation that the guaranty will be reduce over time and expire once the tenant entity is secure and operating successfully (3-5 years). To reduce the guaranty, consider taking rental abatement over time in lieu of a cash allowance or, consider offering a percentage rent inducement, urging the landlord that shared success is the bi-product of shared risk.

While the advantages of securing contribution capital from the landlord can expand and accelerate your growth profile, it is critical to remain disciplined in your approach to making real estate decisions. Ask the right questions, and understand the associated and hidden costs. Above all, resist the urge to be baited into risky decisions with the allure of tenant allowance funding.

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