Multi-Unit Franchisee
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BY HELEN BOND

LEASE NEGOTIATION 101

Laurel Wilkerson

Zeroing in on the right site and the right deal

After 34 years of negotiating leases for 150 hair salons in California and the New York Metro area, Gary Grace appreciates the advantages of being part of a franchise system with a well-known name.

"You get more respect from the landlord because you have the power and success story of the brand behind you. It really makes a difference," says Grace, CEO of California-based GG Enterprises, which today owns 36 Supercuts salons and one Cost Cutters. "The bigger the name signing the lease, the more secure the landlord feels, and the more leverage you have in negotiating."

These days, nearly all prime real estate is rented, not sold: an estimated 98 percent of retail and commercial space is available only for lease. And while a familiar name might get a franchisee in the door, landing a lease that leads to long-term success takes not only due diligence and attention to the fine print, but also the ability to balance the dual roles of franchisee and tenant, says attorney Amy Cheng, a partner with Cheng Cohen in Chicago.

"As a multi-unit franchisee, you are kind of in the middle," she says. "You have to negotiate the lease with the landlord to protect yourself, and yet you have to get the franchisor's approval. Communicating with both parties is essential for making sure things go smoothly."

Cheng, who works with franchisors and has negotiated deals for multi-unit franchisees, says complications arise when a franchisee brings a franchisor—and the franchise agreement terms—to the table too late, resulting in a three-party negotiation.

"Multi-unit franchisees often don't think about the requirements of franchisors and getting the landlord to understand how important those requirements are up front," she says. "If you have a good franchisee and a good location, it is always my hope that lease negotiations are not what kills the deal."

The art of leasing

The level of support franchisors provide varies widely by system, size, industry, and the individual needs of franchisees, says Jim McKenna, president of McKenna Associates, a franchise consultant in Milton, Mass., and founder of The Franchise Real Estate Institute. To take advantage of a brand's real estate expertise, he says, franchisees should take the time to learn what assistance their franchisor offers and speak with other franchisees to find out if the system delivers.

When it comes to learning the ropes of site selection and lease negotiation, most larger franchisors can be invaluable in helping franchisees find the best available site. Smaller systems, with fewer resources and connections, may offer training and guidelines to identify sites and to educate new franchisees on the required lease language and brand's site selection requirements.

The franchisee then does the legwork, based on the system's criteria, such as geography, demographics, size, tenant mix, traffic, parking requirements, and visibility. Franchisees also can take advantage of site research companies such as Esri and Claritas, using the success factors identified by the franchisor, says McKenna; some franchisors contract directly with these firms and provide these services to their franchisees.

"The best thing a franchisee can do is to listen to the franchisor's advice," says McKenna. "They know their site success factors and what you should pay for the deal."


Gary Grace

And, don't stop there, he says. Since the right location is key to long-term financial success, especially for retail concepts, it's smart to seek additional support—whether from a real estate expert at the home office or through a broker—to prepare for the leasing process, particularly since landlords negotiate leases for a living. "All franchisees need to be aware that it is a critically important decision and they need to use the best commercial broker in their area, as well as a local 'connected' real estate attorney," he says.

John Gordon, real estate professional with New Orleans-based Smoothie King, which recently announced an aggressive expansion plan, relies on a network of retail space tenant rep brokers as his eyes and ears on the ground to hunt for the most suitable sites, even before the "For Lease" signs go up.

These are connections that can count—and add up to big savings over the lease term. As the economy improves in different parts of the country, many franchisees, particularly small-box tenants, are fighting over the same locations, says Gordon, who recently partnered with two franchisees to open seven stores in Mississippi and Florida over the next four years. "We have to be quick, negotiate hard, and be reasonable," he says. "We have to understand what deal points matter and focus on them."

Landing the best location

Armed with the brand's site selection criteria, franchisees must be analytical and unemotional when searching for a location, says McKenna. "Don't fall in love with a piece of property," he says. "Fall in love with your wife or your husband, never with real estate."

And the cheapest rent is not always the best deal. There may be a better site right across the street that costs more per square foot but has a greater chance of leading to higher profitability over the term of the lease. McKenna says opting for a site because the rent is lower can mean locating "60 feet from success."

Marco's Pizza franchisee Laurel Wilkerson, an attorney who spent 20 years as an Army JAG Corps Officer, says that when searching for new locations it pays to be open-minded. She is known to scout sites by driving grid by grid, taking the easy-in, easy-out "soccer mom" approach to uncover where customers live, visibility, and traffic patterns by time of day.

Wilkerson and husband Kevin, a retired colonel with 24 years as an Infantry Officer and a master's degree from Harvard University, are in the midst of a 20-store development in Western Oklahoma, which includes Oklahoma City and Moore, the city flattened by an EF5 tornado last May.

Wilkerson also cautions against just going for the "pretty penny" instead of a location that offers greater long-term bang for the buck. In Moore, for example, the Wilkersons opted for an older site, formerly home to a 7-Eleven that relocated directly across a busy street and that has provided their Marco's restaurant with high visibility, something she says "You just can't buy." In 2012, when they opened at that site, the store set records for the brand's largest-ever U.S. opening.

"Almost every time, we thought we ended up with our second pick and it has turned out to be great," she says. Their strategy is working. In 2012, Marco's named the pair its Multi-Unit Franchisees of the Year.

Coming to terms

Once a franchisee narrows down their choices, the focus turns to the economics of the deal, which can include a myriad of terms that can make or break the business (see below). While there is no standard lease agreement, Cheng says she generally sees two types of leases: a lengthy document that addresses every detail large and small; and one where the landlord has only a two-page document. Both types require a sharp eye, she cautions. And in either case, she says, seek counsel and address any sticky issues at the start.

Franchisees also must look hard for any requirements or regulations in the lease document that restrict them from doing business, such as limits on hours or the type or size of signage, to ensure there is no conflict with their franchise agreement.

Grace always negotiates out the landlord's right to relocate his sign within the shopping center during the course of the lease. "This is just death," he says.

Gordon advises franchisees to make sure the rent commencement date matches the day the franchisee will be ready for business. Otherwise, they will owe rent before the cash starts to flow.

Renewal time

Even with a long-term lease, franchisees must think ahead to renewal options before signing. Cheng advises franchisees to lock down renewal terms in the initial lease to prevent the landlord from changing the agreement at renewal time.

Over the years, Grace says he has seen the power balance in lease negotiation cycle back and forth between tenant and landlord. These days, he is in the process of re-upping his available renewal options and, for the most part, has negotiated rent reductions based on current market value. "I try to be fair," he says. "I am willing to pay market rent, but I don't want to pay more than market rent."

A good track record from a tenant who pays the rent on time and is a solid corporate citizen can be used to leverage the negotiation for a second lease, or to position them for a better site or additional locations. It never hurts to ask.

"Everything is negotiable, 100 percent," says Smoothie King's Gordon. "At

Amy Cheng

the end of the day, walking away from a deal is sometimes your best option. If you have confidence in your tenancy and your ability to do business, if the deal is not right there is no sense paying for it."

Terms to know

After a franchisee identifies a desired location, it's time for the negotiations to begin. In most cases, the landlord provides a letter of intent (LOI) or an initial draft of the lease agreement for the franchisee to review. As Gordon noted, everything is negotiable, such as length of the lease, security deposits, concessions for tenant upgrades, personal guarantees, escalation clauses, etc.

• **The term.** The period the initial lease period will run. A common example is a 10-year initial term with one or more 5-year options.

• **Rental cost.** Rent is generally given as a cost per square foot or in an annual amount.

• **Percentage rent.** Also known as overage rent, agreeing to this clause means paying the landlord a percentage of gross sales over the base amount as a component of rent; frequently found in retail leases.

• **Define everything.** For existing spaces, the lease should define exactly what will be available in the space. For example, a landlord should provide all the utilities, including electricity, gas if needed, water, and sewer connections. Landlords can also provide rest rooms, HVAC units, cooking vents, ceilings, lights, etc. Build-to-suit arrangements require substantially more detail.

• **Lease types.** The type of lease you sign can have a significant impact on your bottom line. One basic variable is how much the tenant is responsible for expenses outside their four walls. In a full-service lease (also known as a gross lease), the rent is fixed and the landlord pays for taxes, insurance, and maintenance out of the collected rents. One common tradeoff is to pay more for base rent and not be responsible for common area maintenance (CAM, see below), taxes, and insurance versus opting for a lower rent and being on the hook for those additional expenses. These costs are bound to increase over time, so landlords build in escalation clauses to match. Understanding these clauses will help in choosing the type of lease, as well as in building projected increases into future budgets.

• **Net leases.** This type of lease has a provision for the tenant to pay costs associated with the operation of the property, such as property taxes, insurance, repairs, utilities, and maintenance (in addition to the basic rent). There are also "double net" and "triple net" (NNN) leases. The differences between these three types of net leases is how much of the property's operating costs the tenant is responsible for paying. While the rent may be lower with a triple net lease, the monthly savings can be devoured if a large and unexpected repair is needed, such as replacing the roof. The chances of this kind of expense occurring are greater in older buildings. Tenants seeking fixed costs over the lease period should weigh lower rent against the chance of costly surprises down the road.

• **Common area maintenance (CAM).** These are expenses the landlord passes on to the tenants. Shared expenses can include maintenance, landscaping and other upkeep, real estate taxes, or specific references to triple net charges. CAM charges are common in shopping centers, where tenants are charged a share of expenses such as parking lot maintenance, snow removal, outdoor lighting, insurance, property taxes, etc. CAM charges do not normally include capital improvements made to the property. Experts encourage franchisees to understand these figures and negotiate a fixed rate or a cap on CAM increases.

• **Tenant improvement allowance (TIA):** This is the sum the landlord agrees to spend on improvements, based on square footage or as a lump sum. The lease clause that covers this is called "Improvements and Alterations." For franchisees, a leased space must be customized to meet the franchisor's specifications. The tenant and landlord should agree on who does the design, the contractor, the timetable, and how to allocate the cost. If the cost exceeds what the landlord offers, the franchisee must pay the overage; using your own contractor provides more control over costs. Also think ahead to franchisor-mandated upgrades, and be clear before signing which improvements need the landlord's approval.


Jim McKenna

• **Rider.** A supplement or addendum attached that becomes part of the lease; the more specific and detailed, the better for both franchisee and landlord in terms of avoiding future disputes. Franchisees frequently have unique requirements based on their franchise agreement. A good franchise attorney will ensure the rider includes all the provisions required by the franchisor.

• **Personal guarantee.** For those new to franchising, it will be tough to eliminate a personal guarantee. Cheng encourages tenants to seek ways to limit liabilities after a few years in business, pay a larger deposit up front that will be refunded in exchange for a shorter personal guarantee, or inquire if other properties can be used to guarantee the lease.

One final thought: If the landlord refuses to negotiate at all, most likely you can find a better deal—and a better landlord—someplace else.