



Eclass 4 – the power of Leases!

Demystifying essential clauses in Commercial Leases and Retail Leases

In this lesson I will take you through some key clauses and terms in a commercial lease. This is important because if you want to be able to develop the ability to pick up a commercial lease and understand what clauses really matter and then you can compare properties against each other to work out which one will give you the best ROI. Of course there are other factors to consider apart from the lease but the lease is the key item that your bank will look at when assessing your loan so this just shows you how important the lease document is.

Remember to always seek legal advice on contracts before going ahead but by understanding what to look for in a lease can mean you can easily assess 5, 10 or 15 properties in a short space of time without taking them all to your solicitor first.

Let's begin!

A lease is a legally binding document which binds the lessee (your tenants) into the obligation of paying the lessor (the landlord) rent for the set amount and duration as stated in the lease document. If your lessee defaults on their lease then you as the lessor can sue them for the balance of the rent owing under the lease. (Depending on when the lease was terminated you may be able to sue the tenant for loss of rent until you have found a new tenant)

Commercial leases in many ways are different from residential leases. Below are some of the reasons why

As a commercial property investor some of your leases maybe retail leases covered by the retail tenancy act (if you are in NSW – other similar legislations apply for other states). These are leases for premises that are included on the retail tenancy act but broadly they are leases that cover shop front and retail spaces. If you have a mix tenancy building or even a suite that is on the ground floor but with street frontage you will likely have a retail lease. Here is a link to retail tenancy guide:

http://www.smallbusiness.nsw.gov.au/_data/assets/pdf_file/0020/31466/Tenant_Guide_07-13.pdf

In the next lesson we will go over in a Real Estate institute Lease (REI) and a commercial lease and also show you copies of a disclosure statement from a real example. In the meantime in this lesson we will be giving a quick overview and point out some important clauses on leases for you. This means when you next look at a lease you can single out those clauses and compare different properties quickly.

Here we go....

Lease term

Lease term refers to the length of the lease. While many residential leases are for 6 or 12 months with many tenants happy to go to month by month at the end of their lease without wanting to sign a new lease, commercial tenants often want the security of a longer lease. Commercial tenants do not want to risk you kicking them out of the premise where they have built their business. Therefore, most commercial leases are for an initial period of 2 or 3 years plus further options for extension (as explained below). Some leases are up to 20 or 30 years.

What are options in a lease?

An option in a commercial lease is a clause within the lease to allow the tenant to extend their lease to your property for an additional term. This term can be as short as 12 months or 3, 5 or 10 years. With commercial leases there are sometimes several options for renewal of lease. So it can be for 3 years plus 3 years which means your tenants after the first 3 years can choose to renew their lease by a further 3 years if they wish.

The reason such a term is inserted into the lease is to save both you and the tenant renegotiating on the lease every 3 or 5 years where your tenants intend to stay for a long time and importantly gives your tenant the right to extend for that additional term which may be very important to them. Of course, if your tenant wants to renegotiate their lease at any time for a longer lease or for different terms it would be in your best interest to see what they want. Your tenant may decide to sell their business in which case they may want to renegotiate their lease for a longer period so the business is worth more to the purchaser. Alternatively your tenant may wish to do major renovations to the premise and they want to make sure with a longer lease they will make full use of the money they will spend on their refurbishments.

An option in lease terms is expressed as 3 x 3 x 3 meaning that it is initially a 3 year lease with an option of 3 years then a further option of 3 years.

Who draws up the lease? Who pays for the lease?

Depending on the length of your lease you may either get a real estate institute lease or have one drawn up by a solicitor. The Real Estate Institute of Australia have standard leases you can buy for a nominal amount (or your managing agent will have one available) for commercial leases of 3 years or less. This means the total duration of your

lease needs to be 3 years or less. This type of lease is usually suited to smaller office suits where the tenants may be just starting out and they are unsure how fast they will grow. Usually the lease will be an initial term of 1 or 2 years followed by an option for a further 1 or 2 years making the total no more than 3 years.

If your lease term is over 3 years, as it often is, if you have a sizable commercial property in a good location, you will need a solicitor to draw up a lease specifically for your property based on your negotiation with the tenants (more about that below). A commercial lease is a common contract for a solicitor to draw up so they often have templates they can modify to suit your specific needs. The cost of getting a lease drawn up can be anywhere around \$500 - \$1500 depending on the complexity of your lease terms and also which legal firm you use. If you choose a top tier law firm be expected to pay above \$1500 for a lease, but since most solicitors do leases on a regular bases finding a local suburban solicitor is no worse off than a top tier law firm and it will save you some money as well.

As part you're your negotiations you will need to work out with your tenant who pays for the lease to be drawn up. If it is a retail lease then the landlord will need to pay for it, but if it is a commercial lease such as for a warehouse, office suite or any other non-shopfront leases then it is usually the tenant that pays for it.

Noteworthy clauses under the lease

Insurance – this usually refers to the insurance your tenant needs to take out to protect your premise and their business. So you need to specify in this clause what type of insurance you want them to include in their business insurance policy. This may include things like business interruption (where the insurance covers for the payment of the rent in the case there is major interruption to business due to natural disaster and other unforeseen circumstances), plate glass (to protect your front window as they can be very expensive to replace), theft and/or break ins (to protect damage to your premise if you had some fixtures in the property you have paid for)

This insurance is different to building insurance which your tenant may or may not be paying for. You may need building insurance yourself as a landlord if you the building is freestanding to cover events such as fire and flooding. You may not need building insurance if the premise you own is under strata title.

Make Good Clause – this is a clause to make sure your tenants return the premise to its original condition at the time that the lease commenced. Often is this is a clause you may give your tenant exemption from depending on what they have done to the premise. For example originally your premise was just a shell but your tenant put in all the necessary exhaust and grease traps to turn it into a restaurant, you may not want them to rip it all out when they have finished at the premise because you can easily relet your premise to be used as a restaurant and charge a higher rate as the fit out is already there. However, if your tenants have done some work within the premise that may not be suitable to a future tenant, like painting every room a different colour, and

additional fixtures to the walls, you may request for them to repaint the whole premise in a natural shade and remove the fixtures off the wall.

Assignment of Lease – this is for when your tenant wishes to sell their business and they want to sign over their lease that they have with you to the new owners of their business. While you may not know the new tenants to your property this does not mean the tenants are going to default on the rent. In fact an assignment does not mean your original tenant is in the clear with the rent once there is a new owner to their business. Technically the tenants that signs the original lease with you is liable for the rent in the lease if your new tenant defaults on the rent. Isn't this great!

Fire Safety – This is a statutory requirement for your premise or any premise in Australia to be fire safety compliant. This usually means that there is a yearly inspection paid for by the landlord but which the tenant has to make sure they comply with. So, if there is anything within the premise that needs to be change to be fire safety compliant the tenant has to make sure they are compliant with it (if that is what the lease provides for).

Use of Premise and Access to Property – this is a clause which sets out what the premise is to be uses for and when they can access the premise. Usually the access is granted to the premise 24/7 but if the premise is a multi-tenancy or if they is any shared or common area you will need to specify when appropriate access is. The use of the premise is important as it may help you to determine any additional business insurance items you want your tenants to take out. For example a restaurant may have more likely events of fire within a kitchen that needs to be covered for compared to a beauty salon where there is less danger of a fire.

Termination – this gives the circumstances and ways you can terminate your tenant and essentially kick them out of your property. Although we would never advise for you to evict a tenant (before you have found a new one) you want to be covered for incidents such as malicious damage to your property or improper use of your premise or the most likely cause of termination being rent default. You need to specify in this clause how long your tenants are in default for before you can evict them.

Rent Default – this is simple clause to cover what happens in the event that your tenant fails to pay rent. It needs to detail what will happen if there is a rent default and how long the tenant has to rectify the situation.

Rent reviews – Rent reviews are at best 4 or 5% yearly increase on your current base rent of your property. At worse it is can be at CPI which currently can be 2%. Under most leases the rent is never adjusted down even in an economic downturn once a lease is signed which is great new security for you as a landlord.

Outgoings – This is what additional expenses will need to be covered by either the landlord or the tenant on top of the rent. This include such things as land tax, strata or building insurance, water rates, electricity, rubbish collection, etc. You will need to set

out a list of what these expenses are and then you will need to negotiate with your tenant who will pay each outgoing. The tenant can pay for 100% of the outgoing which is common for some outgoings or they may only pay for 50% of it depending on if they are part of a multi tenancy building or not.

Lease negotiations

While we will devote a whole Eclass on this topic it is worthwhile just to mention some general lease negotiation points here. Every tenant is different and every business your tenant is in is different and certain things may matter to one tenant more than another so it is worthwhile to look at the whole lease and try to project forward to see if your tenant will be likely to stay for longer than the initial first term period of 2, 3 or 5 years. What you are looking for is to getting your tenant settled into your premise so they have the potential to stay for 10 or 15 years therefore giving you peace of mind. Ultimatums seldom work in lease negotiations as sometimes your tenants will really call your bluff. In one case I know the tenant is shutting down their successful business just because they have decided they cannot stand the demands of the landlord. However, this does not mean you need to give in to whatever request your tenant want but it is worthwhile to think of all the possible scenarios in the future and account for them in the lease so you have a plan to deal with any situation that arises. For example, one good additional clause to put into the lease is the amount of additional rent your tenant will pay if you contribute to or pay for any renovations to your premise. So, if your tenant 3 years down the track wants the front part of your premise completely redone which may cost you \$50k or \$70k then make sure your account for a way for the tenant to pay you back. This may be in the mode of paying an additional 10% of the renovations cost for a set period of time so you can recover the cost of the renovations plus more.

Exercise

Now that you have a general overview of some of the important clauses in a lease your homework for the week is to look through the leases on the properties you have chosen from the previous lesson. If the agent has not emailed you a copy of the lease then please go back to the agent and ask them for copies of the leases on those properties. Even if the lease has expired (rare but can happen) it is still worthwhile to get a copy of the lease so you can have a look through it and take note of the clauses I have mentioned above.

Remember by going through the lease you have on your chosen properties and understanding some of the key terms you will save yourself time and effort on having to take each lease to your solicitor to have it looked out. This way when you have found one or two properties you really like then you can take that to your solicitor to get the final once over. Remember nothing will substitute getting proper legal and accounting advice prior to purchasing your property but now that you understand what to look for in a lease you can potentially look at 5, 10 or 15 different properties and their leases to

help you quickly decide on which one is worth doing an inspection and which does not. This ultimately will save you a lot of time.

Hold on to those leases, in the next class we are going to go through the leases in detail and point out and explain the important clauses in a live example. After the next lesson you will be able to look at leases from totally different point of view and understand it.