

# TENANT LEASING GUIDE

Questions about Using a Broker

DAVID MORGAN

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## **Introduction**

# **FOR RETAIL AND OFFICE TENANTS**

**Whether you're looking for your first location.....**

**Or moving/expanding from your current location.....**

**this Guide will give you answers to all your questions about leasing**

Scenario 1: I'm leasing space for a *new business*; where do I start: The first thing you need to do is to determine your needs:

1. How much space do we need?
2. Do I have a business plan that outlines my business model and estimates the income and expenses for at least 3 years?

2. How much rent can we afford to pay (usually a percentage of your estimated volume)?
3. How important is location?
4. When does my new space need to be ready or when do I want to open my business?
5. Have I taken into account everything that is needed in my new space (selling area, back room, restroom, furniture, phones, computers, copy/fax/postage machines, Internet access, etc.)?
6. Do I want to find the space on my own or hire a tenant rep to assist me?



Scenario 2: I'm thinking about *moving my office or store*; where do I start? The first thing you need to do is to decide if moving is right for you:

1. Exactly why are we moving?
2. How will this move benefit the company and its future?
3. What are the drawbacks of moving?
4. Can we afford to move?
5. Can we afford not to move?
6. Can we afford to lose some business during the transition?
7. Is now a good time to move? Are we gearing up for the holiday season or other period of increased production or sales?
8. If we're thinking about moving to a distant location, can we afford to lose some personnel who choose not to relocate?
9. Is the company in a healthy state to move? Is there a history of indecisiveness, lack of leadership, high turnover, or other morale-related problems?

Once you've determined that you're *ready to make a move*, here are the things you'll need to know about how leasing commercial real estate works.

## **1. How does the commercial real estate industry work with regard to leasing?**



Most owners of real estate hire real estate agents to lease their property on their behalf. The agent obtains a listing agreement which calls for that agent to act on the owner's behalf as a fiduciary in leasing the property. The agreements are performance based, meaning the agent earns a commission upon the signing of a lease. The commission is typically paid one-half upon lease executions and one-half upon tenant occupancy. Owners of real estate can lease their own properties without having to have a real estate license.

Commissions are paid to the Broker who then pays the agent responsible for the lease. Agents typically work on "splits" with the house. Splits can vary anywhere from 50/50 to 90/10 in favor of the agent. Agents are typically independent contractors who are then responsible for paying their own taxes.

In some cases, a tenant will retain an agent to find a space on the tenant's behalf, who is called a "Tenant Rep". Most listing agreements require that the listing agent split the commission earned with the tenant's representative. In most cases, commissions are split 50/50. There are exceptions to this rule. In soft markets where vacancy rates are high and tenants are at a premium, the owner may pay the tenant's representative a full commission. In this case, the listing agent usually continues to receive a half commission, which results in a commission and a half being paid out by the owner.

## **2. How do brokers/agents get paid?**

Commercial real estate agents are typically paid a commission upon the signing of a lease. The commission is paid by the owner of the building and is typically paid one-half upon lease execution and one-half upon tenant occupancy.

The commission is most often calculated as a percentage of the lease value and usually ranges between four and six percent.

Example, if a tenant signs a 3-year lease for 2,000 square feet at \$20 per SF per year, a 5% commission equals \$6,000 (3 yrs x 2,000 SF x \$20 x 5%).

## **3. What's the difference between a leasing agent and a tenant rep?**

The leasing agent has the listing on the property and represents the interests of the building owner. A tenant representative or "rep" represents the interest of the tenant in a lease transaction. Some agents work exclusively on listings, others will take on tenant representation only, while others work on both.

#### **4. What factors affect commissions?**

- A. All any agent has to do is to bring a tenant to a property and show a space in the property to this tenant, and the agent is legally entitled to a portion of the leasing commission as the “procuring” broker. A tenant may never see the agent again, but since that agent showed them the property, that agent will be entitled to be paid a commission. These situations can also get real messy. For example, if later on that tenant hires a tenant rep, a commission dispute will likely occur if the tenant enters into a lease on a property that was shown to them by another agent.
- B. Commercial real estate commissions are, in most cases, calculated as a percentage of the rent due under the lease. The higher the rent and longer the term, the most commission is paid. This may be great for the landlord, but is usually contrary to what the tenant is trying to achieve.
- C. Commissions are paid only if a lease is successfully executed. The quicker a lease is signed, the faster the agent gets paid. While this may be great for the agent, care needs to be taken to ensure that compromises aren't made just to get the deal done quickly.

#### **5. Are all properties listed?**

No. In some cases, an owner will lease the property directly. Sometimes, the owner will employ an in-house leasing agent. Typically, these are called open listings, where the owner will pay a full or partial commission to any broker who brings a tenant to the property. An in-house leasing agent is usually paid on a salary basis, so their incentive to enter into a lease is different than from a listing agent who is paid a commission.



It's important to understand that when you're negotiating with an owner, the terms of your lease take on a much greater importance. The owner is going to receive your entire rent payment, while the listing agent receives only a small percentage as his commission. Also understand that if you hire a tenant rep, there's a possible conflict of interest. He may get paid a full commission on an open listing versus receiving a half commission on a listed property.

#### **6. Is finding a space without hiring a broker a good Idea?**

Generally speaking, the answer is no. You as the tenant enter in a lease once every so often. A broker negotiates for space on a daily basis. Would you go into an IRS audit without having your CPA by your side?

## **7. But do I need a broker to help me find space?**



No. What you need a broker for is their expertise surrounding the leasing process. A good broker is much more than just a space finder; you should view them as you would your attorney or accountant. You want their advice as to what space is best suited for your business and what are the best terms that the space can be leased for. A good broker will help you in all aspects of the commercial space transaction by saving you tremendous amounts of time and money. That starts with understanding your business and ends with a signed lease. Finding the space is simply one small step in the overall process.

By utilizing a good broker you tap into their extensive knowledge of the local market and their expertise in their industry which will assist you through the lease negotiation process. A good broker will show you all of the available spaces in the market, the obvious ones and the hidden ones. Their work allows you to spend your time on starting, maintaining or growing your business.

## **8. When would I want to find space on my own?**

You don't need to retain the services of a tenant rep broker if you're looking for a small space and/or a short-term lease. Generally, speaking, since the total lease consideration is small, the commission that will be paid is even smaller. It's hard to find a good broker willing to work for a small commission; however, you might want to ask a good broker the question because a good broker may know of a space in the marketplace that is right for you and won't take up much of his time. Remember, it takes the broker just as much time to help you lease 5,000 sf for five years as it does to lease 1,000 sf for three years. In addition, the listing agent will usually work harder to lease a small space if the commission doesn't have to be split.

## **9. Who does a broker work for?**

Brokers generally work in two capacities, as listing agents or as tenant reps. Some if not most, do both, meaning that they have property listings and they also work as a tenant rep. If you're working directly with the property listing

agent, make no mistakes, that broker is working for the property owner. If you hire a tenant rep that also has listings, then you need to have a very good understanding of what listings they have and what conflicts, if any, that creates. For example, in addition to the fiduciary issues that come with representing both parties in a transaction, the agent will most likely make more money if you lease a space at his listing. Instead of having to split the commission, he collects both sides.

## 10. How much does it cost to use a broker?



Most brokers will tell you that their service is free; their fee is paid by the landlord and it doesn't cost you, the tenant, anything. Generally, this is true. To understand why a broker may not always be free, we must look at each of the four most common type of leasing scenarios:

1. You hire a tenant rep broker and lease space in a listed property.
2. You don't hire a tenant rep broker and lease space at a listed property.
3. You hire a tenant rep broker and lease space directly from an owner.
4. You don't hire a tenant rep broker and lease space directly from an owner.

Scenarios 1 and 2 are by far the most common, as most commercial space is listed by the owner with a real estate agent. In Scenario 1, your tenant rep broker is indeed free. This is because when you sign a lease at a listed property, the listing agent is required to split the commission due on the lease with your tenant rep broker. If you didn't have a tenant rep broker (Scenario 2), the listing agent would have kept the entire commission for himself; hence the split results in your broker being free. There is a bit of gray area here, which happens when you're leasing space in a soft market. Since tenants are at a premium, the market dictates that a full commission is paid to your tenant rep broker. This adds 2-2.5% to the cost of the transaction to the owner, which the owner will try to recover in other areas of the lease. It is unlikely that you'll pay a higher rent, as your alternatives in the marketplace prevent that. You may end up with less tenant improvements, but your tenant rep is there to make sure you don't.

Scenarios 3 and 4 offer the most debate. Under Scenario 3, while you don't pay the tenant rep broker directly, the owner does. This adds cost to the lease and the owner will try hard to recover that cost, either with a slightly high rent or lower lease incentives (i.e., one less month of free rent provided). However, a good tenant rep broker will negotiate for a better lease than a typical tenant can achieve without representation. Clearly there are savings under Scenario 4, but it takes a lot of work by the tenant to be able to receive the full benefit of those savings.

## 11. How do I hire a broker?

The best way to get a broker to work for you is to hire them as your exclusive tenant representative. Most brokers have representation letters to you to sign and once they know that you are committed to them, they will work hard for you.

**12. What's the best way to select a broker?** There's no best way to select a broker, but here are some things to keep in mind:

- Ask another business owner who they utilized and if they were happy with the results
- Call on signs around the area where you want to locate and talk with different brokers until you find someone you are comfortable with
- Check client references
- Understand what properties, if any, a broker has listed that could create a potential conflict of interest
- If you haven't hired a broker, only let a broker show you spaces that they have listed
- Don't hire a broker if you're unsure about moving.



## 13. What is a representation letter and should I sign one?

A representation letter is something a tenant rep broker will ask you to sign. It has several purposes. First and foremost, it demonstrates your commitment. Once the tenant rep broker has that letter from you, they know they are much more likely to get paid a commission on your lease. This means that they will work hard for you. In fact, a good tenant rep broker will not do much more than a simple market survey without a signed letter. If you want to get the most out of the brokerage community, I recommend that you sign an exclusive agreement rather than working with several different agents on a non-exclusive basis.

**14. Now that I've hired a broker, what should I expect from him/her?**



A broker is like any other service professional. You should expect them to represent your interests, to give you good advice and to help you through the first phase of the leasing process; that is helping you determine how much space you need, what are your most important selection criteria, and then finding and negotiating for the space that best meets your needs. Don't be afraid to ask your broker all kinds of questions. Know how much money your broker is going to make on your lease. That will help you determine just how demanding you can be and how much work you should expect. Remember that your broker doesn't get paid unless a lease is signed, therefore, their primary aim will be to make the transaction happen. No matter which broker you hire to represent you, the person who cares most about your interest is you. Ask questions, know your options. Make sure your broker understands what is important to you in the lease negotiation.

### **15. My broker doesn't have much experience; should I be worried?**

The answer to this question depends on the size of your lease. If your plans call for a large space with a long lease term, then your broker's experience is a very important consideration. On the other hand, if you're leasing a small space, then you may be better off using a broker who's fairly new to the business. The reasoning here is that a younger broker is looking to establish himself and will work harder for a small commission. As the tenant, you need to know how much commission your lease is going to generate and then determine how to best get your money's worth from your broker. If you're working with someone who is new to the business, then you need to understand what kind of training the broker has had. It's also important to know if the broker is working together with an experienced broker or is totally on his own. You need to know what resources the broker has available to him, particularly if he's never leased a space from the landlord and/or listing agent you're negotiating with.

### **16. What's the difference between a large and small space?**



Opinions vary on the answer to this question. Basically, a small space user is any company with an office or retail space need that is 3,000 sf or less. A medium space user has a space need between 3,000 sf and 10,000 sf, while a large space user needs more than 10,000 sf.

The definition also changes based on space type and metropolitan area. The numbers tend to be bigger for industrial users, where 5,000 sf or less is considered to be small. In New York City, 10,000 sf is considered small. On the other hand, 5,000 sf is huge in a city like Albuquerque.

It's also important to answer this question from the building owner's perspective. For example, a 3,000 sf space user is much more important to the owner of a 20,000 sf, 2-story building than the owner of a 500,000 sf, 25-story building. Some owners prefer to have large space users so as to limit the number of tenants they have to deal with in any one building. Other owners prefer small space users, as this reduces their vacancy risk when it comes to any one tenant moving out of the building. Generally speaking, small tenants tend to be the most profitable type of tenant for the owner. They tend to be less sophisticated and therefore less demanding. A large tenant is much more likely to require a specific and therefore costly build-out, while a small user can often take possession of a space with a simple painting and re-carpeting.

## **17. Now that I've found a space, how long of a lease should I sign?**



This can be one of the most difficult decisions you'll need to make. There are a number of factors that come into play here (yes answers are more indicative of a longer lease term, while no answers indicate that short term lease flexibility is more important):

- Is my business stable such that I don't expect my future space needs to change?
- Does the space that I'm leasing require a substantial investment in tenant improvements?
- Do I expect rents to increase significantly in the future?
- Is the location of my new space very important to the success of my business?
- Is relocating my business hard to do?
- Is my rent lower if I sign for a longer term?

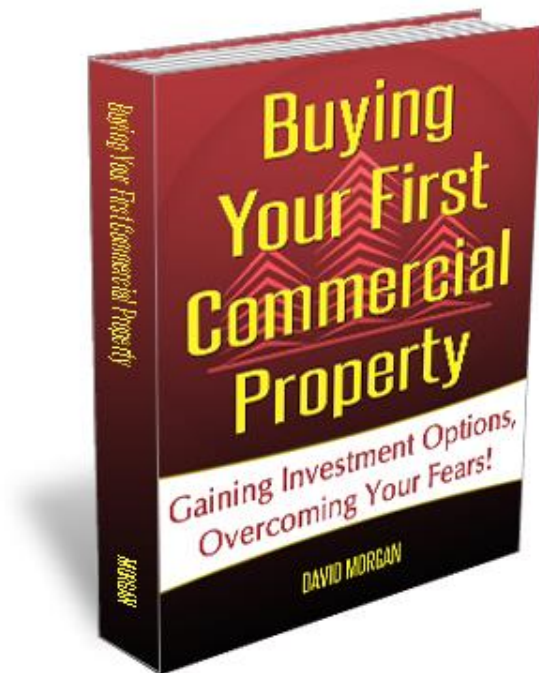
One potential pitfall to avoid is bad advice from your broker or the property's listing agent. Remember, the longer the lease term, the more money is paid out in commission. While that may be good for the broker, it might not be what is best for you. Ask the question, "What is the difference in rate between a three year and a five year lease?" Once you have that answer, then decide.

## About the Author

David Morgan has been a commercial real estate broker, developer, investor and manager for over 40 years. He is a consultant and a best selling author of books about commercial real estate.

Visit his website at <http://davidmorganconsultant.com> or contact him by email at david@davidmorganconsultant.com.

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