8 things you need to know BEFORE SIGNING A COMMERCIAL LEASE

Let's start with the basics. If you are reading this and have not signed, or even *read* a Commercial Lease Agreement (I know many of you have signed *without* reading them, but your secret is safe here, I promise!), then our mission is to help explain some of the very basics of a Commercial Lease Agreement and commercial leasing in general.

Ok newbies, strap in and let's go:

Commercial Leases ARE NOT at all like Residential Leases!

1 Consumer Protection

To begin with, Residential Leases are governed by consumer law; this means that the Government administers legislation to be geared towards Tenant protection, accounting for those less able to understand or protect themselves. This legislation puts protection around most of the standard documents, processes and rules i.e. what can and can't be agreed between the Landlord and the Tenant.

Commercial Leases are governed largely through Commercial or Business Law. Therefore, if you get it wrong, it will involve expensive Lawyers and legal recourse to fix or fight. There's no commercial equivalent to the Residential Tenancies Authority. Documents, while reasonably standard, can be amended to document whatever is agreed. If you sign a document, then you are bound to it - regardless if you had read and/or fully understood what you were signing.

2 Outgoings

Commercial Leases typically require the payment of outgoings. What are Outgoings? These are the Landlord's (also known as the Lessor) costs to own and operate the property. Items such as the Property Rates, Body Corporate (if applicable though excluding Sinking Funds in most states), Insurance, Water & Sewer charges, external building maintenance plus Agent's Management fees are all standard Outgoings. In some cases, the Land Tax or a Centre's marketing costs are also included in the Outgoings Definitions in a Lease. There can also be many others. Therefore, IF your rental is plus outgoings, read and re-read what they are, understand them and ASK for an annual budget of the outgoings <u>before</u> you sign any Commercial Lease.

3 Personal Guarantees

If you sign a Commercial Lease in a company name, then the Director/s are typically required to sign a Personal Guarantee. Much like a Bank loan, this simply means that if the company can't pay, then it will be the Guarantor's responsibility, right through until the Lease ends or is assigned to another party (with Landlord agreement). If you don't pay, then the Landlord or their Lawyer, has legal rights to pursue you through the Courts to recover the monies.

4 Bonds/Bank Guarantees

Similar to Residential Leases, a Bond is required to potentially compensate the Landlord if you damage the property or don't pay the required rent at any time. A commercial Bond amount is whatever is agreed upon. This is typically between three to six month's rent, unlike the residential one month's legislative maximum.

This Bond can, however, be provided through a Bank Guarantee rather than cash. A Bank Guarantee is exactly that, your selected Bank guaranteeing to provide the agreed sum (say six month's rent) if called upon. The Landlord can call upon this Bank Guarantee if you are in default on your Lease and have not rectified in the stipulated timeframe within your Lease i.e. unpaid rent, condition breaches, etc.

The Bank has to provide this in cash if called upon, no exceptions. As such this Bank Guarantee is essentially treated by your Bank as an undrawn Personal Loan. Accordingly, in most cases, they will require security to cover their possible payout, plus an application fee and ongoing charges for the facility.

If you pay cash, then understand as there is no commercial equivalent to the Residential Tenancies Authority (i.e. Rental Bond Authority), then usually your Bond is held by the Landlord, their Lawyer or Agent. Unless the Lease stipulates to the contrary, it IS NOT held by an independent third party.

5 | Lease Terms

Most Residential Leases are 6 or 12 months in Australia. Commercial Leases can be any time frame from month to month to 20+ years if mutually agreed. So yes, your term is highly negotiable but rarely will a Landlord agree to tie up their property for anything less than a 3 or 5 year period. Why? Well largely this rests in the Bank and the valuation process which is a whole other topic but for now, let's just say that the longer the Lease, the more the property is worth. If you have Bank debt, this is crucial for the lending ratio (LVR – Loan to Value Ratio).
In most cases, an empty property with a potential long term Tenant, is better than a confirmed short term Tenant that reduces the property's value. You would think some cash is better than none - right?
I'll explain this another time.........or PM me for the detailed answer.

6 | Tenancy (internal) Maintenance (Your full care, cost & responsibility)

In Residential Leases, if something breaks, you cry, whine, complain and then call the Landlord or Property Manager and demand it be fixed, right? (Lol) In Commercial Leases, it breaks - you fix it.
Anything from a light bulb to the front glass. It's your care and cost in most Commercial Lease Agreements.

7 | Rent Reviews

This is the mechanism for rent increases throughout your Lease. There's three main types usually defined in the lease; CPI, Fixed and Market Reviews.

CPI
Consumer Price Index also commonly called inflation. This is calculated by the Government and published quarterly. Usually, the relevant State or Territory where the premises is located applies. What this means is if the inflation or CPI is 2.75, then the rent is increased by 2.75% for the coming year.

Fixed Review
A Lease will state that the rental rate is to be increased by a fixed amount. Commonly a percentage will be used, such as say 3%, but it could also be a stated monetary amount, sometimes called a 'stepped rent'.

Alternative Review
This is a combination of the above two types; typically the Lease may state that "the rent will increase by CPI or a fixed percentage, whichever is the lesser."

Market Review
In a market review, the rental rate for the following year is reviewed by a comparison of what the current market is paying for similar premises relating to size, type, location and even profile. These are most typically used at the end of a Lease term to determine the rent for the next period when an option has been exercised. (see Lease Options explained below)

This typically is determined by comparison to the most recent Lease transactions in the area, or outside the area if there are no recent and nearby comparisons. In other words, what would the premises go for in today's market.

In reality though, when a market review is called, it becomes a negotiation that goes something like this;
- The owner states what they think the rent should be;
- You as the Tenant reply with your proposed rent;
- Either a rental figure is agreed which is heavily predicated on the market dynamics (supply and demand) or the emotions of greed and fear.

If an agreement can't be reached, then a more formal process is conducted which is outlined in the Lease and allows both parties to engage a Valuer to formally assess the market data. If this step does not bring the two parties to agreement, then a formally appointed independent party referees the data and their decision is legally binding.

8 | Lease Options

A Lease Option is exactly that, an option for another Lease. For explanation, let's say an agreement is struck for a 3+3+3 Year Lease. This means the initial (bound) Lease term is three years with two more three-year options, at the election of the Tenant. What is most typically asked and perhaps misunderstood, is who gets the option to decide. In 99.9% of cases, this is the Tenant, however while the Tenant can say if they wish to take up the Option, there's more to know.

These Options can only be exercised if the tenant is NOT in default of any Lease terms and needs to be done typically between the period six months and three months before the Lease expires. Once exercised, the rent is to be set for the following year according to the rent review mechanism in the Lease (see point 7 above). So if it's a CPI or a Fixed Review, it's easy to define. However, if there's a Market Review, then the Tenant is required to say "Yes, we will stay", with perhaps no idea of the rent for the next year.

So there you go, enough information to be dangerous but also informed. I hope that helps you on the exciting journey of Entrepreneurial discovery.

The overall lesson you need to take away is - BE INFORMED, READ AND RE-READ Commercial Lease Agreements *before* you sign them. Some last longer than marriages and don't always provide the fringe benefits.....

If you're a little more advanced on your Commercial Lease understanding and need some clarification around term definition or just have a question, shoot me an email at kgrisman@theboardingoffice.com.au

If I can't help, I'll put you in touch with someone who can. There's no catch and no charge, I have just been in this space for over 20 years and find its over complication entirely unnecessary. I'm happy to help where I can.

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