



Hunt Corp. Commercial Real Estate Q&A: Lease enhancement - by David Hunt

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Q: We are planning to lease a larger manufacturing facility on Long Island. Our broker says the landlord is going to require "lease enhancement." What does this mean, and how should it be negotiated?

A: Lease enhancement refers to a means of providing additional assurance to the landlord that you will be able to live up to the terms of your lease. Landlords are concerned with the prompt payment of rent, damage to the premises beyond normal wear and tear, and amortization of their up-front costs over the term of the lease. Lease enhancement would typically be required in larger or more complex transactions where the landlord has significant expense and possible exposure to default by the tenant. In smaller transactions, where a landlord may be responsible for minor construction and a coat of paint, a typical security deposit equal to two month's rent may be sufficient. In a larger transaction, however, where the tenant installation and real estate brokerage may entail a landlord cost in the hundreds of thousands, or possibly millions of dollars, lease enhancement may be required for anything less than a rated tenant.

The forms of lease enhancement are varied and subject to negotiation. They may take the form of additional security, personal or limited guarantees, letters of credit or any other form of monetary guarantee. It can also take the form of the tenant actually making a monetary contribution to the work-letter. Any monies advanced by the tenant on this basis obviously do not have to be amortized over the term. Another means of providing lease enhancement is the prepayment of future rent.

Lease enhancement is really a means of balancing risk and investment for the landlord. If you have decent financial statements, and can demonstrate that the payment of rent can be easily accomplished, you certainly can make your case for limited or no lease enhancement. Likewise, if the landlord's investment is minor, I would take the position that the need for lease enhancement is not necessary.

When our firm represents tenants exclusively, we usually take the position that the need for lease enhancement diminishes over the term of the lease. Obviously the landlord has much less risk after he has already received several years of rent paid on time, and that should be reflected in the agreement.

If lease enhancement is required and the cash is available, you can offer to prepay rent (e.g. prepayment of 1st, 13th, 25th month's rent upon lease execution.) This puts cash in the landlord's hands for your installation, but the advance is "burned off" after the final month's prepaid rent is used. If cash is tight, but your credit is good, the answer is often a letter of credit from your financial institution. This is a guarantee from your financial institution that allows the landlord to draw against your line of credit in the event of a default. While this obviates the need for a cash payment, it does tie up credit that may otherwise be available to your firm. Make sure that the letter of credit diminishes during the term of the lease.

In the end, there are no set formulas or rules that must be followed. The solution to meeting the landlord's need for lease security is limited only by the creativity of the participants.

Do you have a question regarding commercial real estate? Email your question to Commercial Real Estate Q & A, at email@huntcorp.com for possible inclusion in a future column.

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