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TENANT IMPROVEMENTS - SIFTING THROUGH SCENARIOS

Written by Brigitte Graf | Jun 27, 2014 | 0 Comments

So, you read a previous article by The Ambulatory M&A Advisor and ultimately decided upon leasing space for your new ASC or urgent care center. This option made the most sense for your situation, and you're ready to begin outfitting your new space. As you anticipated, herein lies the more expensive part of your venture. You're looking to get a certain allowance from your new landlord in the form of Tenant Improvements (TI), but this brings a new string of questions.

What are Tenant Improvements exactly? How much can I expect to get toward TI from my landlord? Will this be enough for all the changes I need to make to the space? What are my options for financing any overages?

There are multiple potential scenarios for financing your TI's. Here, the experts have explained and decoded the more common arrangements.

Tenant Improvements Interpreted

"TI's have been an important marketing tool in commercial real estate for many years and are offered for every type of commercial property including office, medical office, retail, and industrial buildings," explains John Simone, President of Simone Realty.

Those looking to develop a medical space face a unique situation in terms of TI's.

"In the concept of a medical office building, the developer will typically build a 'shell' and leave the internal space vacant because they don't know what the tenant's needs will be when they move in," said Noel "Wynn" Searle, Principal at Mohr Health, LLC. "The tenant allowance provided by the developer usually doesn't meet the requirements of the tenant, particularly if it's an ASC. In that scenario there's a variety of ways that the overage can be addressed."

Like so many aspects of real estate, TI allowances have gone through their fair share of developments in recent years. According to Simone, the industry typically offered allowances based on various components of the proposed fitout in the 70's and 80's. However, recently the process has been simplified by the practice of offering a fixed dollar amount instead.

"Usually the tenant finish out allowance is factored into the developer's pro forma, allowing them to calculate their returns and compete for quality tenants," said Chief Investment Officer at Mohr Capital, Gary Horn. "In medical buildings, because they are so specialized, you typically have a higher tenant allowance to attract quality tenants and supplement the investment required by the tenant. Medical tenants in particular,

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depending on their intended use, typically have to supplement tenant finish out allowances provided by owners. "

That being said, the exact amount of TI allowance will most likely be dependent upon two things: the amount of empty space in the building and the strength of the market you're in.

"In many cases the TI allowance, if any, might be pegged to the amount of vacant space in the particular building in which the tenant has an interest," Simone said. "In cases where the owner's vacancy rate is very low, the allowance will also be low or non-existent."

According to Alan Ayers, content advisor and board of directors of Urgent Care Association of America, market comes into play when the landlord looks at what it is he or she wants out of the deal.

"Essentially, TI is an incentive that landlords provide to attract prospective tenants," he said. "In a strong rental market, TI may be hard to come by because landlords can maximize what they charge without offering incentives. But if landlords are facing a lot of competition for quality tenants, then they are often more willing to provide incentives to lock in a long-term lease."

Adam Maciak, president and CEO of Boston Urgent Care, advises prospective tenants to lay out terms early for what they'd like in terms of TI.

"When negotiating the lease, or preferably even earlier when negotiating a Letter of Intent (LOI), it's best to include your parameters of expectations relative to the TI so that by the time you get to finalizing the lease the landlord can work from the agreed upon LOI." he said.

Rental Rate

One of the more prominent factors that play into how high of an allowance will be offered to the tenant is the rental rate.

"There is no such thing as free money, so if the landlord is willing to pony up cash for tenant improvements, the landlord necessarily is going to recoup that incentive through higher rent over the term of the lease or through a reduced return on his/her investment in the property," Ayers said.

According to Simone, it is common to see a more generous allowance as a result of a high rent.

"Landlords can benefit from higher base rents even if they have to offer higher improvements allowances," he said. "For a tenant to accurately assess the true value of the allowance, some mathematical calculations are required."

Simone advises tenants to ask three specific questions when reviewing the landlord's proposal:

- What is the total cost of all improvements required to fitout the space?
- What portion of the total cost will be paid by the landlord (the TI Allowance)?
- Then, ask how long you are likely to remain in occupancy.

In order to most accurately answer these questions and because the allowance will typically be paid at the beginning of the lease, Simone recommends performing a discounted cash flow analysis on the amount of the allowance.

In some cases, any finishing costs that exceed the initial TI allowance will directly affect the rental rate.

"If the landlord has to do anything above their pro forma tenant finish allowance, the landlord is basically making the tenant a loan by amortizing the above standard allowance into the rental rate," Horn said. "If they sign a ten year lease, typically what the landlord will do is take those dollars they provide as a supplement to the tenant finish allowance and charge an interest rate on that amount, and then divide it by the square footage over ten years and that's the add-on to the rent."

But ultimately, the necessary expenses to finish out an ASC or urgent care space are so high that the tenant will have to look to other options to finance them.

"In ASC space, one scenario is that the tenant gets a set dollar amount that isn't enough to finish out the space," Searle said. "The tenant then must finance the balance of the tenant finish."

Choosing to add in those costs to the rental rate might cause some complications down the line for the tenant, according to Ayers.

"If a tenant is paying an inflated per square footage rent because of TI incentives that were granted at lease signing, then the tenant may end up overpaying at renewal if those same capital incentives aren't repeated,"

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he cautions. “A bad deal for the tenant may be a continuation of a rental rate that was set to recoup initial TI that has long been paid back by the tenant in the form of higher rent. If rent levels don’t adjust to market upon renewal, a tenant may end up paying several times over the years for the landlord’s initial build-out of the space.”

As far as financing overages goes, there are several preferable options to look into.

Financing You Overages

“When opening a new urgent care center, an entrepreneur is going to need cash to build out the physical facility,” Ayers said. “A center that needs $350,000 for build out, $150,000 in furnishings, fixtures, and equipment, and another $350,000 in working capital is looking at close to a million dollar cash investment out of the gate. That’s a big loan and a big credit risk for the bank. If an entrepreneur can reduce the amount of funds needed by sharing the cost of build-out with the landlord, then he can reduce his financial exposure and possibly even open more centers more quickly.”

Additionally, in borrowing from a bank the tenant could face certain time constraints for paying back that loan.

“If you’re going to request a loan from a bank, the bank would likely require its loan be repaid prior to the expiration of the initial term of the lease agreement. Additionally, a bank will more than likely want a personal guarantee,” Maciak said. “If you can manage to have the landlord pay for a portion of the TI, it may be a better overall scenario for you. The goal isn’t just to limit your immediate financial exposure with a new center, but to limit your personal and financial liability over time as well.”

Depending upon the type of lease you plan to operate under, there could be the possibility of your company expensing the extra charges. Doing so would decrease the impact on the company’s balance sheet.

“There are two kinds of leases in play in the US: capital leases and operating leases,” Horn explains. “Operating leases are expensed through the company’s financials. Capital leases are liabilities that they have to carry on their balance sheet. If the tenant is going into a building and the lease is qualified as an operating lease then they can expense all those things and then go out and borrow the money for excess tenant finish which will ultimately impact their balance sheet. If the landlord pays for it and it’s a qualified operating lease then it’s just expensed and there’s no balance sheet impact.”

Horn goes on to explain that most companies have the advantage of having a CFO running things. It is the CFO and others in similar positions who need to be engaged in the process and convey the financial impact of financing options and the impact on a company’s balance sheet.

Ayer’s advice to prospective tenants is to step back and take a good look at the bigger picture.

“Think about where the practice may be headed in the long-term, and calculate the profit and loss impact of various scenarios including borrowing money from the bank, raising capital from investors, and utilizing TI and landlord funding,” he said. “Remember there is no such thing as ‘free money’ so the starting point is to understand that every source of funds will have a ‘cost’ associated with it–identifying the ‘cheapest’ source of funds will require looking at the long-term P&L impact of every possible scenario.”

All in all, Simone recommends that future tenants keep in mind the power of coming in prepared to negotiate.

“Tenants need to do their homework when searching for office space, whether it is existing space or a build-to-suit,” he said. “TI’s are almost always negotiable and an experienced commercial real estate broker can add great value to the transaction with knowledge of the specific market.”

Tags: Adam Maciak, Alan Ayers, ASC Startup, Bank Loans, Boston Urgent Care, Gary Horn, John Simone, Leasing, LLC, Mohr Health, Noel "Wynn" Searle, Rental Rate, Simone Realty, Tenant Improvements, TI, TI Allowance, Urgent Care Center Startup

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