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How to Lease Commercial Real Estate: The Ultimate Guide

A commercial real estate lease is a rental agreement that allows a business to rent commercial space from a landlord. Commercial leases come in three main forms: full service leases, net leases, and modified gross leases. The process of identifying, negotiating, and signing a commercial lease is a long process and it's important to understand the required steps which are discussed in detail in this article. We'll go over 6 key steps to leasing commercial real estate.

1. Set Your Commercial Real Estate Parameters

The first step when leasing commercial real estate is to set your property parameters. This is because there are a wide range of commercial properties available for businesses of all types. These parameters will help you limit your search to commercial spaces that suit your needs. Specifically, you'll want to understand the following:

- Ideal customer (or employee pool)
- Property type and zoning
- Desired size
- Maximum budget
- Accessibility

Let's take a look at each of these commercial real estate parameters.

Ideal Customer (or Employee Pool)
Understanding your ideal customer is the most important property parameter if you're a business looking to attract physical visitors to your location. Restaurants, retail locations, and similar types of businesses are good examples. Further, these businesses should know where their ideal customers are located.

For example, a fast-casual restaurant will want lease a commercial space in an area populated by people who like fast casual dining. Alternatively, a Michelin Star restaurant might want to choose another location in a more affluent area.

If you're looking for office space, however, this isn't as important. Instead, you'll want to find a commercial space that's convenient for your employees. You can conduct a similar analysis and find an area that's highly populated by your ideal employee pool, such as is the case with Silicon Valley and the technology industry.
Commercial Property Zoning

All commercial real estate properties are zoned for a specific use. A warehouse is a good example of a commercial property zoned for industrial use. Other commercial zoning includes leisure, office, retail, and restaurant. The type of zoning dictates the type of business that can operate out of the commercial building.

For example, if you're looking for office space, you won't be able to lease property zoned for retail or a restaurant. Conversely, you can't rent a space zoned for offices and convert it into a restaurant. Make sure that you understand your local zoning laws as well as the type of zoning your business needs.

To do this, you can check with your local chamber of commerce or by Googling either your zip code + zoning regulations or your city + zoning regulations. We give you an example of commercial property zoning when we discuss the commercial requirements and best practices for storefront sign zoning.

Desired Size
The commercial lease options available are largely dependent on the size and layout of the space you need. To calculate the size, you'll need to determine the number of customers or the size of your workforce in order to derive the necessary square footage.
For example, restaurants and retail locations typically require 15 square feet per customer on average. Offices, on the other hand, typically require between 100 – 150 square feet of usable workspace per employee.

So, if you're looking for a retail or restaurant location, you'll want to figure out how many customers you expect to have, on average, and multiply that by 15 square feet. If you're looking for an office space, you'll want to forecast the desired size of your workforce and multiply it by 100 – 150. This will give you the size of the commercial space you need.

Maximum Budget
Another thing you'll want to determine is your maximum monthly budget. This will help you limit your searches to only spaces that you can afford. The maximum budget is largely dependent on your business's size and performance.

To help, it's important to determine the average price per square foot for your area. Price per square foot is typically derived from the annual lease amount divided by the total rentable square feet of the space. You can find the average price for your area by typing your zip code into LoopNet's directory of commercial properties available for lease.

Once you find the average price per square foot, you can take it and multiply by the square footage you need for your business. This should give you your expected annual budget for your commercial lease. Divide that by 12 to find your expected monthly lease payment.

From there, you'll want to add up your expected utilities and common area maintenance fees (CAM) and include it in your max budget calculations. A good rule of thumb is that utilities will typically run you ~$2 per square foot annually and CAM fees will cost between 15% – 35% of your annual lease payment.

You'll also want to include expenses for any expected build outs or annual rent increases. The cost of build outs are largely dependent on the type of business, but it's possible to get the landlord to cover some or all of the costs. For rent increases, expect that your lease payment might increase as much as 3% annually.

From there, you need to ensure that your maximum budget doesn't exceed 8% of your expected annual gross income. Anything higher could put your business in financial distress.

Accessibility
Accessibility is also a major parameter for retail businesses and restaurants. For example, these businesses will want to have adequate parking for their customers. Further, they'll want to choose a location with a high amount of foot traffic and vehicle traffic.
Calculating the size of your desired parking lot is easy. The rule of thumb is to have a parking spot for every three customers. Determining traffic is trickier and potentially more lucrative. To help, we wrote an article on how to calculate your desired foot traffic. If you want to calculate your desired vehicle traffic, you can refer to our article on how to choose a location for your restaurant.
For more information regarding your commercial property parameters, read our article on how to choose a restaurant location. The information is helpful for anyone looking to lease a commercial space.

2. Find a Commercial Real Estate Broker

Most commercial real estate leases are facilitated by brokers. There are typically two types of commercial real estate brokers involved:

1 Leasing agent – Brokers who represent landlords
2 Tenant broker – Brokers who represent tenants
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Listing agents are hired by a landlord to list their commercial property. Listing agents earn a commission that's paid by the landlord, typically between 3% – 6% of the total lease. Tenant brokers, on the other hand, represent tenant interests. However, tenant brokers also typically earn a percentage of the overall commission paid by the landlord, knows as the tenant broker's fee.

This means that a listing agent always has a duty to act in the best interest of the landlord. The tenant-broker, while he or she represents the tenant, doesn't always have a duty to act in the best interest of the tenant. Depending on the arrangement, the tenant-broker can sometimes act more as an objective third-party, which we discuss below.

When to Use a Tenant Broker
It's not mandatory that a tenant uses a broker. However, tenant brokers can typically help a tenant in the following ways:

- List of available real estate
- Accurate market pricing and comp data
- Knowledge of local market conditions
- Negotiating skills
- Access to financing options

Further, this value is usually free to the tenant since the landlord typically covers the tenant broker's fee. It's therefore usually a good idea to engage a tenant broker and have them help you find suitable locations to lease. However, some broker agreements are nonbinding while others are binding, which we discuss below.

How to Find a Commercial Broker

Tenant brokers can be found online or through a personal network. The Broker List, for example, has a list of searchable broker profiles. You can search by name, company, or zip code. Alternatively, you can find a broker by asking your network.

Questions to ask when considering a commercial broker:

- What is the broker's experience with your specific commercial needs?
- What is the size of the broker's real estate practice?
- How is the broker being compensated?
- What is the broker's fiduciary duty?
- Is the broker knowledgeable with the local market?

Specifically, you'll want to find a broker who has the right mix of experience and attention. We interviewed Carrie Wood, the Chief Marketing Officer of LeaseRef, who told Fit Small Business that:

"You want to choose a broker that is at the intersection of knowing what to do and genuinely caring about you.

If you have a broker that's too successful you may be a low priority. If you choose a broker that's inexperienced but attentive, you may end up paying for their novice mistakes. My advice is to not choose a broker but instead choose a team. Pick a junior/senior combo so that when you're hunting for space you work more with the junior, and when it comes to negotiating the deal you have the experienced veteran leading the negotiation."

Once you've identified a broker you trust, you'll have to sign a written contract. This contract usually stipulates that the working relationship is either:

- Exclusive arrangement
- Nonexclusive arrangement

Let's take a look at the differences between the two.

Exclusive Arrangement with Commercial Broker
An exclusive arrangement is one where the tenant works exclusively with one broker for a 3 – 12 month period. During this time, the tenant can't work with another broker. A commission between the tenant and broker is negotiated, equal to a small portion of the expected tenant broker fee. However, this commission is paid only if there are no tenant broker fees.

This, of course, is rare and landlords will almost always pay a tenant broker fee, thus waiving the commission between the tenant and broker. This is a good option because the tenant broker will then have a fiduciary duty to the tenant.

Nonexclusive Arrangement with Commercial Broker
A nonexclusive arrangement comes in two forms: 1) right to represent and, 2) not for compensation.

Right to Represent Nonexclusive Arrangement
A right to represent nonexclusive arrangement is similar to an exclusive arrangement except that a tenant is allowed to speak with other brokers. However, the tenant still pays a commission, due even if a lease is signed with through a broker.

Not for Compensation Nonexclusive Arrangement
A not for compensation nonexclusive arrangement, on the other hand, gives a tenant maximum flexibility. It's nonbinding and there are no commissions negotiated. Instead, it gives the broker the right to speak on your behalf and schedule listings for you to see. However, while it provides flexibility, this arrangement gives the tenant broker less of a fiduciary duty.

How to Work Without a Broker
Remember that signing an agreement with a tenant broker isn't mandatory. While a tenant broker is helpful, there's always a small chance that you'll end up having to pay a commission.
If you'd also like to look for commercial real estate properties yourself, you can find commercial real estate listings on such websites as the Commercial Real Estate Listing Service or LoopNet. However, if you choose to look for yourself, you'll have to conduct the following without the help of an experienced broker:

- Finding new listings
- Setting up walkthroughs
- Negotiating the lease

The only benefit of not using a broker is that there's no chance of paying a commission. Otherwise, it's probably best to use a tenant broker.

3. Understand the Different Types of Commercial Leases

There are typically 3 types of commercial leases. The major difference between them is the way costs and fees are assessed.
The three types of commercial leases are:

- Full service lease
- Net lease
- Modified gross lease

Docracy has a searchable database of open-sourced lease agreement templates to help you get started. Let's look at each type of lease in a little more depth.
Full Service Lease

A full service lease is the most common type of commercial lease for office buildings. With a full service lease the rent is all-inclusive. What this means is that the landlord is responsible for paying the expenses associated with the property, including property taxes and insurance, repairs and maintenance, and utilities and janitorial services.

This is by far the best type of lease for the tenant. There are no hidden costs and businesses can forecast their monthly and annual lease payments. In this scenario, the landlord takes on the responsibility of maintaining the property.

Net Lease

A net lease is a lease agreement where the landlord charges a lower annual rent when compared to a full service lease. However, landlords can also include monthly "usual costs," which include such things as property taxes, property insurance, and common area maintenance items (CAMS). Net leases can be either a single, double, or triple net lease.

With a single net lease, a tenant pays rent plus a pro-rata share of the building's property taxes. With a double net lease, the tenant pays a portion of the property insurance in addition to rent and property taxes. With a triple net lease, the tenant pays the pro-rata share of property taxes, property insurance, and CAMS.

This means that while the base rent is lower for the tenant, the tenant is also responsible for the monthly costs associated with maintaining the property. These expenses are typically added onto the base rent monthly. Triple net leases are the most landlord-friendly. A triple net lease is most common for restaurants and retail locations.

Modified Gross Lease

A modified gross lease is a compromise of the full service lease and the net lease. With a modified gross lease, a tenant might pay for their portion of their property taxes, property insurance, and CAMS, but they pay it as a lump sum payment along with their rent.

The rent on a modified gross lease is therefore fixed and there are no hidden costs or unexpected charges. If any of the taxes, insurance, or CAMS increases, the rent remains the same. This is not the case with a net lease. Utilities and janitorial services are covered by the landlord with a modified gross lease.

4. Identify the Right Commercial Property

When considering different commercial property listings, make sure you assess the following in addition to your property parameters:

- Location – Make sure that the property is either around your ideal customer or ideal workforce. Also, you'll want to find a space that has adequate foot traffic and vehicle traffic as well as adequate parking for customers or employees.
- Amenities and Services – You'll want to understand the full range of amenities offered by a commercial space. These amenities and services may include such things as communal rooms, free Wi-Fi, loading bays and docks, dining options, outdoor space, sewage and utilities, on-site security, and more. The zoning of your business will often dictate the type of amenities and services you require.
- History of Landlord – This is important to understand since commercial leases are typically multi-year agreements. The landlord you choose will most likely dictate the lease agreement, changes to the agreement, rental increases, and more. There are websites like ReviewMyLandlord that can help you better understand who your potential landlord is.
- Anchor Tenants – Some multi-unit commercial properties have an anchor tenant. This tenant, like a Wal-Mart, anchors a mall or shopping center. If the anchor tenant leaves, the landlord might be able to legally get out of the property's other leases. Make sure you know about any anchor tenants before you sign a lease.

Conduct Multiple Walkthroughs
You and your broker should identify multiple commercial spaces to view. This helps you get a better understanding of average price and gives you a leg up during the negotiation process. During your search you'll also want to compare rents to each other to ensure you're staying on budget.

A rule of thumb is that you should consider between 4 – 10 commercial properties prior to signing a lease. Alex Cohen, a broker and principal of Future Workplace, tells Fit Small Business that:

"If it's a retail space then location is critical. Proximity to other retailers, access to transportation, and visibility/signage opportunity can be critical. In this case, there may only be 4 or 5 spaces available that meet the business's criteria and objectives. A good broker will sometimes develop creative alternatives that might be outside the locational parameters but offer other advantages – such as co-tenancy or lease term flexibility.

In terms of office space, typically tenants may consider 8 -10 alternatives. Tenants will then narrow the options down to 4 – 5 and go on physical tours. Tours are typically conducted in a single day, but if you tour more than 4 – 5 during one day, the spaces can all seem to meld together, challenging the decision-making process."

These walk-throughs are called "technical property reviews." They're conducted with your broker and the landlord's broker. Once you've walked the properties, you'll want to consider the different lease terms of each.

You'll also sometimes want to walk a property with a licensed contractor. This is because some commercial spaces require lease build outs, which are necessary additions or improvements to the space. Build outs can be fully or partially covered by the landlord. It's important in this scenario that you get an accurate renovation estimate and negotiate a build out into your lease.

The deciding factor between your options will often be the lease terms. Let's take a moment to discuss the different types of commercial lease terms as well as the common commercial lease terms.

5. Negotiate Commercial Lease Terms

Once you've considered your commercial property options and their associated leases, it's time to choose one or more commercial spaces and negotiate the leases. When formally entering into a commercial lease negotiation process, you'll want to start by requesting the terms in writing. This request can come from you or your broker and is supplied by the landlord's broker.

From there, you'll want to write a business letter of intent (LOI) that represents your offer or counter offer. The LOI is a chance for you to sell the landlord on why you would make a great tenant. This is especially beneficial in a commercial real estate market with high demand.

The things you'll want to include in a letter of intent include:

- Statement with your intent to lease
- Description of your business
- Number of years in business
- List of products and services, including pricing
- Your proposed terms

The terms can be either the same as the terms proposed by the landlord's broker or a counter-offer by you or your broker. The terms include the rental price and type of lease, but they also include more nuanced terms. You can counter any and all of these lease terms. If it's a counter offer, the negotiation process begins

Common Commercial Lease Terms
Regardless of the type of lease, commercial leases will often have similar lease terms. While the payment structure might differ, all leases include such things as the required deposit, the length of the lease, and more. Specifically, you'll want to understand the following terms of your lease:

- Use clause – This clause determines the type of business that can use the space. For example, some spaces are zoned for retail while others are zoned for office spaces. This use clause is particularly important if you expect to sublease your space in the future, since it limits the businesses available to sublease.
- Length of lease – Commercial leases typically range from 3 – 10 years. A short lease can be advantageous because it gives a business flexibility and reduces any future financial burdens.
- Assignability – A lease has to be "assignable" if a business wants to eventually sublease the property. Further, an assignable lease makes it possible to include the lease in the sale of a business. For example, a restaurant with a great location might be bought out by another restaurant because the location is so good.
- Capital expenditures – These expenditures determine who's responsible for the repairs, maintenance, and other costs associated with the commercial property. A net lease, for example, charges a tenant for all the capital expenditures. A full service lease, on the other hand, requires the landlord to cover all capital expenditures.
- Rent and escalation – All leases stipulate not only the monthly and annual rent but also any future rent escalations. An escalation is a term that allows a landlord to legally increase the rent during the lease. It's common to see rent escalations equal to 3% a year. Make sure that there are no abnormal escalations in your lease
- Deposit – Most leases require a deposit. The deposit is fully refundable and protects the landlord from a delinquent tenant or a tenant that causes excess damage to the property. The typical deposit is between 3 – 6 months rent.
- Lease build-out credits – These credits represent the ability for a tenant to make leasehold improvements in their commercial space at the expense of the landlord. These expansions and improvements are necessary for the successful operation of the business. With build-out credits, landlords either offer a reduced rent, reimburse the tenants, or pay directly out of pocket.

- Termination clause – Clause within the lease that allows the landlord and/or the tenant to terminate the agreement under certain conditions. Termination clauses are great if it allows you to terminate the agreement, but increases your risk if the landlord can also terminate the agreement.
- Rent abatement – This term stipulates that if the commercial property is damaged, the tenant won't have to pay rent (or pay a reduced rent) until the damage is fixed. This is a great way to reduce a business's risk.

However, according to Carrie Wood, the Chief Marketing Officer of LeaseRef, the most overlooked item in a commercial lease is the building's gross-up factor:

"The gross up factor is the difference between the square footage of your actual useable area and the listed rentable area. This difference is a tenant's proportionate share of common areas (mostly hallways and washrooms).

For instance, a suite that has 4,000 square feet of useable area usually is measured at approximately 4,500 square feet. But while you can only use 4,000 square feet, you'll be charged for 4,500 square feet of space. This is by far the least understood lease clause by both brokers and tenants and the largest difference maker in commercial leases."

When looking at your lease, you'll want to negotiate terms so that you're minimizing your gross up factor.

6. Commercial Real Estate: Leasing vs. Buying

After looking at a number of spaces that are available to lease, you may start to wonder whether it's better to buy or lease commercial real estate. Of course, there are occasions when it might be better to purchase commercial real estate rather than leasing it. For example, if you buy a commercial space, you'll take advantage of equity, depreciation, cash flow, and asset appreciation.
Specifically, the benefits of buying over leasing commercial real estate include:

- Build equity – You can use this equity as collateral for additional expansions.
- Own an appreciating asset – Over time, commercial real estate properties can increase in value, letting you eventually sell for a profit. However, assets can also lose value, making it an investment with risk that you need to consider.
- Depreciate the building – You can claim the annual depreciation on your tax returns.
- Increase cash flow – Commercial spaces typically require owner-occupied businesses to occupy 51% of the building. However, you can rent out the remaining space and receive rental income.

Further, it's not uncommon for commercial buildings to be sold which can leave lessees in the lurch. If you're leasing a space that's sold to another landlord, it's possible that you might get kicked out of your space. This is typically part of the termination clause. Still, if you own your own space, you'll never get kicked out.

When it comes to the benefits of leasing, tenants get to avoid any down payments. Instead, they pay a refundable deposit equal to 3 – 6 months rent, which is often far below the 10% – 35% down payment needed for a commercial loan.

Further, lease payments can be deducted, reducing a business's tax burden. This is in contrast to owning a property, which only allows you to depreciate the asset over its useful life. Of course, if you finance a commercial real estate property, you can also deduct interest payments and origination fees.

What's more, owning a commercial property can be more stable than leasing. If you're interested in buying a commercial property, read our article on the best commercial real estate loans. We outline five loans and discuss which ones are right for your specific needs.

Bottom Line

A commercial real estate lease is a long-term rental agreement between the landlord of a commercial space and a business. There are many types of commercial leases and many types of commercial spaces. Leases include full service leases, net leases, and modified gross leases. These leases help tenants rent out office spaces, retail and restaurant locations, as well as industrial spaces.

It's important that when you're looking for a commercial lease that you first set your property parameters. From there, decide whether or not you'll work with a broker. Once decided, identify properties within your parameters and negotiate favorable lease terms. And if you're interested in buying over leasing, check out our article on the best commercial real estate loans.