



## Tips for First-Time Commercial Real Estate Landlords

### **How to Run Your Business Like a Business**

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Many first-time commercial real estate owners/landlords get into the business with the hope of building equity and generating relatively passive income. The good news: that outcome is entirely possible. But it's important to understand that it won't necessarily happen quickly, nor without lots of careful planning and hard work.

The truth is that owning and managing commercial real estate is a big responsibility and requires significant commitment and investment. Serving tenants, growing the value of a building, mitigating risks, and having long-term success as an investor and landlord is a long-term process. It's critical to know what you're getting into, and to take the appropriate steps to help ensure success, rather than engaging in a trial-by-fire approach that costs you time and money.

In this part one of a two-part series, we address a number of important tips and topics for first-time commercial real estate landlords, up to and including the negotiation and execution of a commercial lease with a tenant.

### **Run Your Business Like a Business**

For many first-time landlords, buying and operating a commercial property is a part-time endeavor. But that doesn't mean it should be run with a part-time mindset. Buying, leasing and maintaining a commercial property requires attention and care. It's a business and needs to be run like one.

As a first step, a landlord should work with their accountants, attorneys, and other professionals to make sure they get set up as a proper business. Too many landlords get into the business and try to run a commercial property as a personal-income hobby. Mistakes such as not selecting the right business type (or worse, not selecting one at all), could have major ramifications at tax time or if something goes wrong. Additionally, making sure you have a clear understanding of what your insurance policy does and does not cover can help avoid

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disputes if something goes wrong.

A Limited Liability Company (LLC), corporation, or other legal structure is, generally, a best practice in commercial real estate. This will help a landlord limit potential personal liability and maximize tax-saving opportunities. It is also a best practice to create some sort of governance document (i.e. an operating agreement, bylaws, or partnership agreement), even if there is only one owner/operator but especially if there are multiple owners. Agreeing ahead of time on items such as how repairs are made, how capital calls work, if there is a shortfall in funds, and how the owners can get out of the business, tends to be much easier at the start of the relationship instead of after the honeymoon period is over.

In addition, landlords should create and execute a business plan, including a budget that takes into account the costs of not just the property acquisition, but also insurance, marketing, repairs and continuing maintenance, reserves, professional fees, and other expenses.

Landlords should also familiarize themselves with the terminology and finance principles related to the commercial real estate industry. This includes concepts such as discounted cash flows and capitalization rates, among other things.

### **Vet Prospective Tenants Carefully**

Tenants are the lifeblood of a commercial real estate business. Having good tenants makes the process of owning and managing a building profitable and enjoyable. Bad tenants, on the other hand, create tremendous stress and expense.

Therefore, it's incumbent on landlords to carefully vet prospective tenants. One way to do this is to run background and credit checks. But good vetting goes beyond this.

If possible, landlords should try to meet prospective tenants in person, or by video, in order to gain a better understanding of their businesses. After all, the financial health of your business as a property owner is dependent on the underlying health of your tenants' businesses. While taking stock of a prospective tenant, request and review: tax returns, letters of credit, operating reports and balance sheets. It is also a best practice to run a litigation search to see if there were issues in the past. This will help you assess the financial strength of the prospective tenant and the likelihood that they will be able to perform their obligations over the course of a lease.

### **Negotiating and Executing Commercial Lease Agreements**

Once a landlord has evaluated a prospective tenant, and determined that they are a good fit, the focus turns to the negotiation and execution of a commercial lease agreement.

Every lease negotiation and agreement is unique. As a commercial landlord, you need to be aggressive and vigilant to ensure that the commercial lease deal you strike is appropriate, fair, and furthers your business objectives. As with most negotiations, the outcome a landlord should be looking for is a win-win which prices



your risks as a landlord into the rent: the final deal allows the landlord to own and operate the building at a profit while enabling the tenant to do the same with respect to their business.

In many instances, the negotiation process begins after a tenant tours the property and informal discussions begin with the property owner. This initial process often culminates in a tenant submitting a letter of intent, which sets forth key deal points such as the amount of rent and lease term. While a letter of intent is often non-binding, it is an indication of tenant interest in the property and an intention to move forward with lease negotiations in good faith.

When formal negotiations ensue, the tenant will often be represented by an attorney or commercial real estate broker. Landlords—particularly first-time ones—should also use an experienced commercial real estate attorney to represent them during the negotiation process. One of the common mistakes first-time landlords make is simply using a form lease agreement, found on the internet as a starting point for negotiations. These forms often lead to costly oversights and omissions as they are basic agreements not tailored to the unique aspects of the transaction. An attorney can help ensure that the landlord is protected and smooth the process of coming to agreement on the key terms.

Some of the key terms that landlords should be focused on during the negotiation process include the lease term, amount of rent and any rent increases during the term of the lease, the sufficiency of a security deposit, option-to-renew terms, rights to sublease, contributions for common area maintenance, rights to relocate the tenant, anchor tenant provisions, the need for a personal guaranty, terms of default, limitations on liability, and many more.

Once a deal is struck, it will be documented in writing and signed by the parties. Every commercial lease agreement should be in writing, and if a commercial lease in Michigan is for a duration of more than one year, it must be in writing to be enforceable.

### **Part One Final Thoughts**

Becoming a successful commercial real estate landlord involves a learning curve, but gets easier over time. One of the ways to get started without stumbling is to work with a trusted advisor, such as an experienced commercial real estate attorney, who will guide you through the process. If you have any questions or require assistance, please contact Robert Hamor at 248.785.4737 or at [rhamor@fosterswift.com](mailto:rhamor@fosterswift.com).