In the Marketplace

Percent rent can make sense

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Retail leases should be a partnership between landlord and tenant. One way to help achieve that relationship is percentage rent—a method of compensation in which the tenant pays a percent of annual gross sales to the landlord.

Typically found in large shopping centers, percentage rent can be used for all types of retail, including service-related businesses, and smaller properties like a convenience store or restaurant. To date, the rent structure is rare in Maine; but with continued expansion in the state's retail market, the arrangement is expected to become more prominent.

Here's a look at the benefits of percentage rent, and how it can be applied.

Percentage rent is primarily used in conjunction with a base rent and is applicable only once a certain level of gross sales is achieved by the tenant. The breaking point in which the percentage rent starts is typically based on the tenant's historical sales in comparable stores.

For example, if it is mutually agreed that the projected annual sales will be $600,000, then the earnings above and beyond this breaking point will be subject to the percentage rent. The actual percentage point that is applied is also negotiated and can range from 1-8 percent depending upon the type of retail establishment.

According to Dollars & Cents of Shopping Centers, Urban Land Institute, Washington D.C., the percentage point applied to card and gift shops ranges from 5 to 8 percent, 2.5 to 4 percent for drug stores, 1.5-5 percent for liquor and wine shops, 5 to 8 percent for pet shops, 4 to 7 percent for restaurants, and 1 to 2 percent for supermarkets.

Elaborating on my earlier example, let's say that the prospective tenant is a card shop and is willing to pay 6 percent over their breaking point of $600,000 of annual sales. If the card shop did $750,000 in sales, the landlord would receive an additional $9,000 in income (6 percent of $150,000).

This method of compensation is attractive because the landlord can use percentage rent as reinsurance that the location will meet or even exceed the tenant's expectations. The landlord is willing to put a part of potential rental earnings on the line to demonstrate to the tenant that they will be successful in their retail complex.

In some situations, a landlord may be willing to take a below-market base rent in return for a larger percentage over the breaking point. With some well-established national retailers, landlords may even eliminate the base rent and solely base their rental income on percentage rent.

There are numerous reasons why percentage rent can be mutually beneficial to both parties. First of all, it is hard to predict what the fair market rent should be for a tenant who has a long term lease. Retail leases are typically five to ten years and market conditions are continually changing.

In a long-term-lease scenario, a landlord may charge a tenant too much rent, making the tenant's rental expense burdensome. The tenant may end up relocating or closing before they have given the location enough time to mature in the market.

On the other hand, a landlord could lock into a long-term lease at a below-market rent and with limited annual increases. In this situation, the landlord is receiving a limited return on the investment while the tenant is reaping profits from recording-breaking sales.

By applying a portion of the rental income to percentage rent, both parties to percentage rent, both parties are tied into the market conditions and the viability of the shopping center. Neither party wins if the tenant does dark. The landlord should have incentive to keep the operation as efficient and as profitable as possible.

There are several things that a landlord should consider when using percentage rent. The safest percentage rent is the combination of base rent plus a percentage of sales. The tenant should also be responsible for their share of the NNN expenses for the property (real estate, taxes, property insurance, common area maintenance, utilities, etc.)

If a landlord has reduced or eliminated the base rent, a contingency should be inserted in the lease that requires the tenant to reach a certain amount of gross sales per year. If the tenant fails to meet that minimum sales figure, the landlord reserves the right to terminate the lease.

But overall, the key to percentage rent is that it can beneficial to both landlord and tenant. Recognition of this successful formula, amid the influx of national brands into the Maine market, could lead to a change in the state's retail leasing philosophy.