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The Commercial Classroom: What should tenants pay in rent?

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What should a tenant
pay in rent?

Representing the tenant requires doing what is in the best interest of your client the tenant; sometimes this means educating them. How much rent can they afford to pay? Do they know? We ask our client what is your budget for rent, they reply but where did they get that number?

Today we have the ability to compare our client's rental expenses to the industry standards for their type of business. This data can be found on the free site, Bizstats.com and more detailed information can be found on the proprietary site, Bizminer.com. The information is gathered from tax returns of thousands of companies. They break down the allocation percentages for many categories including rent. Here are a few examples of industry standards, percentage of rent expense to gross sales income (known as the Industry Rent to Revenue Ratio, I - RRR):

* Offices of doctors: 4.97%;
* Offices of dentists: 5.44%;
* Clothing stores: 7.53%;
* Wine and liquor store: 3.34%;
* Manufactures of wood products: 1.55%;
* Manufacturers of computers: 0.8%.

This can now be applied to the gross revenues of the business to determine what the tenant should be paying in rent. However, this must be modified based upon the type of lease, and if the tenant has "additional rent" pass troughs an adjustment must be made. Local market conditions must also be considered. This will determine the Dollars to Occupy Ratio (DOR).

(I - RRR + Other Expenses + Market Conditions = DOR)

Using the clothing store as an example; it is in a retail strip that requires the tenants to pay their own gas and electric and CAM charges. These expenses equate to approximately 20% of their base rent, so an additional 1.5% will be added to their
I - RRR. The location is not the greatest so a negative adjustment of .05% will be factored for market conditions. Thus the DOR for this store is 8.53%.

(7.53% I- RRR + 1.5% Other Expenses - .05% Market Conditions = 8.53% DOR)

If the store had $3 million in sales revenue, the base rent should not exceed $225,900. ($3 million X .0753 = $225,900). Their overall DOR should not exceed $255,900. ($3 million x .0853 = $255,900) Use these numbers to guide your tenant in their rent negotiations.

This adjusted percentage of what rent should be, may also be compared to what the tenant is paying currently. Add together their annual base current rent and any additional rent items; divide this total by their annual revenue to determine their current rent to revenue ratio. Compare this to the industry standards.

If your client is not making enough profit, maybe they are paying too much rent! Suggest another less expensive location or renegotiate their lease for them.

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Smith has been writing and teaching commercial continuing education courses for over twelve years. He has authored seven commercial continuing education courses. He has written three textbooks on commercial and investment real estate with instructor training materials used to teach commercial courses throughout the United States. He has also written "The Commercial Classroom: Lessons in Commercial and Investment Brokerage," and most recently, "Buy the Numbers: Investing in Real Estate."

He is a director and past president of the New York State Commercial Association of Realtors, the Metro-Long Island Chapter of NYSCAR, and the Long Island Commercial Network (LICN). He has previously served as a Director of the Long Island Board of Realtors, a director of the Commercial Industrial Brokers Society (CIBS) and as a director of the Real Estate Practitioners Institute at Long Island University.

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