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Qualitative and quantitative performance measures to evaluate the health of your occupancy costs - by David De Lise

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There are a number of qualitative and quantitative performance measures utilized by commercial real estate professionals to evaluate if tenants are paying rents that are sustainable and “healthy” as these costs relate to their overall sales or gross revenue. This analysis is important to tenants, developer’s, bankers and real estate agents alike.

Looking at the retail sector – not all categories of shopping center or mall tenants can afford to pay the same rental rate, have the same occupancy costs or successfully operate at the same profit margin as tenants from a different retail category. It’s not a one-size-fits-all measurement.

Let’s start with the basics. A health ratio, which is also referred to as occupancy costs, is the relationship between a tenant’s annual gross sales and total occupancy costs. The formula is fairly straightforward: Total annual rent (including net charges) divided by the gross annual sales for that specific location. This analysis works for retail and office tenants, industrial and even medical occupants. That is to say, it’s a very valuable tool used to forecast the probability of success and longevity for a particular tenant at a specific location. A “healthy” ratio for a large law firm will be different than for a 2,000 s/f toy store, which is different than a healthy ratio for a fast-casual dining concept.

As an example: A jewelry store evaluating sites for their next great location is quoted an annual rental rate of $24,000 in total rent (base rent + net charges). The store projects annual sales of $125,000 at this new location. Can they afford to be there? Will they be successful over the long term? Using the calculation mentioned, we simply take the annual occupancy cost of $24,000, and divide by the annual projected gross sales of $125,000, which produces a health ratio of 19%. Is this a good ratio? Does this mean every tenant coming into the center can/should expect to pay 19% occupancy costs and thrive at the location? The easy answer is not necessarily.

As mentioned, not all tenants can afford to pay the same rent, nor do they have the same occupancy cost ratio, as another tenant in a shopping center, within a high-rise office/medical building or within a large, multi-tenant industrial complex. Just as every business has a different business model, with differing operating expenses, revenue generators and different reasons for being at a particular location, healthy occupancy cost ratios differ by tenant categories. Just because Carbucks can afford to pay $40 per foot or more in rent does not mean that a card store or a novelty toy shop that has lower price points for their merchandise, different labor costs, etc... can survive paying the same rental rate as Carbucks might. Ultimately, the amount of rent that a retailer, or any tenant for that matter, can reasonably afford is tied directly to their sales performance. It doesn't matter if a tenant sells widgets, sporting goods or gourmet coffee – increases in rental rates, operating expenses or a decline in sales performance all have a material impact on a tenant's ability to maintain healthy profit margins.

A tenant who maintains reasonable operating costs is far more likely to stay at a property for a longer period of time as compared to a tenant with a health ratio that teeters at unsustainable levels. The ability of a landlord to pass all operating expenses along to the tenants is meaningful from the landlord's perspective. However, if rents are at such levels that any increase in operating or inventory costs, labor shortages or a reduction in sales volume could negatively impact a tenant's ability to pay rent and survive this could spell trouble for the landlord. Tenant turnover costs landlords money.

Unoccupied spaces have a negative impact on the performance of a property and the perception of performance to prospective occupants, real estate agents and lenders. We would all like to say we got the highest rental rates for "our" property/assignment however, the fact of the matter is that as a professional commercial real estate advisor, I have an obligation to my clients to articulate the importance of a reasonable balance between rental rates and occupancy costs/health ratios of the tenant roster. I am often surprised that, when we have a discussion about health ratios and occupancy costs with tenants or developers, there is typically a look of bewilderment. They may have heard of the measurement, but have little idea how to calculate the ratio or its relevance on their long-term success and sustainability.

Back in the day there was a wonderful reference tool which broke out the individual retail categories and assigned a "suggested" health ratio for many different retail categories, and oftentimes they were very granular with their information going so far as to break out information on different "types" of tenants within the same category. It was a great resource and quick reference tool that we had at our disposal. Sadly, the publication no longer exists and we are left to maintain databases of currently acceptable health ratios by tenant type, and competition analyses in order to appropriately evaluate a site/property.

While this is a little more time consuming, and a bit more cumbersome than merely referring to a publication for data points, it is still a critical performance measurement that every commercial real estate agent, developer or tenant should be familiar with, and fully understand the implications on the success of a property, and the sustainability of a tenant, or a roster of tenants.

The team of advisors at Berkshire Hathaway Verani Realty are seasoned professionals with deep experience in analyzing occupancy costs and health ratios for tenants and property owners throughout Northern New England. Call us for a no obligation, complementary analysis of your existing lease, if a tenant, or your roster of tenants, if a property owner.

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