ECONOMICS

MAKING THE BUSINESS CASE FOR RETAIL LEASING

VACANCIES

By Errin Welty, Vierbicher, LLC

Filling vacant retail space is a persistent challenge downtown, yet vibrant, diverse retail offerings remain a crucial element of a successful commercial district. Every downtown has a few stubborn vacancies that detract from its visual appeal. While this article tackles the two most common causes of lingering vacancies — namely undesirable space characteristics and unmotivated landlords — the tactics discussed can be applied to any challenging retail situation.

DEFINING THE MARKET AND CREATING DESIRABLE SPACES

The first step in understanding vacancies is to assess the individual spaces. Are they too big or too small to be useful to potential tenants? Are the dimensions appropriate? Making this assessment may initially take a bit of legwork, but the resulting information is valuable in focusing marketing efforts and leasing discussions throughout downtown. Follow these three easy steps to assess vacant storefronts:

- First, survey all the retail spaces downtown. Identify those that are leased and to whom (soft goods, restaurants, service firms). How big is the average space for each category?
- Next, look at the vacant spaces themselves, without considering past uses. Is the size compatible with an existing use? Are the dimensions appropriate? A rule of thumb is that stores should generally be no more than twice as deep as the storefront is wide. If not, the space may be inefficient and less desirable.
- Last, develop a strategy to make inferior spaces competitive. This may require investment in space build-out. An example of build-out is the addition of a wall or partition to subdivide a too-large space or to divide a "too-deep" space front to back. This can result in leasable storage space for upper-floor tenants in the new "rear" space.

DETERMINING SUPPLY AND DEMAND

Developing a compelling business argument for a landlord requires addressing both fiscal and risk-related issues. Making a convincing argument requires background research. First, quantify demand. Develop an understanding of what type of retail lease rates and businesses are feasible. Picture the types of retailers that are desirable for your downtown. Develop a set of feasible lease rates for these types of tenants.

Generally speaking, a local retailer can comfortably afford to pay 15 percent of the store's average annual sales in rent. Consider these two scenarios: A smoothie shop sells $5 smoothies out of a 1,500-square-foot storefront. The store would have to sell 6,000 smoothies in a month just to pay $20 per square foot in rent. Conversely, if the same store sold $100 jeans, the store would only have to sell 300 pairs to pay the same rent.

Next, identify the decision-making factors limiting supply or willingness to lease. This step involves meeting with individual property owners to identify their unique business drivers. Determine how they view their property, what rates they feel are reasonable for the space, and what their financial position is. Find out if they are looking for long-term stability or higher lease rates, and ask if they have agreements with other tenants that prevent certain uses from occupying the space. The answers to these questions will determine the kinds of retailers and lease terms that will be attractive to individual property owners.

COUNTERING RESISTANCE

With information gathered from background research, addressing landlord concerns is a simpler task. Some of the most common concerns are outlined on the next page, along with a counterargument and backup strategy for additional action by the downtown organization in especially challenging situations.

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Above: *Filling one or two key downtown spaces with successful retail stores can spark interest in the district as a retail destination and demonstrate to property owners that retail is viable for their buildings.*

Left: *If a landlord is holding out for a higher-paying tenant, show the owner the tradeoff between leasing the vacant space at a slightly lower rate versus leaving the space empty for a year or more.*

I don't want to put any money into the space. Many landlords do not want to invest in the significant upfront expense of retail space build-out. They think that retailers who do not invest their own money in the space are more likely to leave. *Counter:* The cost of this type of construction would likely be under $1,000, which equates to an investment of less than a day's rent to make the space more competitive. Additionally, these improvements often cost the landlord less than the tenant (due to access to favorable financing). This means that both tenant and property owner are better off if the landlord funds the improvements in exchange for higher lease payments from the tenant.
Backup Strategy: Initiate a revolving loan program to fund tenant improvements, available to either landlord or tenant.

I need $X amount of rent from the space. Landlords who perceive their properties to have a certain value, or who need to meet specific income targets, may be unwilling to pass up the expectation of a higher lease rate by signing a lower rent lease today.
Counter: If a building owner is holding out for a higher rental rate, develop a model that shows the long-term tradeoff to the landlord of leasing the space at a slightly lower rate versus the cost of leaving the space empty for a year or more. You may even want to include increased rent on other units/space in the building due to the presence of a desirable retail tenant.
Backup Strategy: Recommend percentage rents, where a tenant pays a lower base rent, plus an additional percentage of sales above a set revenue minimum. A revolving loan fund could be used to subsidize the earlier rents to the building owner, with a percentage in later years returning to the downtown district. This scenario makes the downtown organization a de facto investor who will benefit financially as business improves.

Retailers are risky tenants. In this case, the building owner is partially right. Retail businesses ***are*** riskier, especially when many downtown retailers are new or local entrepreneurs without a track record.
Counter: The strategies above, which minimize tenant improvement costs and demonstrate the overall value to the owner of leasing the space versus the overall cost of unproductive vacancy can mitigate, but not overcome, this argument.
Alternate Strategy: Create a master lease with the landlord, where the downtown organization, local nonprofit, or other umbrella organization signs a lease for the entire retail portion of a property and subleases individual spaces to retail tenants. This type of scenario removes risk to the property owner and allows retail flexibility in the space.

Even in the best of retail environments, vacancies will remain an issue. However, successfully filling one or two stubborn or key spaces can spark interest in downtown as a retail destination and demonstrate to property owners that retail is viable in the district. The ability of a dedicated Main Street manager to improve the retail climate by creating a compelling downtown vision that remains grounded in reality can fuel this transformation, leading to long-term retail vitality.

Errin Welty is a market analyst at Vierbicher. She works with public and private sector clients to create market-based solutions for economic and planning issues. Errin has significant downtown experience, having been on the staff of downtown organizations in St. Cloud, Minnesota, and Denver, Colorado, and a founding member of Wheat Ridge 2020. She has a lifelong passion for enhancing and preserving downtown's place in the community. She recently relocated to Madison, Wisconsin, from Denver, Colorado, where she managed Grubb & Ellis's research and marketing department.