The bank of first refusal

A look at the pressures on credit management in the commercial-property sector during times of economic distress

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Commercial landlords are, in many ways, the bedrock of an economy, as every trading firms needs property from which to operate – even if the 'shop' itself is online only – and the large corporate companies are also a favourite investment vehicle for global pension funds.

These funds want to see a healthy return on their money, so the rental yield, over the period of a commercial property lease, is a key part of the business model.

Any unexpected variation to the income stream will naturally cause consternation on the part of the investors, and, in extreme cases, start them looking around for the exit.

This situation is not helped because, in too many cases, a struggling tenant will look first to its landlord for a way of smoothing cashflow or reducing outgoings, rather than approaching its bank, in the mistaken view that the landlord is a financial institution rather than just another – albeit very important – supplier.

In the front line

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Professionals working in the property sector are, therefore, on the front line when faced with requests for rent reductions or payment frequency changes, and it is, therefore, sensible to set out some guidelines which can be applied fairly and equally to all such applications, and which also protect the landlord from unnecessary financial risks.

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Even though most new commercial leases operate on a monthly payment cycle, there are still a large number of quarterly leases out there, and these tenants tend to be the first in the queue when asking for your financial assistance.

I will, therefore, focus on quarterly to monthly concessions, although the same considerations apply to weekly payment concessions on monthly rents, and seasonally adjusted payment terms or reductions for certain calendar-based businesses.

Self defence

There are, of course, some instances where it is prudent for a landlord to grant a temporary or permanent concession, allowing a tenant to pay monthly on a quarterly lease.

I should stress that, in this case, the landlords' right to quarterly income should be maintained either by it being formally documented in a side letter, or by not documenting the arrangement at all – the latter is only appropriate for short-term arrangements as, if any payment terms become established over a year or more, it could be argued that the lease has been permanently varied by consent.

This way, the payment concession can be made conditional on the tenant's payment performance, and a default period can be built in which removes the concession if the tenant is two days late with a payment, for example.

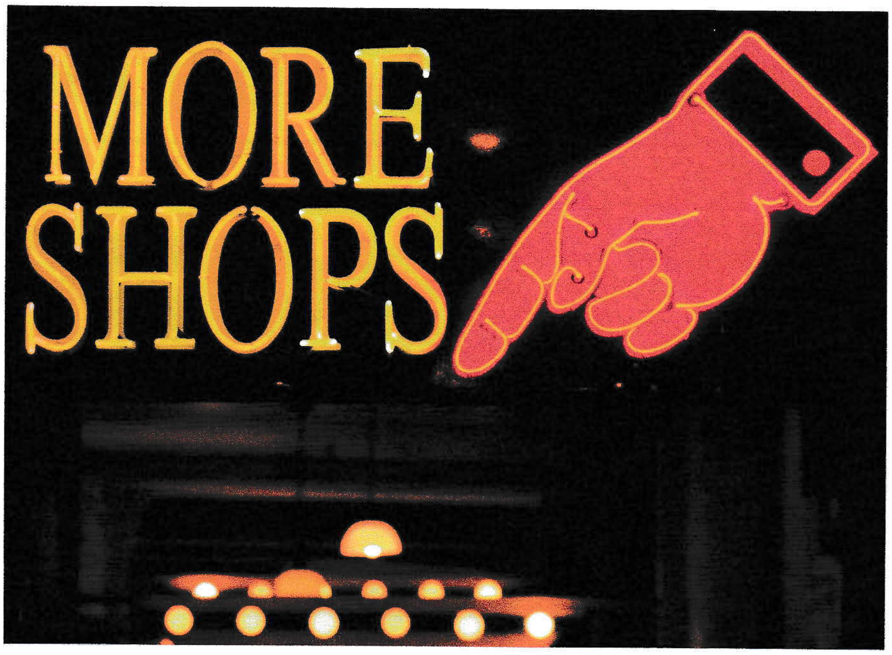
Sadly, the 'give them an inch' proverb applies all too often in these situations as tenants misinterpret a 'yes' to a change to payment terms as a 'yes' to paying only when it is convenient for the tenant and not before.

The landlord should not regard staged rental payments as the answer to all the tenant's ills either, as, more often than not, the payments will just have to be chased three times in a quarter rather than once.

The reason a tenant asks for certain rental concessions is because other suppliers are twisting the knife and there is not enough money to go round. This means that, regardless of the reason, the tenant's cash planning has not worked, so do not assume that the other suppliers will back off as a result of a landlord's concession.

At this point, we revert to what should be a standard credit-management procedure, and look closely at the overall financial performance of the tenant company, as well as the individual trading performance of the property in question.

Paradoxically, we are now looking for something which seems to be a contradiction in itself – something which I call manageable distress. If things were going well, the tenant would not be asking for concessions – and remember, any variation to the lease terms which impacts the landlord is a concession – or would they?



When to say 'no'

Many times, I have found that a tenant, who is applying for a concession, is simultaneously stripping out money from the business either in dividend payments to the directors, in management charges to a group company, or, even worse, by spending a fortune on a store-opening programme elsewhere which will not only benefit the tenant, but other competing landlords as well.

It is not the landlord's job to subsidise any of these activities.

So it is vital for the landlord to satisfy itself that the distress communicated by the tenant is both genuine, and can be permanently remedied by the proposal on the table.

Being naturally suspicious, I would also have a look at the tenant's debt structure before agreeing to anything, as suppliers of capital are still suppliers, and the landlord should not be subsidising timely payments to any of them by taking a hit on the frequency of its own income.

On receipt of any kind of concession application, one of my first questions is: who else is being compromised to help the tenant out of a hole? If the answer to this is 'nobody', then it means a very short and forthright conversation.

Conclusion

As I have already mentioned, there is still the view adopted by some tenants that landlords are not businesses, which exist to make a profit of their own, but rather benevolent uncles joined to their tenants by the heartstrings, who also have an emotional obligation to ensure that their counterparties under the lease are profitable, even to the extent of underwriting losses.

If one side asks for a favour, there should be a corresponding compromise the other way as well

A lease, or any other kind of tenancy, is a business transaction with obligations on both sides. So if one side asks for a favour, there should be a corresponding compromise the other way as well.

If changes to rental payments are requested, and the financial checks endorse their suitability in managing a short-term problem, then the landlord should be looking for advantages as well.

Is there a rent review pending which the landlord would like to see resolved in its favour?

Is the tenant company part of a larger group which could provide a guarantee to de-risk the situation for the landlord?

Does the landlord want to increase its ability to manage the distressed tenant's exit from the particular centre by way of a break clause?

All these things are up for discussion as soon as the tenant asks for something that the landlord is not obliged to give. In the second part of this article, next month, we will consider when it might be appropriate to say 'yes'. CCR