Focus on Leasing:
Protecting your Improvement Allowance

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- **Introduction** –Tenants who lease office space or retail space rarely pay out-of-pocket to get the space ready (build out) for their use. Frequently the landlord will give the tenant funds (a tenant improvement or "TI" allowance) to cover some or all the cost of building out the premises. The TI allowance is not a gift, however. Customarily, a TI allowance is treated like a loan with interest, but the payments are included in the tenant's base rent and amortized so the landlord is paid back (with interest) over the initial lease term.

  A TI allowance allows a tenant to essentially borrow funds for its initial leasehold improvements, avoiding debt and keeping its cash flow consistent. In the Washington, DC marketplace there has been a significant increase in average TI allowance during the past two years. "*Since the first quarter of 2017, the average allowance has risen 22.6% to a cyclical high of $86.19 per square foot*" based on research by Newmark Knight Frank as quoted in the Washington Business Journal on August 2, 2019.

  Landlords and tenants have different perspectives when negotiating a TI allowance, and a tenant will benefit by understanding some of these key issues.

- **Construction Costs** – Landlords often want the TI allowance to be used for hard improvements that might be used by future occupants, adding value to the landlords property. Examples of hard costs are cement, drywall, carpet, etc. In addition to hard costs, Tenants also want to use the TI allowance for soft costs, such as architecture, engineering and accounting fees.

- **Other Costs** – In addition to hard and soft costs of construction, a tenant may want to negotiate the right to use the allowance on related costs such as furnishings, fixtures and equipment and moving costs. Landlords often let a tenant use the allowance for these type of expenses, up to a capped amount (*e.g.*, not more than $5.00 per square foot).

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- **Unused Allowance** – Landlords will typically provide that the tenant will forfeit any unused allowance amount. Arguably this is not equitable if the full amount of the allowance is already "baked in" the base rent. A tenant may want to push for the right to have any unused allowance funds to be credited towards future rent. Landlords who agree to such a right often limit the amount of such credit like the limit on furniture and moving expenses.
- **Who Pays First?** – Landlords typically want a tenant to pay their contractors and suppliers on a monthly basis and get reimbursed upon presenting paid invoices. A tenant may want the right to submit unpaid invoices and have the landlord pay the contractor directly.
- **Payment Frequency** – For office leases, it's customary for the landlord to make a single disbursement of the allowance funds each month while construction is progressing (subject to the tenant delivering lien waivers, invoices, and other required deliverables). For retail leases, however, it's customary for the tenant to fully complete its build-out and open for business, and then receive a single disbursement of the allowance. A retail tenant may want to negotiate for periodic or monthly disbursements, to provide more flexibility for its cash flow.
- **Administrative Fees** – Landlords often charge administrative fees for tenant improvement work even if the tenant is doing the buildout. These fees are taken out of the TI allowance. During the lease negotiations, an astute tenant will be aware of the fees and whether the fees are appropriate in the DC market.
- **Your Transaction** – The issues in this article highlight some of the key points to address in TI allowance negotiations. In all cases, we advise you to consult an experienced commercial real estate broker and experienced commercial real estate attorney to advise you in negotiating and structuring the best terms for your TI allowance.

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