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Leasing commissions: the mystery explained

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COMMERCIAL REAL ESTATE

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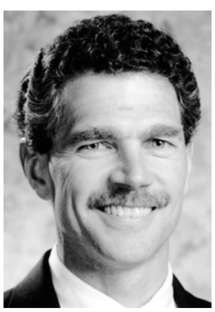

Leasing commissions — this feels like a taboo subject for a real estate practitioner to write about. Why? Partly from fear — brokers are taught from their earliest licensing courses, and reminded frequently at continuing ed seminars and professional conferences, that commission rates are not to be discussed among our colleagues. It is verboten. Price-fixing charges and penalties loom overhead. Also, I think that many businesspeople consider it a somewhat unsavory subject to bring up, sort of like asking your doctor while he is performing some procedure, "By the way doc, exactly how much am I paying you for this anyway?"

During the hundreds of lease transactions that I have negotiated over the past 15 years, it is rare that the tenant turns to me and asks, "Hey, how much am I paying you for this anyway?" So to try to satisfy some of that pent-up curiosity, this article attempts to shed some light onto the mysteries of leasing commissions.

First, my disclaimer, which will hopefully keep the anti-trust watchdogs happy: This material is not meant to establish, fix or set any commission rates or guidelines for commission rates. This material is based on my company's practice and experience in the market and there have been no discussions with other agencies regarding their commissions or pricing structures in preparing this material.

Basically, leasing commissions are based on rental income over the term of the lease. A percentage is applied to this rental stream equal to the commission rate. Often this rate will decrease as each year of the term progresses. That is, 6 percent of the first year's rental income, plus 5 percent of the second year, plus 4 percent of the third year, plus 3 percent of the fourth year, plus 2 percent of the fifth and any subsequent years.

This is our fee schedule for leasing commercial properties – office and industrial. You will notice that I say "plus" between each year. That is because this leasing commission is an "up-front commission." In other words, it is paid in total, up front, at the beginning of the lease. If the tenant goes out of business or defaults on the lease, then it does not result in a rebate of part of this up-front commission. While we hope that this situation never occurs, it begs the question, "Are there any alternatives to the up-front commission structure?"

One alternative is the "installment commission." My firm started offering this method as an alternative to clients about five years ago. I picked up the idea from some Memphis brokers while at a national conference. They were surprised that brokers in the Northeast were paid up-front for the entire term of the lease. Their part of the country, it seems, practices what I have called the "installment commission" method. This method is very simple— it is a flat rate that is applied to each year's rental income at each anniversary, but only if the tenant is still in place and paying rent. The "installment commission structure" offers an owner a way to lower initial expenses in renting space while spreading the risk. We have been offering our clients the option of selecting either the up-front commission structure using our sliding scale or the installment commission structure using a flat 5 percent.

So what does the commission run on a typical leasing transaction? Let's take an average 3,000-square-foot office tenant that rents for an initial three-year term at $18 per square foot. That gives an annual rental income of $54,000, or a total rental stream over three years of $172,000. Applying our up-front commission schedule of 6 percent + 5 percent + 4 percent over the three-year term gives a total commission due of $8,100, or a little less than two months of rental income. Our installment commission alternative would result in an annual fee of $2,700, or $8,100 over the three-year term. If there is another cooperating broker to the transaction, then this commission is split equally between the two agencies as a co-broke fee.

Commercial leasing transactions are generally considered one of the more difficult processes to negotiate. There are many steps, from the initial site viewing to final lease execution and tenant fit-up, that require close monitoring. The broker often plays the role of a mediator, trying to keep two parties on opposite sides moving toward the same goal without alienating them, knowing that they must live in harmony for many years to come. While it is not widely understood, the broker's role in a successful lease transaction is key. NHBR

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