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Post-COVID-19 Pandemic Outlook — Restaurant Ground Leases

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As businesses begin to emerge from the COVID-19 pandemic, brick-and-mortar retail and restaurant leasing is showing strong growth. U.S. retail vacancy fell to 6.1 percent in the second quarter of 2022, the lowest level in at least 15 years, while asking rents for U.S. shopping centers in the quarter were 16 percent higher than five years ago, according to real-estate services firm Cushman & Wakefield. Most developers are opting to renovate outdated shopping centers rather than building new ones.¹ The development of outparcels or pads in re-developed shopping centers, catering to national restaurant brands, also saw unabated growth during the pandemic. Restaurants with drive-throughs have seen especially strong performance.

Ground leases are typically used in shopping center pad or outparcel transactions for single-tenant users. Prospective restaurant tenants should always perform due diligence on the site, including review of all applicable recorded documents affecting the proposed use, as well as assessing the impact of any existing reciprocal cross-access and parking rights, pass-through costs, and signage restrictions. The lead times and significant capital outlay involved with the inspection of the proposed site – such as performing a new survey, Phase I environmental site assessment, and property condition report for existing improvements, if applicable, as well as determining the necessary entitlements and permits for the development and intended use of the restaurant – are obtainable require contingencies and termination rights not typically seen in in-line retail leases.

Sophisticated and experienced restaurant operators typically address many of the issues facing such development in the letter of intent (LOI) phase. Regardless of how detailed a LOI may be, though, significant issues will be resolved during the negotiation of the lease.

These issues are particularly important in restaurant ground leases:

- *Term* – An initial term of 10 to 15 years with additional five-year options is typical.
- *Permitted Use* – Tenants desire flexibility in use and concept while landlords seek to maintain their preferred mix of retailers by limiting each tenant's permitted use. If alcohol is to be served on the leased premises, the availability of a liquor license and any applicable restrictions has to be investigated.
- *Restrictive/Exclusive Use Covenant* – Typically in the LOI phase, restaurant developers will seek restrictions on the remainder of the landlord's property to have the exclusive right to a particular restaurant segment (e.g., quick-service pizza, sit-down Italian, or French bistro). Drafting exclusives granting a landlord the needed flexibility to lease the remainder of the shopping center while narrow enough to protect a tenant's desired exclusive use requires skillful negotiation and drafting by attorneys. An instrument such as a memorandum of lease memorializing the exclusive use covenant and the restricted territory may need to be recorded after execution of the ground lease to put potential competitors on notice.

- *Inspection, Entitlement, & Permit Periods – Contingencies* – Governmental entitlements, physical inspection of the leased premises, zoning, building permits, drive-through lanes, and outdoor seating areas are all items that require a tenant's due diligence and significant capital outlay that will usually not be incurred until there is a fully executed lease. Tenants should seek sufficient inspection, entitlement, and permit periods to perform their due diligence with an ability to kick out of the lease if the desired development and use is unobtainable.
- *Construction of Improvements & Signage* – Restaurants with a prototype store and signage package should seek the landlord's approval of the same during the negotiation of the lease. Tenants should also confirm whether any third-party approvals to the proposed build-out and signage are needed, with the lease conditioned on their receipt and the landlord's promise to assist. Extending utilities to the leased premises – who is responsible and who pays for it – should be negotiated during the LOI stage.
- *Construction Period and Rent Commencement Date* – Tenants typically construct the improvements located on a ground leased outparcel and often seek to condition the rent commencement date until such construction is completed so tenants have enough time to staff and stock the location. Landlords typically require tenants to commence and complete construction within set timeframes. Tenants will usually seek automatic extension(s) of construction periods if certain events occur. These provisions are heavily negotiated and require an experienced hand to lead the process.
- *Continuous Operations* – Landlords will usually seek a continuous operations covenant (it is of greater importance if there is a percentage rent component) within "normal business hours," which should be defined in the lease. National/regional credit restaurant tenants may be able to limit their continuous operations obligations to something less than the full lease term; however, landlords often require a right to recapture the premises and reimbursement of any unamortized construction allowance provided to the tenant if operations cease.
- *Parking* – Restaurants require more parking than other retail uses, which can lead to issues during negotiation of the lease. Applicable reciprocal easement agreements and covenants, conditions and restrictions, and existing leases must be reviewed to determine if exclusive parking spaces can be granted (e.g., for "to go," Uber Eats, or "curbside" service). The number of designated parking spaces is typically negotiated in the LOI phase and should be identified on a site plan attached to the final lease.
- *Drive-Through Lanes* – About 57 percent of customers at hamburger fast food restaurants use the drive-through window, compared to 40 percent at quick-service Mexican restaurants and 38 percent at chicken fast food restaurants, according to The NPD Group.² Obtaining the necessary entitlements and permits to construct the desired number of drive-through lanes is critical to the economic viability of many restaurant concepts.
- *Outdoor Seating* – An exclusive outdoor seating/patio area will typically be negotiated in the LOI. Typically, tenants do not pay rent for the outdoor seating but are responsible for insurance, maintenance, and indemnification of the landlord. Complaints from neighboring tenants because of excess noise, odors, and impairment of access to other premises are concerns that landlords seek to address in the lease.

If you have questions about this alert, please contact [Kamron Massumi](#) or one of the members of Baker Donelson's [Retail and Mixed Use](#) Group.

¹ Kate King, "Retail Real Estate Is Enjoying Its Biggest Revival in Years," *Wall Street Journal* (Oct. 4, 2022, 1:24 p.m. ET), <https://www.wsj.com/articles/retail-real-estate-is-enjoying-its-biggest-revival-in-years-11664875802>.

² Steve McDonnell, "What Percentage of Sales Are From Drive Through Windows at Fast Food Restaurants?," *Houston Chronicle*, <https://smallbusiness.chron.com/percentage-sales-drive-through-windows-fast-food-restaurants-75713.html>.