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Corporate Strategies

Fading Flexibility

Office Concessions Dwindle as Vacancies Tighten

By Amanda Marsh

With office vacancies strengthening in most U.S. markets, landlords are hopping into the driver's seat as tenants experience rental rate increases and declining lease flexibility.

"Because the markets are tightening, there is less free rent and tenant improvement allowances," said Robert Bach, senior vice president of research & client services for Grubb & Ellis Co. "Construction costs are way up for tenant improvement allowances, so landlords can't be as generous as they were when the market was softer."

Besides construction costs for office product, other landlord expenses have been increasing. "Landlords cannot project future costs," noted Ron Gottesmann, a principal of NR Investments Inc. in Miami. "In the past three months, insurance has gone up 300 to 700 percent. Electricity and taxes have gone up. Even if you increase rental rates, it does not mean that you'll make money." The unpredictability of the current office market makes planning ahead especially challenging for landlords. "It is one of the difficulties," said Peyton Owen, COO of Equity Office Properties Trust. "You're making promises today for what can happen in the future."

Ross Moore, senior vice president & director of market & economic research at Colliers International, said, "Free rent is pretty much gone. It was largely a token measure. I cannot remember the last time I saw free rent—perhaps years ago."

Franklin Speyer, executive vice president for Cushman & Wakefield Inc., noted that in many markets, tenant improvement allowances are down, and in top-tier markets like New York City and Washington, D.C., most concessions are not even available.

"Landlords are interested in cash flow and the credit of the cash flow," Speyer said. "They don't have to offer flexibility in these tight markets."

In South Florida, the demand for office space allows landlords to forego incentives, Gottesmann explained. "Everybody was focusing on (building) residential and not office, and now there is a lot of demand for office space." According to Lisa St. John, a managing director for Jones Lang LaSalle Inc., "Tenants are at the landlords' mercy" in Los Angeles.

Others deny that flexibility in office leases is nonexistent in top markets. "(Getting flexible terms) is obviously more challenging, but it is never impossible," said David Goldstein, executive managing director of Studley Inc. "The challenge is if there's another tenant that's willing to settle for less (and) looking at the same space. That's the complication. Sophisticated tenants understand (that) flexibility is significant in a transaction."

Space flexibility in office leases is also dwindling, according to Bach. "There is less space for tenants to expand, so there are less options," he said. "Landlords don't have to wheel and deal as much as when the market was softer and there were less tenants making commitments."

Goldstein added, "It's where the opportunity lies. Some buildings are set better. (With) others, certain floors are encumbered. The key is finding soft spots in landlord stacking plans." The ability to secure expansion space is outlined in terms such as "true right" or "right of first offer." He explained, "If your leverage is adequate, you should still get (space flexibility). We've had pretty good success in negotiating for favorable expansion rights."

Premiums & Penalties A whopping 93 percent of office tenants "are perfectly willing to pay for flexibility," said CoreNet Global director of global research Eric Bowles. In a recent study of global companies that included mostly U.S. firms, the foundation discovered that 68 percent of office tenants were willing to pay as much as 5 percent for flexibility, while 25 percent were willing to pay more. That is a testament to the availability of flexibility today. "Something is scarce when the market is willing to pay," he said.

Colliers' Moore is not convinced that landlords would accept that percentage. "I can't imagine landlords accepting a 5 percent premium," he said. "They would take on more significant (amounts)." The study stated that tenants perceive landlords as a barrier to obtaining flexibility, which Bowles attributed to the lack of skills needed, on both sides, to effectively negotiate flexibility. "We see a need for tools to price flexibility," he said.

Such software is used widely in the United Kingdom through the OPRent program. The risk-analysis software compares likely cash flow on a conventional lease with that expected from the flexible lease. It then offers insights into the likelihood of various terms being operated in different markets and attributes value to them. In the United States, Chatham Research Alliance and CB Richard Ellis Inc.'s global corporate services have teamed to explore real optional modeling that can give an idea of how flexibility should be priced, said Darcy Mackay, a senior managing director with CB Richard Ellis. They have not come up with a release date, and Mackay was not able to elaborate on the project. "We're still kicking tires," she said.

Goldstein said that he is not so sure such software is needed in the United States. "Pricing flexibility is not a science, it's an art form," he said. "There's a unique way of doing it." Owen contended that it is a mixture of both. "A methodology would be interesting," Owen added, "especially if it was accepted by the (commercial real estate) market."

Another reason landlords may be perceived as a barrier to flexibility is inexperience, noted Gottesmann. "(Some landlords) step into the commercial side without understanding how it works," he said. "They get without giving, waste money and blame the tenants."

And tenants are offering to pay for flexibility not just in premiums but also in penalties. If a lease cancellation is necessary, the landlord can work around it and will charge the tenant for such factors as unamortized capital or the cost to re-rent, Speyer pointed out. "It's better to have an out than not." Goldstein agreed. "Even if it's at cost, it's a right tenants have. If you can get it, it's a useful tool and can avoid subleasing risks."

David Binswanger, president & CEO of Binswanger Corp., said the condition of today's markets allows tenants to easily sublease unneeded space or give it back to the landlord. However, he is still a believer in termination rights. "You should get them; you don't know what the cost will be," he said. "They should be in every tenant's package." He added that landlords are also in a better position to accept terminations because it is easy to replace a tenant in tight markets.

Many of the companies that want termination rights are in dynamic industries, such as technology or finance. Binswanger, however, said neither industry is as focused on getting termination rights as they should be. According to St. John, "To more stable companies, it's not as important because they'll be there in five or 10 years."

Overall, the right to terminate a lease hurts the landlord, so many are not offering the concession. "The lender doesn't see it as a 10-year lease, but rather a five or seven-year lease," St. John said. "They assume the tenant will exercise the right," which may mean more capital costs or vacancies.

Even if a tenant does not have contracted rights or concessions, the landlord may still leave room for negotiation. According to Owen, a landlord may consider renegotiating lease terms to avoid losing a tenant and paying out re-renting costs. He noted that Equity Office's large office portfolio allows accommodation, and the company has a strategic program aimed at retaining its top 100 tenants.

Owen said he expects office markets to continue improving and flexibility to decline even more next year. Binswanger sees current conditions continuing. "Whenever things start to lean toward an extreme, you scratch your head and wonder if you're close to an end," he said. "The economy continues to grow, and there was a huge amount of (development) supply this cycle. I see more status quo than tightening or falling off."