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## Lease Flexibility Standoff

Shortened business cycles push corporate office users and landlords into tug of wars. **By Jennifer Popovec**

Over the past seven years, mortgage banking firm Lime Financial has operated out of three different office buildings, expanding from 2,500 sq. ft. to more than 50,000 sq. ft. of space in Lake Oswego, Ore.

Each time Lime Financial needed more space, landlord Equity Office Properties Trust tore up the existing lease and drafted a new one, says Mike Baldwin, COO of Lime Financial. His company now employs roughly 450 workers.

As a company in fast-growth mode, Lime Financial values the flexibility that Equity Office, the nation's largest office REIT, provides. The company received first right of refusal for adjacent space at no extra cost and also secured a buyout option so it can opt out of the lease.

"I don't think we should pay more for flexibility, particularly if we're expanding, because we're going to be a bigger customer," says Baldwin.

Unfortunately, for most corporate users, Lime Financial's experience in lease negotiations is the exception rather than the rule. Despite all of the discussion about the changing needs of corporate America, only select tenants are able to wrangle flexible lease terms in this country, say industry experts, many of whom doubt industry flexibility will ever become commonplace in the United States.

Some owners will yield on this point. Their willingness to offer lease terms with special considerations is influenced by market health and the lending community, which typically scorns expansion

options and opt-out rights.

Market conditions are perhaps the most important variable. When national office vacancy was soaring in the high teens in 2003, landlords were far more willing to entertain a tenant's request for an early termination or first right of refusal, which prevents an owner from leasing space without a tenant's approval. In today's market, where the office vacancy rate in some cities is under 10%, there is a reluctant willingness.

Another issue: Long-term office leases are no longer the norm and have decreased steadily over the past six years. The average office lease term in 2006 is 56.5 months compared with an average lease term in 2000 of 61.2 months, according to Grubb & Ellis. Yet lease terms

for CBD office space have increased over that same period to 74.5 months from 69.8 months, which suggests that tenants are more willing to commit to downtown space for a longer period.

### What's it worth?

If the results of two recent surveys of corporate executives are any indication, tenants are now willing to pay a premium for flexible lease terms. Industry experts say that Corporate America's real estate needs are changing far more quickly today than in the past, predominantly because business cycles of expansion and contraction have shortened.

Nearly 40% of respondents to The Boston Consulting Group's 2005 study of real estate executives said that their five-year projections for space demand were typically off by more than 100% due to new businesses, shifts in market demand and inaccurate forecasting methods.

The inability to accurately predict space needs is a key driver in the demand for lease options, says Sandy Apgar, director of the real estate practice for Boston Consulting Group (BCG). In fact, all 16 Fortune 500 corporate real estate executives in BCG's survey indicated that they were willing to pay extra for flexibility.

Similarly, a recent research report from CoreNet Global titled "Portfolio Optimization: Flexibility" found that 93% of 48 real estate executives surveyed were also willing to pay for lease options. In 2004, a similar CoreNet survey found that only 65% of respondents were willing to pay for flexibility.

"I haven't experienced scenarios where

tenants have actually paid for flexibility," says David Goldstein, executive managing director of Julien J. Studley, a national tenant representation firm. "To me, flexibility is an inherent right of a significant space user with significant credit." A tenant like Coca-Cola is able to demand options and opt-out clauses simply because of its financial clout, he points out.

Pete Larson, executive vice president with Transwestern Commercial Services in Washington, D.C., agrees. "A strong credit tenant is going to be able to demand greater cooperation from a landlord when it comes to options."

That attitude was fine even just two years ago, but today more tenants are willing to pay up to 5% more to ensure lease options, says Eric Bolle, CoreNet's director of global research. The organization's 2006 survey finds that seven out of 10 respondents feel that a lease with flexibility is worth as much as 5% more than one without it. In the 2004 survey, just three out of 10 respondents felt that way.

BCG's survey also found that building owners impede flexibility. "It's surprising to see how difficult and challenging it is to convert owners from the tradition of long-term leases and the management of real estate as a fixed asset to shorter term leases that are structured with flexible options," Apgar notes. "It's a major change in the way business is done."

In the United Kingdom, lease flexibility is far more common. In fact, many British owners now use a sophisticated method called "real options" to factor in the risk created by offering flexible lease terms. These owners use this method to

appropriately value shorter lease terms, expansion options and opt-out clauses. By contrast, only a handful of U.S. owners and service providers are working on software programs in hopes of tackling the valuation problem (*see sidebar p. 58*).

### Lenders don't flex

Flexibility has a limited upside for owners since tenants typically gain the most benefit. "It's natural to want all the flexibility on your side, but the value of a building is based on cash flow, so the owner's fundamental goal is to have tenants stay for the long term with periodic rent increases," says Bill Flaherty, senior vice president of marketing for Maguire Properties. "That's why flexibility is something that every landlord would like not to discuss."

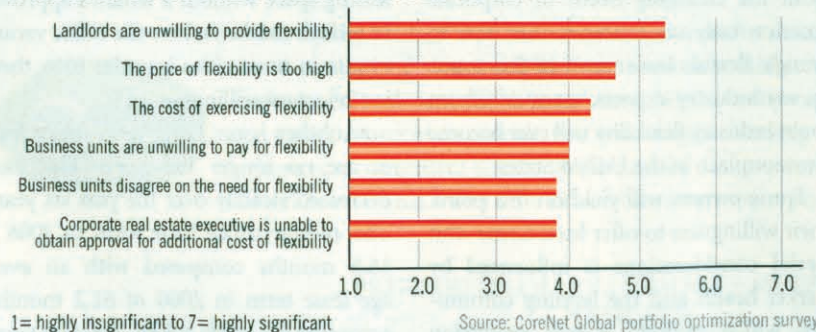
The more flexibility guaranteed in the leases, the more risk an owner assumes, says Bill Weghorst, senior vice president of PM Realty Group. He adds that Corporate America often finds itself at odds with landlords, but for reasons that are far more complicated than they seem.

Owners and the brokers who represent them contend that they really do want to meet tenants' needs by offering flexibility. But in doing so, they can be — and usually are — penalized by the lending community. "There has been a serious disconnect for many years that lenders expect a certain cash flow from a building, and an owner can't go around giving out termination options and expansion rights," says Steve Swerdlow, president of global corporate services for CB Richard Ellis. "Financing structures are perhaps the biggest impediments to flexibility."

Since lenders base the present value of office buildings on the anticipated income stream, the longer the leases are in place, the more valuable the building is and the more likely lenders are to offer favorable loan terms, says Wally Reid, a managing director with Holliday Fenoglio Fowler's Houston office. "It really comes down to the cash flow of the lease and who's providing the cash flow," he says.

In fact, Flaherty claims that lenders are so opposed to flexibility that they actually value a 10-year lease with a five-year early

#### ON A SCALE OF 1 TO 7, CORPORATE REAL ESTATE EXECUTIVES SAY THAT LANDLORDS ARE THE BIGGEST BARRIER TO LEASE OPTIONS.



termination option as a five-year lease. "My lender says that you have to plan on them breaking the lease," he explains. "And, if the market slightly changes, all of the control is switched to the tenant because it damages the net operating income and the value of the building." Moreover, owners can incur heavy improvement and brokerage expenses to land a new tenant.

### The owner's curse

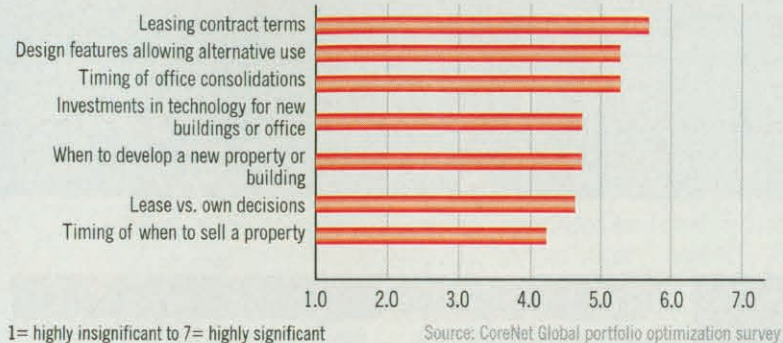
Because early terminations and space contraction options can be onerous to owners, many are less enthusiastic about offering even first right of refusal or expansion rights. "Every time you give up something in the form of flexibility, it hurts you in some way," says Weghorst. Nonetheless, he estimates that more than 50% of all leases have some form of options. "We want the income and tenants, so we do our best to accommodate them while trying to minimize the encumbrances on our buildings."

Expansion or first right of refusal options are a fantastic flexibility tool for tenants, but they make it more difficult for owners to lease that space. "In a multi-tenant building, it's impossible to figure out when a space will be available," notes Wes Powell, senior vice president of Jones Lang LaSalle, adding that an owner isn't going to want to sit on vacant space for months or years.

Powell estimates that fewer than 7% to 8% of lease contracts include expansion or contraction options, and none of the tenants are paying for the privilege of flexibility. "Expansion options are not something that you offer to every tenant coming in because, before you realize it, you'll have 50 tenants with options that could tie you up," he explains. "I've inherited buildings that have options that hurt the owners rather than helped."

Most expansion and first right of refusal options are offered to tenants as a perk. Even in tight markets like New York City and Washington D.C., owners compete for tenants. "If we can figure out a way to provide that flexibility and get that tenant into the building without dimin-

### ON A SCALE OF 1 TO 7, CORPORATE REAL ESTATE EXECUTIVES CITE LEASING CONTRACT TERMS AS THE MOST PRESSING ISSUE



ishing the value of the building, we'll do it," Powell says.

Tenants can expect to pay for shrinking space or terminating leases early. In a situation where a tenant gives space back or terminates early, an owner would typically demand that a tenant pay back the owner's unamortized costs as well as a termination penalty. Additionally, some owners request that tenants absorb the cost for re-tenanting the space.

The problem is that the companies that most need flexibility — smaller companies with more volatile growth expectations — are often unable to pay a premium for lease options and are less likely to get it, says Ellen Friedler, a partner with Neal Gerber Eisenberg, a Chicago-based law firm. "If you find a landlord who says they will try to accommodate you, that's a very positive thing."

Jennifer Popovec is a Dallas-based writer.

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