The Secret of Why Many Office Sublease Spaces Remain Vacant

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A generally well-kept secret in the office industry is that a significant percentage of available office space marketed for sublease simply never gets sublet.

Interviews with sublease brokers from a number of the major brokerage companies around the San Francisco Bay Area, confirm that estimates of such space range from 25 percent to 50 percent.

The percentage of sublease space that remains on the market varies from one submarket to another. It is higher in a tenant's market, especially when the overall vacancy rate exceeds 10 to 15 percent, and lower in a low-vacancy vibrant market. The dynamics of this aspect of sublease space may not apply in certain cases, such as a high-end plug and play with four-plus years remaining on a lease and/or with a high-credit sublessor in a premier building in a red-hot market. However, all brokers interviewed agreed that there are always office sublease spaces that come to market, don't get subleased, and eventually revert to the landlord as direct space. Most sublessors do not understand the dynamics of the sublease market and are surprised to learn that they will not be able to rent the space they are vacating at the rate they are paying, let alone at a rate with profit. Now let's take a closer look at the dynamics of the sublease market.

Sublease Terms Tend to be Shorter than Direct Leases

There are many factors behind the "sublease" phenomena. Most sublease terms are offered with less than 36 months remaining on the lease. Whereas most direct leases are for (at minimum) five-year terms. When a company signs a direct lease for a five-year term, it usually does not expect to be acquired, experience serious business downturn, or face rapid growth and insufficient space. All of these conditions are future scenarios, which, if they do occur, may not happen until one to three years into the lease term.

Most companies require a lead-time before relocating, eating into the (typical) remaining 36 months on the original lease. The amount of lead time required usually varies with size. A 50,000-square-foot office user may require 18 to 24 months while a 3,000-square-foot office user may only need six to eight months of lead time. Once a user goes to market, the 36-month sublease term may actually work out to be only 20 to 30 months, considering the time it takes for sublease documentation, notice to current landlord, existing lease expiration, etc. Many companies will not relocate for such a short term unless they are able to get an extended term from the landlord. In an up-market with rising rents, some landlords may be unwilling to grant any lease extension. They may feel that it is more prudent to keep the current tenant obligated and search for a new tenant toward the end of the term when market rents may be much higher. The landlord's strategy in this scenario places the sub-landlord in the difficult position of finding a short-term subtenant. Usually this can only be accomplished by offering the space at a substantial rental discount, i.e., 50 to 70 percent of current market rents for direct space.

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Sublandlords Cannot Pay for the Same Tenant Improvements

A five-year direct space tenant can usually get the landlord to pay for reasonable tenant improvements. Depending on the specific market and condition of the space, these can range from $10 per square foot to $30 per square foot or higher. Subleases, on the other hand, are generally done on an "as-is" basis because the sublandlord is primarily concerned with cutting its losses and not spending any additional capital.

If a sublandlord were to pay for a sublessee's TIs, much of any monetary gain would shrink—being used for tenant improvements associated with its sublessee. As a worst case scenario, consider a $20-per-rentable-square-foot tenant improvement allowance amortized over a 36-month sublease term at eight percent interest. This would equate to $0.65 per square foot per month just to cover this TI allowance! Looking at this scenario from a different perspective, if an office space were sublet at, say, $1.50 per rentable square foot with a $15 per rentable square foot tenant improvement allowance and a 30-month sublease term, the sublandlord wouldn't get any real sublease rent for the first 10 months—or even longer when the commissions and any front-end legal costs are factored in. The shorter the sublease term and the lower the sublease rate, the more difficult it becomes to deal with the issue of tenant improvements.

Additionally, while most landlords are geared up to monitor, supervise, and manage construction projects through their property or asset management departments, most tenants do not have these resources available to make sure that a TI project goes smoothly. The sublandlord may have vacated totally, moved out of the area, or downsized to a much smaller workforce, and thus may be forced to hire a project manager to oversee the work, use the landlord's resources, usually at a cost, or divert management to check in on the TI construction. Thus, few subleases involve more than minor tenant improvements paid by the sublandlord. This is another reason why, in many cases, sublease rentals require a significant discount rate to be competitive with direct space.

Sublease Tenants May Be Financially Weak

The pool of potential office users for short-term sublease space is different from the pool of direct space. Many Fortune 1000 corporations do not take terms less than five years, so these tenants will not lease space unless a lease termination of the existing leasehold interest is combined with a direct lease. The largest pool of sublease space users consists of start-up or fast-growing companies that may not have superior credit.

Strong tenants may need to sublease excess space. In many situations, however, weaker tenants who are downsizing to the sublease space may present profit issues. Consult your attorney as this is not intended as legal advice, but if the sublessor goes into bankruptcy, the underlying sublease might be cancellable at the landlord's option. Financially weak sublessors may have this huge obstacle to overcome unless the landlord is willing to sign a non-disturbance and attornment agreement, which would require the landlord to honor the sublease terms in the event of a sublessor default.

Sublandlords Lack Landlord's Marketing Advantages

The landlord may have its own vacant space in competition with the sublease space. There may be lease clauses in the master lease that prohibit (1) subleasing space to an existing tenant in the building or complex or (2) marketing the space at lower than full market rents. The landlord may enforce restoration clauses providing that, if the sublandlord demises the sublease space or does other tenant improvements, the sublandlord must pay for all the expenses in turning the space back to its original pre-sublease condition.

The landlord of major office projects may have an extensive marketing budget and promotional campaign while the sublandlord is reluctant to invest any money in promoting its vacant space. In addition, landlords usually have their listing brokerage sign on the property, while few lease holders can promote their subleases in this manner.

In addition, direct space negotiations are between the landlord and the tenant, while sublease negotiations include three parties—the sublandlord, the subtenant, and the landlord. This can add complexity and additional processing time.

Subtenants Can't Negotiate the Existing Lease or Customize Space

Subtenants are usually subject to the existing lease in its entirety, without negotiation or modification. Direct tenants can negotiate lease clause changes that are relevant to their business operation or corporate standards. Direct tenants can usually get some type of lease renewal options, while subtenants rarely can.

When a tenant can customize its office space to its own specifications, (e.g., size of private offices, layout, etc.), the result is usually much more efficient space than the "as-is" condition that a subtenant must accept. Subtenants may live with inefficient space, but usually at a significant rental discount.

Although direct space landlords can often subdivide space to accommodate smaller tenants, sublandlords may not have this option, given the cost of demising, which may include fire-rated corridors, and upgrading ADA, life-safety, and existing requirements. Thus, they may have little flexibility in the tenancy size, which can dramatically reduce the number of potential subtenants.

For example, I recently had a sublease assignment where my client had grown through the years by adding adjacent suites to their main space. They eventually outgrew the building and relocated, but all the subleasing prospects were seeking smaller suite sizes and not the entire space. It seemed a simple solution just to re-demise where the original suites were, but updated life-safety changes in the local city code required fire strobes and emergency lighting, costing more than $5 per square foot. Also, the client had consolidated their phone and data into one main phone board. This meant each smaller space was without a phone board and would need at least partial rewiring to each data outlet.

Sublandlords Need to Spend Funds Up Front

Sublandlords are usually not set up like the landlord for marketing their space. They usually don't have a space planner ready to meet with prospects, a real estate attorney on call who specializes in office leases, a relationship with tenant improvement contractors to get rapid estimates, or a relationship with the local city or governmental planning department if life-safety or other existing issues become relevant.

For example, if (1) there is a possibility the sublease space might be subdivided to accommodate smaller subtenants, or (2) the sublease space is a portion of a larger suite and the tenant is retaining a portion of the space, it is strongly recommend that a space planner be hired at the onset to develop plans showing potential office subdivision scenarios. Perhaps this could be the building space planner who already has the project on Cad and already has a relationship with the city planning department staff.

This would be a good time to get an initial review by the city, the fire department, or other regulatory agencies, as well as at least an informal blessing from the landlord. To wait until the prospective subtenant is finally in hand and then begin this process can often add enough time delay to cause the prospect to look elsewhere. I have learned this lesson the hard way, and if the client is reluctant to expend these up-front funds, this might be a situation where you terminate your listing rather than spend irreplaceable time and energy on what could turn out to be a mission-impossible assignment.

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Long-Term Versus Under-the-Gun Approaches to Leasing

There is another major difference between the motivation and business objectives of an office building owner versus those of an office sublessor. The owner is usually in it for the long haul and may have significant property appreciation, even if one space is vacant. The owner may be better off waiting six months for the right tenant at a higher rent. In contrast, the sublessor is under a time gun. For example, not only does each month's vacancy lose potential sublease income but, as the remaining sublease term decreases, the value of the sublease may erode.

Brokers Earn Far More in Direct Lease Business

Brokers representing an office tenant in the marketplace usually have many alternative spaces to show their client. As-is, short-term leases are less profitable for brokers and more complex than a direct lease with landlord tenant improvements. Further, there is usually an immense commission difference between a direct and a sublease transaction even thought commissions are negotiable. However, no matter what the percentage of commission to be paid over the lease term, income will be significantly higher for a full-term lease than for a short-term lease with a discounted rental rate and a shorter term.

Most office brokers take on sublease listings, and many spaces do get sublet. However, one does not hear about those sublease spaces whose term simply runs out and the space reverts to the landlord. Brokers faced with making a fraction of the normal market commission may still expend time in marketing these sublease listings, but in many cases it is a loss-leader to help out a former client or a long-term relationship.

Putting Sublease Brokers on Retainer

A novel approach that sublandlords might consider would be to pay their sublease broker a monthly retainer, e.g., $500-$2,000/month depending on the size and magnitude of the remaining leasehold. For this fee, sublandlords would obtain a predetermined list of marketing and promotional items that would increase the chances of a successful sublease. The retainer approach would prioritize this sublease space within the agent's scope of other activities, and the payback of actually getting the space sublet versus paying rent through the lease term might be substantial. Agents may even be willing to credit 200 percent of up-front retainer fees toward the eventual sublease listing. Typically, listing agents send out a few broker blasts, post the listing on various Internet sites, and may send a promotional mailing to neighboring office tenants, and then focus their attention on other, more profitable activities.

First "Low-Ball" Offer May Be Best Deal

After almost 30 years of working on office subleases, I see one phenomenon that seems to repeat itself: the "first offer" syndrome. Whether the sublease space has just been put on the market or has been actively marketed for months, the first sublease proposal is usually at a bargain discounted sublease rate. Usually the sublandlord either turns it down outright or counters with a much higher rate. The listing agent may point out the value of this proposal, but not wanting to alienate the client, may reluctantly agree the offer is too low prompting the prospect to go elsewhere.

In some cases this is the best approach, but many times, with hindsight, the first "lowball" offer ends up the overall best economic transaction for all concerned. Getting a higher rate six or 12 months later means potential rental payments on the vacant space have been lost. Time is one of the biggest enemies of subleases, and with a 30-month term, waiting 12 months to make the next deal means you only have an 18-month remaining term, which at this point may not be viable. Looking back, as hard a decision as it seems at the time, the first "lowball" severely discounted proposal many times is actually the best overall option for the sublandlord. For the sublease listing agent, who may have to do many subsequent tours, broker mailings, and marketing reports, the loss-leader of this assignment turns into an increasing time and energy drain.

In summary, many office spaces available for sublease never get sublet. What can be done to increase success in subletting? The listing broker should be prepared to market the space as aggressively as possible, with upfront promotional budgets for broker open houses, broker bonuses, and other marketing activities. Make sure the leasing agents have an incentive to bring their clients to your space, especially considering that they can just as easily show only direct space. Pay your listing agent a monthly retainer tied to a specific list of marketing activities. Be prepared to take a discounted proposal, especially if it occurs when the space first goes to market. Waiting for the proverbial higher rent deal to come along six or 12 months later may not be such a prudent decision after all.