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Lease Restructuring in Today's Market

A Valuable Tool for Tenants and Brokers

By Howard Greenberg, SIOR

Rent is a function of the market. This simple, succinct summary of our business, which I learned more than 20 years ago in a Continuing Education class, distills the complexities of our business down to the basics: supply and demand.

Since the recession, the supply of office space has, for the most part, remained stable with little or no new construction. Tenant demand, however, has been reduced significantly. Companies have gone out of business, reduced headcount, and encouraged telecommuting. Many large companies no longer reserve dedicated space for employees that spend less than 100 percent of their working time in their offices. Trends since 2008 show that large, publicly traded companies generally reduced their space when they renewed their leases. All in all, deal velocity has plummeted in nearly every market.

If Landlords' agents or in-house leasing departments are keeping busy with functions other than marketing and canvassing, it is generally with internal deals: renewals, expansions, downsizings and lease restructurings of existing tenants in their own portfolio. This small amount of new business has been overwhelmingly on the small-tenant side.

All tenants that face lease expirations are going out to shop the market, and are negotiating very hard on any new deals or renewals. It has not been a fun time to be a landlord. The rent delta between Class A buildings and Class B buildings always shrinks in a soft market, as A buildings lower their rents to compete more effectively with their less-glamorous neighbors for the few deals that are out there. Savvy tenants generally take the "flight to quality" in soft markets, as the costs of upgrading to newer and better quality facilities is much less than in normal market conditions.

As daunting as these trends are for landlords, they create opportunities for tenants and their real estate representatives. The hungrier landlords are for deals, the more opportunities tenants have to improve their economic positions. Even if tenants have multiple years left on their leases, astute landlords are willing to "blend and extend" to keep them happy and prevent them from getting into brokers' cars and seeing what other buildings are out there that are nicer than theirs, and whose owners are as hungry as their landlord is (or hungrier) to make deals. These days (at least in my market) real estate is a "zero sum game" where tenants will move to the same amount of square footage in another building to get a new buildout, with some free rent and a lower PSF cost. This is what I call "rearranging the deck chairs" and it involves no net absorption for the market or any change in the vacancy rate.

With these market conditions in mind, I have been very effective in the past few years in achieving significant economic savings for my clients by restructuring their existing leases.

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A law firm client of mine was leasing approximately 25,000 SF of space in two non-contiguous units in the same building, and had about 4 years left on its latest lease executed in 2004. They had already expanded twice since moving into the building as a 14,000 SF tenant in 2001. Their typical buildout always had upgrades, including millwork and glass, for which the tenant typically paid about $15.00 PSF in cash for above the landlord's building standard construction.

There was a 12,000 SF space on the same floor that was soon to become vacant. My client needed about 6,000 SF of expansion, but that unit was not divisible. After much back and forth, the landlord suggested that we turn back our existing 6,000 SF non-contiguous unit, and he would build out the entire 12,000 SF unit for us, for a net expansion of 6,000 SF.

My negotiating strategy was to "fictitiously divide" that new unit into two halves: the "replacement unit" and the "expansion unit." Once the landlord agreed to this concept, we did a "blend and extend" on the tenant's existing 25,000 square feet of space, and did a new "today" deal on the "expansion unit" even though they were part of the same physical space. The tenant rolled back its rents (agreed to in better economic times) approximately $5.00 per square foot on its existing 25,000 square feet, received a refurbishment allowance for that space, and its base years were brought up to the current years, saving significant dollars on operating and tax escalations. The "expansion space" was leased at a very aggressive economic package (the "today" part of the deal), including a significant amount of free rent, lower face rent, and a full, upgraded buildout with no cash contribution from the tenant. The landlord (a REIT) booked a six year extension on 25,000 square feet, plus a new 10 year lease of 6,000 square feet, and solidified the second largest tenancy in the building. Each side gained something from this transaction.

In another case, my client was an 84,000 square foot collocation data center and disaster recovery center. It had 3 ½ years left on its lease, and needed to expand its disaster recovery seating area by 16,000 square feet. I developed a negotiating strategy whereby we informed the landlord that we would take the expansion space, but only if it gave us an early renewal on our existing space, which represented more than 30 percent of the building and tens of millions of dollars of capital investment by the tenant.

It would have cost this tenant many millions of dollars to move (and they would have had very, very few options due to their power needs and other infrastructure requirements), and the landlord knew that. Had we waited later in the term to exercise our renewal option, the rental increase would have been a large one, and our leverage would have been minimal. The expansion space was our only leverage, and we used it to secure a very early ten year fixed-rate renewal at a very modest rental increase, while raising our proportionate share of the building to more than 37 percent. The landlord secured a 20 percent expansion of the space and a ten year renewal of its anchor tenant some 3 ½ years before its lease was up. This solidified his cash flow on 100,000 square feet for 13 ½ years. The tenant avoided a "game of chicken" and the possibilities of either a very high renewal rent or a very costly relocation, while at the same time securing more revenue-producing space for his business.

On the tenant side, the best opportunities for this type of strategy exist with stable or growing companies or law firms, including: good credit tenants; tenants that require reconfiguration or refurbishment in their space; tenants with large investments in their space; and tenants who are location-sensitive and are not easily able to move. In my experience, the REITS and larger landlords generally respond better to the blend and extend concept. The REITS basically live quarter to quarter, and are all about increasing occupancy, whereas larger landlords see the "big picture." They typically take long-term views toward maximizing the value of their assets, and they have the capital to spend to fit out or refurbish space and pay real estate commissions.

Buildings that have recently lost large tenants are good candidates, as they want to stabilize their rent rolls and announce new deals to the market. Buildings that may be facing significant competition from new construction (or whose competitive neighbor buildings may have lost tenants and are making themselves more attractive through upgrades and repositionings) are also anxious to stabilize their tenancy to avoid further tenant defections to what may be perceived as a "newer product."

Even if the tenant wants or needs to relocate, frequently a multi-building landlord will accommodate them (often in a better quality or better located building) elsewhere in their portfolio in order to keep and/or grow the tenant. Landlords are happy to pay commissions for these deals, and they will pay them now, as opposed to when the extension term commences. Even if they deduct the value of the rent roll-backs in the commission formula, that is a small price for the broker to pay.

Other benefits that can be secured for tenants in blend and extend transactions are rights of first offer on adjacent spaces, new renewal options, termination options, updated base years for real estate taxes and operating expenses, and allowances for needed refurbishments or reconfigurations.

These types of services are a real "value add" for tenants, and put significant dollars in their pockets by both rolling back their current occupancy costs and having the landlord absorb the capital cost of refurbishment and/or a new buildout.

A real estate professional using these strategies shows that he or she is more than a broker looking to earn a commission—but a strategist who monitors the market and continuously looks for opportunities for clients to reduce their occupancy costs and enhance the value of their real estate. Certainly you should spreadsheet the savings you achieve against the tenant's existing lease and/or against the current market, (including amounts for potential relocation costs, construction and cabling costs for new space, etc.) and share those numbers with your tenant. It puts a hard value on what you have accomplished, highlights the long-term savings the tenant will enjoy, and reinforces your value to the tenant as his real estate consultant.