Commercial Real Estate

By Stephen A. Cross, CCIM

Leasing in a Down Market Cycle

When the supply of vacant space substantially exceeds demand, the market is said to be in a "down" cycle and favors tenants, *but not all tenants* – only those who are fully informed and understand the intricacies and nuances of the process, and have access to meaningful data. This article will focus on strategies savvy business people, healthcare professionals and corporate decision-makers can use to take advantage of down cycles.

ALL'S FAIR IN LOVE AND LEASING

The reality of real estate signs.
One indicator of excess supply is the number of real estate signs that "adorn" commercial buildings. However, not all buildings with these signs have vacancies. Recognize that real estate agents and brokers are salespeople, and are not barred from advertising space that does not exist via these mini-billboards. *Caution:* While it is theoretically possible to obtain information about vacancies and pricing by driving around and calling off real estate signs, this is a time-consuming and, considering the price of gas, expensive way to gather information.

Subleases can be bargains.
Another characteristic of a down market is the amount of space being offered for sublease. However, many sublease terms run for only a period of months, or one to two years. If the termination date of a sublease is not adequate for your needs, you may be able to negotiate a longer lease period and favorable terms directly with the landlord. In this instance, the original tenant may be permitted to terminate their lease early in exchange for subsidizing some or all of the landlord's re-tenanting costs, including free rent, tenant improvements and other leasing incentives.

Information is (purposely) scarce.
Only a fraction of the thousands of available spaces, including subleases, are advertised to the public; and of those that are, few mention price. In order to make a fully informed leasing decision, you need to know as much as possible about recently completed transactions (comps), what spaces are available (vacancies), their condition, and the asking prices. *Strategy:* Because data on leases is proprietary (not part of the public record), the only practical way to assemble meaningful information is to retain an experienced commercial real estate advisor; a person that has personally completed hundreds of transactions similar to your requirements, does not represent landlords, has access to commercial databases, and has first-hand insight as to which property owners are apt to have the most pressing needs to lease space.

If you don't ask – they won't tell.
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As de facto employees of the property owner, their only job is to lease space for the highest amount possible and with the fewest concessions. *Insight:* Informal negotiations may begin during the touring phase of the search process, and if you reveal too much information about your businesses' circumstances, budget, strategies and choices, you run the risk of diluting your negotiating leverage later on. *Strategy:* When speaking with any leasing agent or property manager, your only objective should be to obtain useful information, not to give it. Unwitting disclosures will be used against you at the bargaining table.

COMMON CONCESSIONS

Landlords with excessive vacancies on their hands are likely to grant generous concessions, also known as leasing incentives, to potential tenants with good credit. These can include, but are not limited to: a reduced rental rate, a period of free rent, above standard tenant improvements, moving allowances, free covered parking, and extended warranties. Of these, free rent is a perk that costs a landlord nothing on an already vacant space. *Strategy:* If your space needs may change within the next two to three years, consider signing a short-term lease at a deeply discounted rate. This allows the landlord to generate at least some revenue until the market turns around.

What's reasonable?

In an arm's length transaction, the market rate *at that particular time* is determined by the overall price (including leasing incentives) that an informed tenant is prepared to pay, and the property owner is willing to accept. Regardless of the published asking price, only the principals to a transaction can determine what is reasonable. While listing agents and brokers may have opinions as to value, it is their employer, the property owner, which makes the final yea or nay decisions.

A, B or C?

For the most part, letter grades are (highly subjective) marketing devices used to classify commercial property. From a property owner's perspective, the better the grade, the higher the anticipated rents. In down markets, it is common for "A" buildings to "effectively" lease for "B" or, on occasion, "C" prices. This can be accomplished by keeping the contract rate at or near the asking price, but granting longer periods of free rent in order to drive the effective rate down a classification or two, at least on paper. *Strategy:* Regardless of how grand or modest the outside of a building appears, most spaces look pretty much the same on the inside. So, evaluate all suitable spaces based on their utility, condition, safety, and maintenance of the building grounds. Pay only for the value of the space to your business.

Save big at renewal time.

Treat lease renewal negotiations as you would leasing new space, and negotiate terms and incentives at least as good as those any new tenant could reasonably expect to receive. In a down market, forward-thinking landlords would be well-advised to do whatever it takes to retain your tenancy, rather than face an indeterminate period vacancy (read: a prolonged interruption in the landlord's revenue stream), and the substantial costs associated with re-tenanting a space.

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CLOSING COMMENTS

It has been my experience that below-market leasing opportunities exist in every economic cycle. However, they can be even more substantial in a down market – providing you take the time to become thoroughly informed, are properly prepared, and understand what terms and conditions may be negotiable. Learn more about ways to proactively lower your costs of occupancy and protect your interests by studying the educational articles available at www.crossrealty.com. ■

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