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Flexibility Is The Key

Landlords are being creative in structuring deals to keep their buildings occupied

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It is no surprise that, given the current state of the economy, there is an abundance of vacant office and industrial space in the marketplace, and tenants appear to have gained more leverage in their negotiations with landlords. As a result, landlords are offering significant concessions and are aggressively marketing their buildings and properties like never-before. Is this the new trend? How far will landlords go to keep their buildings occupied to maintain their rental income and cash flow?

According to the Urban Land Institute, in a recent report published with PricewaterhouseCoopers, landlords of multitenanted buildings with staggering lease rollovers should be able to weather the current market. Highly leveraged buildings that rely on income from one or two large tenants will suffer more significantly, as owners are unable to meet debt service requirements if those large tenants falter, contract their space or seek rent relief. In order to stay in the "leasing game," landlords need to have sufficient cash flow and/or available lines of credit to complete tenant improvements and wait out significant free-rent periods. The warehouse and industrial markets may rebound more quickly than the office market as trade financing resumes and consumers feel more comfortable spending. When consumer spending increases and new homebuilding resumes, the warehouse and industrial markets should begin to rebound. In the meantime, landlords of office space have been more creative, while warehouse and industrial landlords are either waiting out the market or, if they have sufficient resources to build, aggressively marketing long-term built-to-suit transactions to a very narrow tenant market.

With the leasing market in turmoil and with tenants vacating space and/or contracting to accommodate a shrinking need after downsizing, landlords are being more creative and in some cases, more generous, in order to keep their buildings occupied. While some tenants may be using the recession as leverage to negotiate a rent reduction, other tenants who are suffering financially may look to landlords for rent relief, often in exchange for a short-term renewal. Landlords are often willing to work with existing tenants who are struggling financially. Such assistance may come in the form of rent abatements or concessions, extensions of term with delayed rent increases and contraction of space. However, more experienced landlords are asking for a business plan from the tenant before agreeing to such concessions. These landlords are seeking to independently evaluate whether the concession will be enough for the tenant to succeed or whether this is a temporary bandaid which will be insufficient for the tenant to ultimately recover. In addition, larger property owners still continue to have a position of strength in the market and are reluctant to yield to pressures from tenants who still have remaining term and have a healthy business, but are simply trying to take advantage of current market conditions.

Tenants appear to be renewing their leases early, often in exchange for reduced rent. As a quid pro quo, landlords receive more term on an existing lease and can show lenders continued occupancy of their buildings. Large companies that are financially stable are able to predict their

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real estate needs into the future and are not likely to be affected by short-term market fluctuations. This allows those companies to approach landlords and take advantage of lower rents by agreeing to extend the term of their leases. However, smaller companies, unsure of their place in the market, may opt for short-term extensions. Although they may not benefit as dramatically from reduced rental rates, such short-term extensions make good business sense for both landlords and tenants. Short-term extensions allow smaller tenants to maintain flexibility in the event they need to downsize or expand. Short-term extensions are also beneficial for landlords as they allow landlords to continue to maintain their obligations while repositioning their buildings in the marketplace. However, landlords who are reluctant or unable to reduce rents have turned to other forms of concessions.

When reduced rents are not enough to entice a new tenant to relocate or an existing tenant to negotiate an extended term, or if a rent concession is not part of the business deal, landlords are turning to tenant improvement allowances as an inducement. Unfortunately, however, only landlords with liquidity can offer such concessions. Tenants are typically reluctant to spend a lot of capital to build-out new spaces or to renovate existing spaces, even if their business is healthy. Improvement allowances are becoming much more important as tenants are hesitant to go out-of-pocket for their build-out or renovation. However, tenants who are wary about a landlord's ability to meet construction obligations or pay tenant improvement allowances are now seeking security to ensure performance. Such security typically comes in the form of a parent guaranty, letter of credit for the benefit of the tenant or a performance bond. Traditionally, landlords have required such security from tenants; however, it appears the tables may have turned. In fact, tenants seem to be taking a much greater interest in the financial stability of the landlords and have sought to obtain comfort that the landlord has the financial ability to meet its obligations under the lease.

With tenants seemingly in control, one would think that tenants would seek to lock in landlords for a longer term. However, that does not appear to be the case. Given the volatility of the market and the inability of many tenants to predict their futures, most are reluctant to commit to a longer term. As the economy improves, and tenants feel more confident about their long-term goals, lease terms may get longer. The interesting fact is that as the economy improves and tenants become more confident, lease rates are likely to rebound. One would think that it makes prudent business sense for a tenant, at a minimum, to negotiate multiple options and/or termination rights if it is reluctant to be tied to a lengthy initial term.

Longer free-rent periods are becoming more common as landlords struggle to keep their buildings occupied. Free-rent periods in excess of six months, and as long as nine months to a year for larger tenants, are becoming "the norm." However, the longer the free-rent period, the longer the landlord must incur carrying costs for the building without the benefit of rental income. If the "free-rent" period includes not only fixed rent, but also operating expenses and real estate taxes, then the landlord must also pay out-of-pocket because it is not getting reimbursed for those expenses. However, in most cases, the tenant remains responsible for electricity consumption and other utilities not otherwise part of operating expenses.

The extent of concessions a landlord can give is impacted significantly by its liquidity. Landlords whose buildings are free of debt have more flexibility to reduce rents and grant concessions. Conversely, landlords who are highly leveraged, or whose buildings are subject to mortgages, often do not have the ability to grant such concessions without lender approval. Essentially, the lender has become the landlord's partner in negotiations and that "partnership" affects the ability of the landlord to freely negotiate a lease. Loan covenants will often require lender approval for leases which do not meet rigid criteria. These lender requirements may slow the process and can impact the terms of a deal.

In addition to monetary concessions, tenants are taking a closer look at lease provisions, in many cases to ensure an exit strategy if required to accommodate changes in their business. While many smaller tenants typically had little leverage to negotiate assignment and sublet clauses, contraction and early termination provisions, they seem to be using today's market as an opportunity to position themselves better in the event of future economic instability. More flexibility to assign the lease or sublet space is critical to a tenant's exit strategy. Ensuring that the landlord must be reasonable in its consent to an assignment or sublet and negotiating specific parameters when no landlord consent is required can be an extremely beneficial tool in the tenant's arsenal. Also, the right to "share" space with others without the landlord's consent is important, as it allows a tenant to juggle its space to accommodate their changing financial position. When a tenant has excess space for a short term, it is much more beneficial to "share" that space on a temporary basis than to relinquish the space to the landlord because the tenant can continue to control such space. Tenants should consider negotiating for the right to add temporary signage, obtain entry and access cards, and share parking to accommodate these types of arrangements.

At present, it looks like it's a tenant's market, with landlords being forced to be creative in structuring deals in an effort to keep their buildings occupied. As the economy improves and businesses become healthier, the pendulum may swing back more in landlords' favor, but it is unlikely that we will ever see the real estate market like the early years of the last decade. ■