What the Sale of an Office Building Means to Tenants

By Will Tober | Hughes Marino Blog

Over the past year, office buildings in the airport area of Orange County—inclusive of Newport Beach, Costa Mesa, south Santa Ana, and north Irvine—have sold at a remarkably high rate. In total, we have seen 29 investment properties change hands since July 2016 and dozens of others have been put on the market for sale, but removed when owners could not achieve their desired prices. In fact, there are currently 12 high-profile office buildings for sale right now. With those numbers in mind, there is a good chance that if you are an office tenant in Orange County's Airport Area submarket, you have already been or could be affected by these transactions—but how?

Most office tenants pay what is called a "full service gross" rental rate. The per square foot rental rate accounts for all of the building's taxes, insurance, utilities, and other expenses associated with ownership. However, after the first year of the lease, referred to as the "base year," tenants are responsible for paying their proportionate share of the increases in those building expenses. For example, if your building's expenses total $10 per square foot in 2017 and increase 4% to $10.40 per square foot in 2018, if you have a 2017 base year your all-in rent payment will go up $0.40 per square foot for the year or about $0.03 per square foot per month. While these numbers might sound digestible, there are three significant ways a sale of a building could drastically impact what tenants are obligated to pay in rent.

Tax Exposure

When buildings sell, taxes almost always increase. It makes sense because in every commercial real estate sale the seller is going to look for a return on their investment requiring the buyer to purchase the property for a higher price than it was originally purchased. However, because the commercial real estate market is likely to have outpaced the annual tax increases associated with ownership, which is capped at 2% per year based on California's Prop 13 measure, the buyer will need to account for some level of tax exposure at the property. The level of exposure depends on the building's current assessments and the price of the purchase. In today's market, it is not uncommon for taxes to double in transfers of office properties in high demand, and all of the

increased tax expense can often be passed onto unsuspecting tenants.

Unless specific protections exist in a lease preventing landlords from passing through such expenses, tenants are the ones forced to cover the new tax bill. To add some specifics, let's say you are a tenant occupying a building that was assessed for $200 per square foot in 2016. Now let's assume the building sells for $400 per square foot in 2017. Assuming property tax is 1.1% of the total building value, we can estimate that in 2017 you will be on the hook for an operating expense increase of $2.20 per square foot per year or $0.18 per square foot per month, just from taxes. In other words, a lot of money.

Capital Expenditures

Many office landlords purchase property with "value add" potential. The idea is to improve some of the building's common areas (i.e. lobby, restrooms, elevators, corridors, etc.) or add additional amenities (i.e. gym, conference center, restaurant, outdoor activities, etc.) in order to justify higher rents from existing and future tenants. Landlords typically look to amortize these expenses over the shortest period possible so even if you're locked into a long-term lease, you could still be stuck with the bill.

Continuing from our last example, let's say after purchasing the building the new landlord spends $10 per square foot on building improvements and amortizes the expenses over an aggressive 5-year period. As a tenant, if you do not have capital exclusions in your lease, you would be charged $2.00 per square foot per year or about $0.17 per square foot per month.

Higher Rents

In some cases, buyers will purchase office buildings simply because they see an opportunity to raise rents to a "market level" without doing anything material to the property. For tenants this practice can be especially frustrating because nothing about the quality of the building has changed and yet the price required to lease their space can go up significantly.

So What Can You Do?

In today's market conditions with low supply and plenty of demand, landlords are becoming increasingly stubborn and will very rarely approve property tax protection provisions in the lease. As a result, it is important for tenants to make sure that at a minimum they are aware of the possible tax exposure that exists at the subject property prior to singing a lease. Then, during their tenancy, make sure that the expenses are calculated correctly and they are not being overcharged.

Landlords are a little less resistant to capital exclusions so it is important for your representative to fight for specific language in the lease delineating what does and does not constitute as capital and prohibiting the landlord from passing those costs through to the tenant.

With prevention in mind, it is crucial for tenants to work with a sophisticated commercial real estate expert to negotiate their leases. At Hughes Marino, our brokers, transactional real estate attorneys, construction project managers, and lease audit experts work together as a team to identify and address possible areas of exposure within the lease document to make sure tenants are protected as much as possible in every foreseeable scenario. □

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