

The psychology of lease negotiations

How to avoid arbitrary landlord markups **Interviewed by Paul R. Harvey**

Business leases are one of the most important contracts a company will sign. They set out the obligations and rights that will govern tenancy for a substantial time period.

A poorly negotiated lease may result in inconvenience, financial hardship and a disruption of your business. At worst, you could be held captive by a lease if you haven't carefully negotiated every facet of your tenancy, starting with the rate calculation.

"When shopping for office space and the landlord tells you he is asking \$4 per square foot for the space — after you recover — you feel pretty good when the rate ends up being settled at \$3.20 per square foot," says Jason Hughes of Irving Hughes in San Diego. "It's not every day that you can negotiate a 20 percent savings, so you may feel satisfied with the final number. But what about those 'something extra' costs that surface later?"

Smart Business spoke with Hughes about the psychology of landlord negotiations and the importance of professional representation when hammering out a business lease.

How have lease negotiations tipped in favor of landlords?

Five years ago, a landlord hoped to rent out his building for \$2 per square foot — and would have given a tenant six months of free rent and a lot of money to improve the space — yet now that same landlord wants \$3.50 per square foot with no free rent and half of the improvement money. The economics are nearly three times as good for the landlord, or one-third as good for the tenant.

Where does the psychology come into play?

It can be mentally satisfying when you buy something at a deep discount. Getting a deal is one of the pleasures in life. But some landlord markups are done with the sole intention of ending up at the 'discounted' rent price. Should that make you feel good?

Let's say the landlord is asking \$4 per



Jason Hughes
Principal
Irving Hughes

square foot for a space and settles at \$3.20 per square foot. Do you feel less taken? Or think of it another way: Would you feel better if most of the other properties nearby were asking for the same rate?

Doing business with respectable people who are problem solvers rather than problem makers is worth a premium. But what if you're paying premium for a problem maker who also provides poor property management and packs operating expense pass-throughs to their tenants with season passes to the Padres and Chargers as well as cases of wine and Cuban cigars?

What is the basis for the landlords' rent calculations?

While most people understand inflation, they cannot comprehend the annual inflation levels that commercial property owners incorporate into their rental increases. The U.S. inflation for the last 10 years has averaged less than 3 percent compounded, yet commercial owners have increased rents closer to 15 percent compounded per year.

These extravagant inflation averages make sense to landlords because their math has been reverse-engineered. The landlords pay whatever they need to in

order to secure the purchase of the property, then they look back into the rental rates required in order to support the purchase price. Supply and demand, positive or negative net absorption, job gains or losses — those notions don't have one iota of influence over this rent calculation. These landlords are operating in a vacuum, so why should they be concerned about worldly issues like employment data?

How can a tenant combat this tilted playing field?

The negotiations favor the house or — in this case — the building and its owner. Not unlike Las Vegas, the house wins far more than it loses.

It's very important for tenants to play the game with all of the advantages available. This is where tenant representatives are invaluable. While they may not have all of the aces up their sleeve, they are able to see the cards being held by the landlord.

For example, regardless of how much a landlord is asking in rent, it is important to know how long the space in question has been vacant. Additionally, is the building well run, and will the tenant actually enjoy being in the building in several years? Or worse yet, does the landlord in question nickel-and-dime tenants to death in order to work his yield?

The way to combat this growing problem called 'arbitrary landlord markups' is to be represented by someone smarter, better educated and craftier than the landlords. Office leases are labyrinths of staggering complexity, requiring an expert advocate to protect tenants from being skewered with myriad hidden costs. Tenants often don't even know the questions to ask, much less the answers. They need competent help.

JASON HUGHES is a principal at Irving Hughes Inc., in San Diego. Reach him at jasonh@irvinghughes.com or (619) 238-4393.

Insights **Real Estate** is brought to you by Irving Hughes