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Do's and Don'ts For Commercial Tenants in This Soft Market

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Today's commercial real estate market is softer than it's been in 15 years, creating a fantastic opportunity for commercial real estate tenants looking to expand, relocate or renew leases. So how do executives from the smallest business owner to the largest head of corporate real estate take advantage of today's market conditions? I still feel strongly that the market is hitting bottom in 2010. So what does a management team member need to do today to take maximum advantage of this opportunity?

Do sign a longer term lease if it aligns with your business visibility. This is the time to lock in long-term low costs, and you get more concessions of free rent, moving allowances and tenant improvements for the longer lease that you sign. In past business climates, companies did not want to sign long leases as they feared they might need expansion space during the lease term, and didn't want to be in a situation where they could not get it. Given that availability rates for office, wet lab and industrial space range from 20 to 30 percent in virtually every submarket, and that there is 50,000,000 square feet of space available across combined office, flex and industrial space in San Diego County, no business owner needs to fear the lack of expansion alternatives for many years to come. Business owners also used to fear long-term leases, as such a lease could limit flexibility in the event of a merger or acquisition. With today's weak M&A climate, most business owners aren't worried about this happening, and find that the acquiring company generally keeps a material presence of the company post-acquisition.

Don't rush out and buy a building. Purchase prices for commercial real estate have not yet come down as dramatically as the deep depression of rents. Rents are down 35 percent, but building owners aren't willing, or aren't forced yet, to take the write-offs to sell real estate at the required discounts to match the softness of the leasing market. Plus, when a company buys a building, they don't get any free rent, and have to pay all of the improvements (which a landlord normally funds in a lease), pay all of the operating expenses, and now are in the management and leasing business. The profile of a company that buys real estate is typically either a large company with mission critical operations at the site (think semiconductor or pharmaceutical manufacturing, chemicals with specialized processes, data centers), or a closely-held and stable private company that anticipates owning the business and building for at least 10 years. We have represented many tenants in buying their own buildings when the price is right and the investment horizon aligns with the business plan, but for most businesses today, the benefits of lower cost and flexibility makes leasing the smarter choice.

All things being equal, do pick the highest quality landlord. The Irvine Co. has done more for UTC than any building owner in UTC in the last 20 years. While The Irvine Co. bought its UTC buildings at the top of the market, it has since put millions of dollars of its own money into landscaping, parking, lighting, signage and replacement of the restrooms and common areas. Kilroy Realty is right there, too, having built most of the buildings that it owns, and focusing on quality of management and operations. Professional landlords have a different commitment to the real estate than most "mom and pops," and institutional owners can properly manage the building and fund necessary tenant improvements and occasional capital upgrades. Your choice of landlord matters, as you are going to show up to work at that building every day relying on the building owner to perform, and there is a wide variety of quality in the market among owners.

Flexibility in a lease is critical, and do ask for it. In long-term leases, we are often getting the right to terminate. We can also negotiate expansion options for a limited period of time at the same terms and conditions as the original lease, and thereafter rights of first refusal or first rights of offer to lease space that might come vacant for expansion during the term. For a tenant that is large enough, and creates the right leverage, there might even be the ability to negotiate a right to give just a portion of the space back in the future should the business take an unfortunate turn. Most tenants think about a lease as a commitment that is frozen in time, but with the right process of creating leverage and asking at the opening round of negotiations for critical flexibilities, a lease can become a more organic and flexible asset to the company.

Don't go it alone. Professional landlords, and their equally savvy promoting listing brokers, will do a great job of making tenants feel appreciated whenever their lease is nearing its expiration. Of course, they should have been treating you like the customer all along, but now that your lease is "at risk" they will reach out and likely offer a token discount in view of the existing "relationship." Unfortunately, that relationship is generally one-sided. The landlords and their brokers know the market, and can quickly make the tenant feel great with a 15 percent rent reduction in a lease renewal, when in fact that same renewal should be done at a 25 percent rent reduction with more free rent, more tenant improvements, a new base year and renewed signage, parking and expansion rights. The landlord and their broker also know when the tenant seeking a renewal isn't really in the market, when a tenant is acting captive and when they are not. Your attorney isn't going to help either, as attorneys don't go to the market to identify, qualify and negotiate competitive sites. Engage a real estate professional that personally knows your industry and submarket, someone that is actively involved in comparable transactions, and ideally someone that represents only tenants and never landlords.

To keep abreast of San Diego's most current trends in commercial real estate, join our LinkedIn.com "San Diego Commercial Real Estate" group, and look for regular postings there.

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