



# CONSTRUCTION

## NAILING THE LEASE

BY: JACK GARSON

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*Tenants enjoying the ride*

Here we go again. When the stock market began tumbling in the spring of 2000, people renewed their on-again off-again love affair with real estate. Soon, we all saw the cranes and “Coming Soon” signs, slick ads and brochures, and dump trucks and orange barrels blocking our roads.

Banks sprayed their money at developers, like a crazy-hose gone wild with indiscriminate lending. Speculators switched from day-trading stocks to flipping pre-construction purchase agreements.

You should have known it was over when your taxi driver told you about his new condo project.

Well, once again, our renewed romance with real estate has come to a hand-wringing, remorseful end. We don’t yet have men with sandwich board signs selling condos on the boardwalk of Ocean City, like we did in the 70s. But the passion is gone and we are now looking at another downturn.

In commercial real estate, the overbuilding was much less dramatic, but easy money fueled massive price inflation. From 2001 to 2006, prices increased 50% or more. As prices rose, owners sold. To avoid taxes, sellers bought new properties in like-kind exchanges, further fueling demand, which grew even

more frenzied. Choice properties doubled or tripled in value.

But, as the subprime losses hit, lenders grew cautious and, in some cases, stopped lending altogether. Without that pool of funding, demand dried up. Commercial real estate prices have fallen 10-20% in just the last two years.

There are some winners. Any buyer with cash or a good source of loans is in a strong position to negotiate good buys. Notably, creditworthy commercial tenants are also back in the driver’s seat.

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Only a few years ago, commercial rents were soaring and tenants got take-it-or-leave-it deals from landlords. With little new construction and many businesses booming, suburban office rents that had been in the mid-\$20s per foot shot up to the low \$30s. Choice suburban retail rents went from the \$30s to the \$40s. In high-demand urban areas, office rents climbed \$10-20 per foot, into the \$50-60/foot range, with similar in-



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creases for premiere retail locations.

Leases grew from tyrannical 40-50 page treatises memorializing landlords’ superior bargaining power to 60+ pages Alice-in-Wonderland tomes where landlords could machine-gun your premises and then charge you a fee for supervising the repairs.

Ah, what a difference a recession makes.

- A prominent local landlord has scrapped its onerous form lease for a shorter, even-handed lease in which it volunteers to be “reasonable.”
- Tenants seeking 5,000 or 10,000 square feet of office space are once again getting red carpet treatment from landlords. If your financial statement is decent, you command attention, numerous alternatives, and good economic and legal terms.
- Commercial rents are flattening and even falling back to earth, even though residential real estate

is in a free-fall and the February uptick in homes sales was a dead-cat bounce. While the priciest properties are reducing rental rates, most landlords are just holding off on further increases and offering free rent and generous build out allowances.

- Landlords are finding themselves with more defaulting tenants, although not nearly as many as plagued landlords in the early 90s. In the office market, the first wave of victims was closely tied to residential real estate and financial services, but the bad times are poised to spread. Likewise, retailers continue to suffer and are likely to enter into bankruptcy and abandon more leases.

Where do we go from here? Expect further rent declines, more business failures, and an increase in spaces available for lease. The bottom should hit in 2009 or 2010, followed by a slow climb. In the meantime, tenants should consider the following:

- Shop aggressively for new space. Having alternatives is the key to negotiating the best deal.
- Start early. For a lease of any significance, start your search one year in advance of anticipated move-in. Don't let your existing landlord stall and wait until you have no choice but to renew in your current premises. Seek out new premises and let your landlord know.
- Get a great broker to assist with your search. They know far more about the market that you can learn and can guide you to the best deal.
- Tenants should also seek to lock in today's more moderate rents in long term leases, preferably with options that also lock in fixed rents. Consider expansion needs and try to obtain future rights to adjacent space.

Landlords should also observe a number of precautions:

- Scrutinize the financial statements of prospective tenants. Avoid letting momentum carry you into a bad deal and don't even send out a lease unless you have approved the prospect's financials.
- Don't stop looking for a new tenant just because you start negotiating with one prospect—unless you both agree to a limited period of exclusive negotiations. Your prospect's fear of losing the space to another tenant can help limit excessive requests.
- Switch from fixed annual rent increases to CPI-based rent increases. For many years, fixed increases have beaten CPI. But nothing lasts forever and inflation is back.
- Take a new look at your lease forms. Too many leases contain draconian remedies that alienate tenants and are ultimately unenforceable. Case in point, impose a daily charge for minor violations rather than trying to terminate the lease.
- Act quickly when tenants fail to pay the rent. You should file suit the instant a tenant is late with two consecutive months of rent. Either the tenant will learn you are not a bank or you will be rid of a bad tenant.
- Where it is appropriate to restructure a struggling tenant's rent, make sure to improve your future position. For example, add a



guaranty if you are deferring rent.

Even though at times the real estate market feels like a rocket ship, it is really a roller coaster ride. We just finished a long climb of higher rents and shrinking availability. Now we are riding back down, a fall that will provide scary challenges for some and exhilarating opportunities for others.

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