PLANNING FOR THE FUTURE: THE VALUE OF YOUR LEASE

By Lloyd C. Birnbaum, Lauletta Birnbaum, LLC   MAY 30, 2014

Typically, commercial leases run anywhere from 3 to 10 years and the term is usually negotiable with the landlord. Not very long ago, the reality of increasing costs of operating a building was made up by increasing the rent every time a new tenant moved in or when a lease was renewed. Now, however, the costs of operating real estate are so unpredictable, most landlords feel they need protection in the form of escalation clauses. It has become customary in commercial real estate leases to have rental rates increase over the term of the lease. Increases take the form of fixed rent steps (i.e., $.50/sf annual increases) or percentage increases (i.e., 3% annual increases). These increases may seem nominal but over a 10 year term they can add up. This is especially true with annual percentage increases due to the compounding effect. Assuming a lease has 3% annual increases, by the 10th year of the term, rent would be more than 130% of the first year's rent. This can be significant in a flat or down market.

An alternative might be to negotiate a shorter initial term of 3 or 5 years with options to renew at fixed rental rate increases for a total term of 10 years. If the market has experienced increasing rents during the initial term then the tenant can lock in with the 3% annual bumps for the renewal term. However, if market rents have stayed relatively flat or decreased then the opportunity exists to renegotiate the rental rates when the lease comes up for renewal. The pitfall of this approach is that if the initial term isn't long enough, the landlord might not be willing to offer a meaningful tenant improvement allowance. This is an extremely important factor that cannot be overlooked.

There are two reasons landlords typically cite for annual rent increases. First, they are justified as hedges against inflation. They are intended to preserve the net effective rents on an inflation adjusted basis. The second reason is to create asset appreciation. As commercial properties are valued based on cap rates applied to net operating income, by growing rent over time, the asset will theoretically appreciate. The problem with these two rationales is that they don't always prove to be true.

Increases to adjust for inflation make sense assuming that the true value (in this case, as measured by market demand) is increasing over time. However, the fact is that rental rates in our market have not kept up with inflation over time because demand for space has not outstripped supply enough to drive up rents. Consequently, leases with annual rent escalations often reflect economics which are higher than the current "market" for that building at some point in the lease term. This helps make the case for shorter initial terms with several renewal options. However, in shorter term leases, landlords usually won't be willing to offer concessions such as free rent and large enough fit-out allowances.

The rationale of creating building appreciation also has its faults. If leases have rental rates that are higher than the current market rent warranted by a particular building, lenders and purchasers for that building will probably "mark the rents to market" when underwriting a loan or purchase. They might very well value

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the building based on current market rents rather than the rents stated in the leases. At a minimum, they would discount the rents stated in the leases if they are over market. So, while increasing rents will increase the landlord's bottom line profits in the short term, the rising rental rates in leases might not necessarily create future appreciation for the building if the market hasn't kept pace with the contracted rental rate.

What does all of this mean for tenants? Tenants coming off of long term leases with rent escalation clauses might find opportunities to reduce rental costs when it comes time to renew and, in some cases, may even be able to upgrade to a better building with a fit-out allowance without increasing their net rent expense. Though the analysis will ultimately depend on the strength of the particular building and the tenant's alternatives, tenants should carefully evaluate how their rent expense compares to current market opportunities and conditions. Maybe they can do better with a shorter term and renewal options. Maybe a more significant fit-out allowance better suits their needs than being concerned about being locked into long term rent escalations. At a minimum, tenants should take a long, hard look at proposed rent escalations before agreeing to them and always consult with a real estate service provider.

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