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TENANT NEWS

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Market Buzz

Market indicators continue to favor tenants. Average asking rent for the Las Vegas office market fell in Q3 to $2.32/SF/Month (Full Service Gross), a $0.04/sf drop from Q2 and a $0.12 drop from a year ago. The steady decline in pricing that began in 2007 Q4 is good news for tenants, but how long will it continue?

Given market conditions and the scarcity of debt, the supply of office space won't change dramatically in the foreseeable future. Before new development makes economic sense, the market will pass through two phases that are expected to last a total of at least 5 years; absorption of standing inventory and completion of partially constructed projects.

In the near term, the more important (and less predictable) driver of price is demand. Absorption, the measure of the office demand, has been shrinking by an average of 250,000 sf per quarter over the past 4 quarters. In Q3 it fell by just 39,000 sf. If that trend continues and absorption becomes neutral or slightly positive, pricing will begin to flatten out in 2010.

The best predictor of demand for office space is growth in the employment base. Once hiring turns positive and the employment base begins to increase, expect office leasing rates to increase within 6-12 months.

From a long term perspective (greater than 5 years), current market conditions are likely to result in an exaggerated market cycle. Typically, the increase in supply (new construction) would vary based on the economic outlook. However, frozen debt markets combined with a recession have brought development to a complete standstill. When demand increases to the point where new development makes sense again, there will be a 2 year lag between concept and occupancy (sometimes referred to as "Development Lag"). During this period, there will be no new supply to cater to rising demand, resulting in dramatic price increases.

Price increases are probably years away but they are as inevitable as the market cycle. The tenants that lock in long term rates in today's favorable market conditions will be protected from the volatility of the market.

Should We Buy an REO?

Tenants entering the market can lock in today's low leasing rates for several years. Landlords will resist locking in low rates for 5-10 years because they assume that the market will return to their favor and they want to benefit from rate increases. An interesting opportunity in today's market is to lock in a low cost of occupancy…forever.

Flexibility, minimal outlay of capital, and the opportunity to occupy otherwise unaffordable real estate, are reasons why tenants lease office space. However, if a business enjoys stable income and its long term office space needs are unlikely to change, purchasing may be a preferable option, particularly if the ownership and management are local.

Transaction volume for office buildings has slowed to a trickle; however banks will increase the number of short sales and REO ("Real Estate Owned") sales over the next 12-18 months. Prices for finished office space have already dropped below $200/sf and the trend is likely to continue.

A business should approach the purchase of real estate from an expense management point of view more so than as an investment. If the debt service and amortized loan deposit are less than base rent and lease deposit (if any), purchasing becomes attractive. The leasing market will continue to cycle between tenants and landlords, but a purchase financed with a low, fixed rate loan will allow a business to enjoy the benefits of today's market for the full term of the loan.

A purchase is a long term commitment (highly illiquid in today's market) and consulting with an accountant and tenant broker is advisable. If your business offers the predictable stability suitable for ownership, keep an eye on pricing. As the cost of ownership drops down to (or below) today's low leasing rates, the numbers become compelling.

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Subleasing is Hot!

Subleasing activity is up dramatically over the past 12 months. Why the sudden increase and is it right for you?

It's not surprising that the supply of sublease space has increased; it's common to include it as part of a downsizing strategy. At the same time, the demand for sublease space has also increased as companies seek short term solutions. The result is that landlords watch from the sidelines as tenants create their own secondary market.

If you're looking for office space, subleasing offers the following *advantages*:

Discounted Rate: Most sublandlords are motivated to attract a subtenant as quickly as possible and will therefore discount the lease rate below the direct lease rate. The discount can be substantial.

Free (or discounted) Furniture: To save the time and expense of moving furniture, many sublandlords leave their furniture in the premises for the subtenant's use. To attract subtenants, the furniture is usually offered at no charge or a substantial discount to replacement cost.

Minimal Commitment: Sublease terms typically average less than direct lease terms and are often less than 3 years. During periods of uncertainty, a short term commitment can be attractive.

The *disadvantages* of subleasing office space are less obvious:

Lack of Tenant Improvement Capital: Sublandlords' goal is loss mitigation, not profit. Therefore, they're reluctant to spend money on tenant improvements as a landlord would. The landlord won't invest in a subtenant's tenant improvements as they don't receive any additional income for a sublease transaction. This is why most sublease space is offered "as-is".

Restricted Lease Negotiations: Although sublease terms are negotiable, landlords generally won't agree to changes in the master lease. This means that the subtenant must accept the terms of the master lease as previously negotiated by the sublandlord.

Lost Options/Rights: Some of the rights or options available to direct tenants are not available to subtenants. Common examples include rights of expansion, contraction and renewal.

Potential Rent Increase: In the absence of a right to renew, at the end of the sublease term, there are no restrictions on a landlord's ability to increase the rent or replace the subtenant (with a tenant willing to pay a higher rate).

Risk of Sublandlord Default: If the sublandlord defaults on the master lease due to bankruptcy, for example, the subtenant's security deposit, rent payment(s) and rights to the space may be at risk. There are written agreements and procedures that can be drafted with the help of your tenant broker and attorney to minimize this risk.

Subleases can be a cost effective solution, especially for a short term requirement. If restrictions and risks are understood and acceptable, a subtenant can potentially enjoy quality office space at some of the lowest rates in the market.

Language of Leasing: *Option to Renew*

An Option to Renew is one of the most important terms for a tenant to negotiate into their lease. As with most options, it benefits the tenant, not the landlord. Options to Renew are typically available to all but the smallest of tenants and usually mirror the primary lease term in duration. The two key elements of an Option to Renew are:

1. **Ability to Retain Rights to the Premises Beyond Lease Expiration:**
   Regardless of whether landlord and tenant can agree on terms, the renewal option grants the tenant a preferential opportunity to enter negotiations (and potentially avoid losing the premises to another tenant).

2. **Pre-negotiation of Renewal Terms:**
   Landlords will resist this element of the Renewal Option as it limits their ability to benefit from market conditions. The most common format is "Fair Market Value", however, tenants with leverage may be able to limit their exposure by negotiating renewal rates in advance or caps on increases.

If the terms of a Renewal Option are less favorable to the tenant than market conditions at the time of renewal, the tenant always retains the opportunity to simply negotiate from scratch.

Timing is Everything – *How far ahead should we look for new office space?*

Each year, we encounter several tenants looking for new office space despite their desire to stay in their previous location. The reason they couldn't remain in their previous space was that they didn't address their real estate decision making process in a timely fashion (or they didn't negotiate renewal options in their lease). Consequently, their landlord found a new tenant to replace them prior to lease expiration.

Tenants often deal with this situation temporarily by "holding over". This means that they remain in the premises beyond their lease expiration date, exposing them in two areas. Firstly, the lease will usually provide for a specified monthly holdover penalty, payable to the landlord. Secondly, if the landlord doesn't permit the tenant to remain beyond lease expiration they become a "tenant at sufferance" and therefore the potential subject of a lawsuit.

The scenario is easily avoided by planning ahead. As the amount of time remaining on a lease term diminishes, the negotiating leverage between tenant and landlord gradually shifts. For example, if a tenant begins negotiating with a landlord 3 weeks before their lease expires, the landlord knows that they won't be competing against space that requires tenant improvements, thus increasing the landlord's leverage.

Ideal timelines vary with size and the complexity of the tenant improvements. Here are some guidelines:

Less than 5,000 sf:

Enter the market 6 months prior to occupancy. This allows time for tenant improvements, including construction permits for minor work. At this size, building from shell condition rarely makes sense as there are no economies of scale, resulting in a high cost per square foot. However, movement of walls and plumbing can be completed comfortably within this time frame.

5,000 – 10,000 sf:

Enter the market 8 months prior to occupancy.

The additional 2 months will allow time for construction from shell, if necessary. Also, negotiations at this size may take a few more weeks than the smallest size.

10,000 – 25,000 sf:

Enter the market 12 months prior to occupancy.

At this size, negotiations will take more time and considerable tenant improvements are likely. Also, the supply of available blocks of space in this size range is likely to be less than for the smaller sizes. Smaller spaces may need to be assembled to create new premises, adding to the complexity of the transaction.

Greater than 25,000 sf:

Enter the market 18 – 30 months prior to occupancy.

This size exceeds the typical office floor plate and multi-floor transactions are inherently more complex as they usually require assemblage of several premises. The supply of blocks of space in this size range is limited and landlords are willing to commit to transactions of this size further in advance. If the requirement cannot be met with standing inventory, a 30 month timeline allows for the negotiation and construction of a build-to-suit solution.

Note that these timelines assume that the tenant enters the market with a thorough understanding of their office space requirements, and an experienced professional (i.e. a tenant broker) leading the process. Tenants considering a renewal should follow the same timeline to maintain their negotiating position with their existing landlord.

Ryan Martin CCIM, specializes exclusively in representing office tenants. For additional information about current opportunities in the office market, contact Ryan at:
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