BASIC COMMERCIAL LEASING INFO AND STRATEGY

This newsletter is made up of several short articles on leasing commercial spaces. From hiring project management services to office building classifications and breaking your lease, these snippets are like healthy little snacks. Except for the first one, which addresses the perfect lease, they are small—and it's hard to read just one!

Strategic Corporate Leasing

Too often, tenants and their brokers gauge the success of a transaction primarily by the difference between the current market rent and the negotiated lease rate. However, by focusing solely on rent, a corporate tenant could actually stand to lose much more than the negotiated savings, ultimately losing considerable money on total occupancy costs.

Among the scores of pages that make up a typical lease document, there are at least 100 negotiable aspects that can lead to significant savings for tenants. These range from smaller items like monthly parking fees and rooftop-access rights to more substantial matters such as sublease rights and termination options. To maximize savings, tenants must negotiate all facets related to their company's circumstances. The following factors are crucial to the success of any transaction:

* *Accuracy of space needs assessment. Is* the assessment of your space needs accurate? For instance, are you sure that you need 30,000 square feet over the five-year term, or could your space be restacked more efficiently to utilize only 28,000 or even 25,000 feet? What about the potential for expansion or contraction over the lease term?

* *Base-building conditions.* Have you identified the deficiencies of base-building conditions when comparing alternatives? If the owner is not held responsible, what is the tenant's cost to upgrade mechanical, electrical, or fire/life safety systems? A seemingly fair comparison of two buildings with the same quoted rent is not truly comparable if one requires additional expense for base-building upgrades.

* *Tenant improvements. How* much of a tenant improvement allowance will you need to build out the space to fit your needs, accounting for all non-construction related costs? Knowing this is essential to accurately negotiating tenant improvement dollars. Is the tenant improvement allowance being offered based on usable or rentable square feet? If based on rentable square feet, you will have approximately 12-18% more funds at your disposal. If you are using project management services, you can also negotiate the building owner's project administration fees.

* *Realistic occupancy date.* When can you take occupancy? This estimate must account for all factors, including scheduling of design, permitting, construction, furniture delivery, technology installation and all other relevant vendors' work.

The best course of action for addressing these considerations is to enlist the appropriate expertise from the beginning. Typically, when a company conducts a real estate transaction, project management is not considered until the ink is dry on the lease documents. Fortunately, more corporate tenants realize the value of bringing project managers into the initial phase of the process—the strategic phase—to assist in creating a stable foundation for cost savings throughout the transaction and the project.

By identifying both short- and long-term space and infrastructure needs, assessing building deficiencies, establishing a project budget inclusive of technology, furniture and relocation costs, and determining a realistic occupancy date, an integrated team that includes a project manager and a real estate advisor facilitates more aggressive negotiation and avoidance of costly mistakes.

Consider the following scenario: A company has signed the perfect lease. The space is in an ideal location for client visibility, workforce recruitment and current employee commuting. The 45,000-sf lease consists of a competitive rental rate that is $5 per foot below current market rates over a seven-year term, plus three months of free rent. At first glance, this equates to a $1.9 million savings.

However, problems arise when, logistically, the company is unable to meet the scheduled occupancy date. In fact, scheduling delays due to unanticipated permitting back-ups and furniture lead times have pushed occupancy out by at least three months, resulting in a loss of the negotiated free rent and a costly holdover penalty on the current lease. The company's situation only gets worse when it comes to light that it actually needed only 40,000 sf, not the 45,000 committed to in the new lease. And, upon closer review, the Tenant Improvements allowance negotiated at $20 per foot really needed to be $35. Taken as a whole, the perfect lease is not so perfect anymore.

In this example, the inaccuracies and improper planning tally up to major expenses. The 5,000 feet of surplus space at $30 per foot over a seven-year lease term equals nearly $1.1 million. At $15 per sf, the additional out-of-pocket tenant improvement expense comes to $657,000. And the cost of the lost free rent is another $337,500, not to mention the corresponding holdover penalty. That's a total loss of at least $2.1 million - more than eliminating the originally perceived savings.

Bringing project management into the fold before negotiating the lease could have avoided much of this expense as well as the shock associated with the unraveling of the perfect lease. Clearly, this hypothetical, yet plausible, case study illustrates how project

management's up front involvement can not only increase cost-saving opportunities but also help avoid unnecessary expenditures and schedule delays.

Make no mistake, the importance of bringing project management into the due diligence and negotiating phases of the project in no way negates the importance of having an experienced corporate real estate advisor representing the tenant's interests. It is the early integration of project management and transaction services that generates maximum benefits. Combining the pre-planning expertise and management skills of project managers with the market knowledge and negotiating savvy of corporate real estate advisors generates efficiency, continuity and accountability.

From strategic planning and transaction support through project preparation and execution, an integrated- service approach creates increased up front transaction savings, decreases client-time involvement, mitigates risk, produces overall occupancy-cost reduction and delivers functional projects on schedule and within budget.

Office Building Classifications

The classification of office buildings as either A, B or C usually relates to design and functionality, the year of construction and the building's location. Classification differs slightly from city to city, but generally follows a standard pattern:

- Class A Buildings. These buildings sport modern construction with state-of-the-art functionality and architectural design, infrastructure, life safety and mechanical systems. Class A buildings are also located in the most sought-after areas. Not surprisingly, Class A buildings typically command the highest rents, include the best amenities and, consequently, offer the least attractive concession packages for tenants.

- Class B Buildings. These buildings are usually highly functional, well-located facilities more than 10 years old. Class B buildings generally feature a less desirable design and infrastructure than Class A buildings, although a well-located B building can be renovated and reclassified as Class A.

- Class C Buildings. Generally, Class C buildings are more than 25 years old and have not been renovated. C buildings are functionally and architecturally obsolete and are located in less desirable areas. They command the lowest rents and attract the least creditworthy occupants. It is not likely that a C building could be rehabilitated to A status, regardless of its location.

Leases: Alterations and Improvements
Most "form" leases provide that the tenant can't make any alterations or improvements to the premises without the landlord's consent. Those provisions are typically too restrictive and you should attempt to negotiate changes. For example, try to get the right to make

non-structural changes or changes costing less than $2500 without the need to obtain the landlord's consent.

Before you can occupy the space, the premises may need some improvements or alterations to make it appropriate for your business needs. Here are some key questions to ask about the initial tenant improvements and alterations:

- What is the scope of the desired changes?
- What is the cost?
- How much time is needed to complete the improvements?
- What permits or approvals will be necessary?
- Will the landlord contribute to the payment for the improvements?
- Who will own the improvements once the lease is terminated?

Propose a clause stating that you are allowed to remove any trade fixtures and alterations that you pay for, provided that you repair any damages to the premises.

If you anticipate the need to make alterations or improvements in the future, the lease should provide that you may make them with the landlord's consent, but that the consent won't be unreasonably withheld or delayed.

Also, beware of a clause that states that at the end of the lease you have to return the premises in their original condition. Try to negotiate a clause that states the following: The premises will be returned to the Landlord at the end of the tenancy in the same condition as at the beginning of the tenancy, excluding (1) ordinary wear and tear, (2) damage by fire and unavoidable casualty not the fault of the Tenant, and 3) alterations previously approved by the Landlord.

Rent Escalation Provisions
Fixed rent over long term leases is relatively rare, because it is to the advantage of landlords to build in rent escalation provisions.

Sometimes, landlords insist on annual increases based upon the percentage increases in the Consumer Price Index (CPI). If you are confronted with such a request, do two things. First, attempt arrange that the increase does not kick in for at least 2 years. Second, propose a cap on the amount of each year's increase (for example, no more than a 3 percent increase in any year). Here is a sample clause for doing that:

"Any rent increases under this Lease shall commence no earlier than two (2) years after the date of the commencement of this Lease. The maximum amount that the rent may be increased in any one year (starting in the third year of this Lease) shall be three 3% over the beginning base rent under this Lease."

1)

If you have to live with a rent escalation clause, consider a predetermined fixed amount—for example:

- $2,000 a month for the first year
- $2,200 a month for the second year
- $2,400 a month thereafter

Such a provision gives you more predictability in planning your business. Make sure that your business plan projections adequately reflect such increases.

Renewal Options
Because your company's future space needs are uncertain, renewal options for an office lease can be quite helpful. However, some landlords may be reluctant to grant such options, because doing so limits their flexibility to market the space to prospective tenants.

If the landlord is amenable to a renewal option, try to get the option rent at a fixed predetermined price. If you can, avoid the renewal options that are based on "fair market rent." Here are the key issues for renewal options:

- How many option terms can you get?
- How long is each option term?
- What is the rent for the option term?
- How much notice do you have to give in advance to exercise the option? (The shorter, the better.)

Length of Lease
The length of the lease has a significant impact on the rental rate. Landlords typically like longer term leases and are more willing to make concessions for such leases. With a long lease, the landlord enjoys the financial security of a regular rental stream over a number of years. And the landlord can avoid the hassle and expense of re-leasing the space.

>From the tenant's side, a long term lease has both benefits and risks. The benefit is knowing that the premises are available at a predictable cost for the long term. The risk is that the company may outgrow the space, may need less space as its business contracts, or is locked into paying what turns out to be above-market rent if demand for rentals subsequently declines.

If you can get it, the best of all worlds is a shorter term lease with renewal options. You are usually much better off getting a 2-year lease with four 2-year renewal options rather than getting stuck in a 10-year lease.

Regardless of why you want to break your lease — you want to move to another location, you can't afford the rent, the people upstairs are too noisy — you'll want to refer to your contract. Terms in any lease are likely to vary from one county to another, but you can still follow some general rules. Here are a few to consider:

Renegotiate with your landlord If you can't fulfill your terms of the lease, you'll need to try to renegotiate with the landlord. It is, after all, in the landlord's best interest to be paid what is contractually due. However, you might ask the landlord to terminate your tenancy so that you're no longer liable for future fees. Also, you could ask your landlord if you can find a replacement tenant in exchange for a release from your financial obligations. Offering to place an ad in your local newspaper is one way to demonstrate your goodwill.

Get it in writing. If your landlord does agree to release you from your lease, make sure you get this in writing. You'll want to make sure, for instance, that the landlord signs a new lease with the new tenant. Hold on to the paperwork for at least three years. It is advisable to consult with an attorney on this point.

Consider subletting. If your landlord is stubborn and prefers not to renegotiate, consider subletting the space to someone else. Again, make sure you get everything in writing and consult with the landlord so that you know what he or she expects from this new arrangement. Remember, your name will still appear on the contract, so you could be liable.

Open your wallet. If you do break a lease in the middle of the term, be prepared to pay for the remaining payment, or, in lieu of that, a penalty for breaking the lease. Just because you don't want the space anymore doesn't mean that the landlord doesn't want his or her money. Remember, when you signed the lease, you made a promise. This might all sound very simple and obvious, but often even the most well-meaning entrepreneurs forget that their vendors are in business, too.

Conduct some intelligence gathering. Once you inform the landlord that you plan to break the lease, find out what you can about his or her efforts to find a replacement tenant.

Consider the penalties. It may be easy to ignore a piece of paper, but a signed contract is binding. A standard penalty may mean forgoing your security deposit and paying the remainder of the rent owed until the landlord finds a replacement tenant. And don't forget: word travels fast — a bad reference from a landlord or just a disparaging word about your ethics could impact your opportunities for renting new space, especially if you want to relocate nearby.

Invest in some legal advice. It doesn't take long for an attorney to review a lease, so make the wise choice by investing in some legal advice. It could save you a bundle in the long run and you're likely to learn something that you'll be able to use in the future.

Take notes. You may be out several thousands of dollars for breaking a lease. That's the bad news. The good news is that this doesn't have to happen again, especially if you keep good records — a solid chronology of events. For example, if the main reason you're leaving the property is because of space limitations, be particularly cognizant of your square footage needs the next time around. If you missed a specific clause in the leasing contract, one that will heavily impact your wallet, make sure that the next document you sign has been carefully reviewed.