

Corporate Real Estate Commentary

Leasing Strategies in an Opportunity Market: The "Stay-in-Place" Scenario

by Tom Driscoll

Companies with leases expiring in the next 24 months have a "one-time" opportunity to optimize real estate's contribution to business success.

Real estate is a strategic resource because it is almost always a company's second highest operating expense and, along with people and technology, a key factor of production.

Having adequate time to execute a negotiating strategy is important because a landlord must believe that the tenant is actually out in the market looking for space.

While the current economy has negatively impacted most Bay Area businesses, it has for some, created unprecedented opportunities. With millions of square feet of real estate on the market, businesses with leases expiring within the next 24 months, can take advantage of the most tenant-favorable market in history. Companies in this position have a "one-time" opportunity to optimize real estate's contribution to business performance by:

- Significantly reducing real estate costs over the long term,
- Increasing operational flexibility and
- Improving employee productivity through the alignment of real estate use with work processes & structures.

And yet, too many companies fail to take full advantage of these market conditions, missing the opportunity to improve profitability and enhance competitive advantage. Of all the real estate situations we have witnessed in the past few months, it is the company that wishes to "stay-in-place" that most frequently squanders this opportunity. To capitalize on current market conditions, such companies must consider the following five "critical elements" in order to produce the best possible results.

Critical Element One – The renegotiation or renewal of a lease is a critical decision because real estate has a major impact on the achievement of business objectives.

Viewing real estate simply as a place to do business and a cost of doing business is a mistake. In reality, most real estate has strategic implications because it is almost always a company's second highest operating expense and, along with people and technology, a key factor of production. Real estate has the potential to be a contributor to business performance because it has a major impact on three key business drivers, which are:

- Finance – Real estate costs impact cash flow, operating expenses, profitability, financial ratios, liquidity, debt, taxation, financial reporting and more.
- Operational Flexibility and Control – The ability of a company to move expeditiously to expand, contract or take a new product to market is either enhanced or limited by real estate.

- Employee Productivity – Real estate impacts employee productivity in many ways including: promotion of collaboration, privacy and access to resources, the level of employee comfort, health and safety, the ability to recruit and retain employees.

Critical Element Two – The "Stay-in-Place" process should be started early.

There are many reasons an early start is important, including:

- Often, market or business conditions, not a lease expiration date, dictate the best time to renegotiate or renew a lease.
- The renegotiation/renewal process, if managed correctly, takes more time than most tenants realize. Taking advantage of current opportunities requires development of a project plan and a negotiating strategy. Further, the time to renegotiate, review documents and make tenant improvements can take as much as four months or more.
- Having adequate time to execute a negotiating strategy is important because a landlord must believe that a tenant is actually out in the market looking for space. As lease expiration date approaches, a landlord knows that a tenant's ability to occupy alternative space becomes more difficult. This gives the landlord the upper hand in negotiations.

Critical Element Three - A tenant must be represented in the lease renegotiation/renewal process.

There are a number of reasons representation is a critical element. They include:

- For a company wishing to stay in existing space, renewing the lease may not be the only alternative. An experienced tenant representation team can offer alternative financial and legal structures that may be superior to a lease renewal.
- Tenant representation teams that include corporate real estate advisors can ensure, through a project plan, that the final solution not only is cost effective, but also supports operations and is aligned with business objectives.

Commentary

continued

In our experience, a landlord virtually never presents a market-rate deal to a tenant until he/she is convinced that a tenant is really considering relocation.

Understanding a landlord's financial situation, negotiation style and upcoming lease expirations is mandatory.

... represented tenants negotiate leases that are 15% to 20% lower in total, effective cost (including commissions) than tenants unrepresented.

- To have a strong negotiating position, a tenant must have current, accurate, "real" market information. Understanding a landlord's financial situation, upcoming lease expirations and negotiating style also adds to a tenant's negotiating strength. "Real" market information, actual transaction details, current proposals active in the market and financial concessions made by landlords, puts a tenant on a level playing field with a landlord. "Real" market information and information about a landlord's situation is not available to a tenant. It is only available from a competent tenant representation team.
- Most negotiation experts advise to never negotiate "your own deal". This axiom is doubly important when applied to lease negotiations. Landlords salivate at the thought of negotiating directly with a tenant. This has little to do with the intelligence, business acumen or negotiation skills of the tenant. Landlords love to negotiate with a tenant who is not represented because the tenant doesn't have the kind of market information that will let them know when a market-rate transaction has been struck. Also important is the fact that while the landlord may negotiate three or four leases a week as a key business activity, a tenant may negotiate three or four leases in a lifetime.

Critical Element Four- A "Competitive Bid" environment is necessary to successfully negotiate with a landlord.

Ideally, a tenant should be prepared to relocate if a landlord is unwilling to agree to a market-rate transaction and satisfy reasonable tenant requirements. Competition among landlords is the critical factor in executing an effective negotiating strategy to stay-in-place. In our experience, a landlord virtually never presents a market-rate offer to a tenant until convinced that the tenant is really considering relocation. Consequently, this is another area where a tenant representation team is vital. The tenant representative, as a third party, not only creates the competitive environment among landlords, but also gives credibility to the notion that a tenant will relocate. A tenant representation team reinforces the negotiating strategy. We have learned that in most cases, it is only when a tenant representative is involved and the market engaged, that a landlord will agree to a market-rate transaction.

Critical Element Five - A Renegotiation/Renewal Project should be treated as a "new" project.

The work processes and structures that dictate the way a company does business change over time. So the longer a company has occupied a leased space, the more dysfunctional the space. Dysfunctional space contributes to reduced employee productivity and high occupancy costs. This means that even if a company negotiates to stay in existing space, the space should be "new" or "refitted". Refitting may be reflected in the size of the space, the configuration of the space, the finishes in the space, or the IT infrastructure of the space. A lease negotiation to stay-in-place may also be the best time to convince a landlord to upgrade inefficient utility systems for which the tenant pays the cost.

The Bottom Line

In the current market, tenants that represent themselves frequently fail to take full advantage of the most tenant-favorable real estate market in history. Engaging a competent tenant representation team is the only way to ensure that a lease renewal/renegotiation becomes a market-rate deal, improving the tenant's real estate situation for the long term. Our experience and that of our colleagues, indicates that represented tenants negotiate leases that are 15% to 20% lower in total, effective cost (including commissions) than tenants that are not represented.

A qualified tenant representation team:

- Includes a strategic advisor/project planner who is not a broker;
- Employs an explicit, market-tested process,
- Has an outstanding track record and
- Is part of a company that has superior market information because it is involved in a large number of transactions.

Real estate is a strategic resource for virtually every business. All companies should consider how to take advantage of current market conditions to make real estate a major contributor to business success.

Tom Driscoll is a corporate real estate advisor with Client Solutions. He can be reached at (408) 987-4150 or tdriscoll@ccarey.com