

# How Will a Strengthening Economy Affect Corporate Real Estate Markets?

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*“And, the multitudes emerged from the darkness, and saw the light at the end of the tunnel...”* That might be how one could describe the experience of coming out of the economic funk that’s gripped the US for the last few years, with business people finally believing that growth will take hold and continue.

The good news is that corporations are spending again. And, those who haven’t actually cut checks yet, appear to be planning to do so. Houses are still selling fast, albeit at a slightly slower pace. Consumers are still spending away. IPO’s and M&A activity appear to be growing again as well. So, things look rosy, right? Not to everyone.

Recently, we were asked how a strengthening economy could affect corporate real estate markets, when taking into account rising interest rates. The answer is that real estate markets could go in any one of a couple of different directions.

## Increased Economic Demand

Corporate real estate markets around the country, including office, distribution, and other space markets, have already seen the result of a growing economic turnaround. Large amounts of surplus corporate space, earlier the potential threat of a difficult real estate recovery, have been re-let or removed from many markets. In some cases, corporations realized as long ago as 2002 that they might eventually need to grow back into what was then earmarked as surplus, and in many cases pulled that space from the market. Additionally, major distribution markets around the US have experienced strong demand and renewed interest, as have first and many second tier office markets. New leases and lease expansions, while not reaching the superheated pace that we saw just a few years ago are being signed at an increasing rate.

## How Will Landlords React?

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Intuitive landlords will act fast, raising incentive packages to be the first to capture the highest quality companies seeking to acquire space. We have seen this already. In some suburban markets, aggressive landlords are negotiating ten year lease transactions at market rents, including incentives of one year free rent or more, and are providing very large tenant improvement allowances. Once that desirable “first cut” has been achieved, we expect that leading landlords will pull back slightly and offer more traditional leasing terms, seeking to increase their returns on a per transaction basis. Since few new speculative buildings have been constructed in the last few years, increased demand will cause absorption of remaining corporate excess and landlord offered space, causing competition among tenants in markets with fewer quality availabilities. This could bring a rise in rents as early as next year. Along with increased rents would most likely come smaller incentives offered by landlords such as: tenant improvement allowances, free rent, etc. Some landlords, those with long term conservative investment profiles, will seek long term lease transactions to lock in returns, while those who take a more entrepreneurial approach to increasing markets will seek shorter term leases to capture rising rents over time. Eventually, a growing economy will lead to new speculative construction in major markets, with second tier markets following, thereafter.

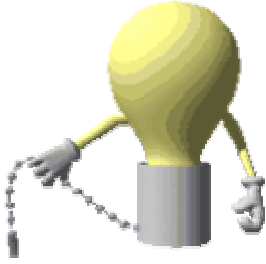
## **Interest Rate Increases**

How will rising interest rates bode for corporate real estate markets? Initially, minimal increases in the prime rate and LIBOR should have little or no major affect. Recent interest rate rises have had little real impact on commercial markets. However, the rule of thumb often quoted is that a two percent swing in interest rates typically affects business decision making. We believe that this rule is true for corporate real estate markets, as well. What could happen? Landlords facing rising debt service costs and increased operating costs might lower leasing incentives and squeeze margins to reduce overall costs and maintain desired returns. As a result, when negotiating lease terms, tenants might be faced with higher rental rates, less flexible business terms, and lower incentives, while existing tenants might experience higher operating costs and/or reduced services. Some landlords might be less interested in renegotiating existing leases as they have over the last few years, and may no longer offer lower rental rates, restructured lease terms, and other incentives, in exchange for longer lease terms. Less experienced and under-capitalized property owners could be realize a devaluing effect on their properties, and might be pushed from competitive markets and forced to sell, or worse. Other investors will be waiting in the wings, seeking bargains. Lastly, the spreads will grow between the monthly costs associated with buying and leasing, which narrowed greatly as a result of low interest rates and drove many companies to purchase instead of lease. The result will be fewer companies buying non-strategic real estate and a marked move back toward leasing for companies occupying smaller spaces.

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## What Should Corporations Do?

Plan, plan, plan! We're already seeing upward pressure on interest rates, and more movement is expected over the next six to eighteen months. Don't take a wait and see attitude toward uncovering alternative business strategies. Analyze your alternatives and plan now to protect your company's flank. If, as a result of intelligent business decision-making, your management believes that it has a clearer picture of the coming economic market, the presidential election, the geo-political situation in the Mid-East, or whatever, and decides to wait it out, then that will be a wise choice.

The expectation is business and economic growth might outpace rising interest rates and minimize their overall effect. Waiting to see what happens before you even begin to plan could easily position your company to miss protective and profitable opportunities, and land your company right back in the dark.

**Andrew B. Zezas**, SIOR, is Publisher of *Business, Profits and Strategy*. Andrew is a member of the Society of Industrial and Office Brokers, and is President of Real Estate Strategies Corporation. He is an accomplished public speaker and presents his company's ideas on business, finance, and real estate to business and trade groups around the country. Contact Andrew at: 908 245 5999 x11.

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