Andrew B. Zezas, SIOR
Relationship Manager,
Strategist, President & CEO
(908) 245-5999 x11
andrew.zezas@realstrat.com

Lease Restructures and The Devil You Know

Most informed business decision-makers have recently restructured their company's commercial real estate leases or are in the process of doing so. While such an approach is now commonplace and often results in increased savings (read as ***greater profits!***). However, understanding the financial position of your landlord and how your company might affect it is essential to protecting your company and avoiding risky and costly errors. This is especially important when your company is considering a lease restructure or any other such significant commitment.

The Coming Real Estate Market In the November 19, 2002 edition of ***Business, Profits and Strategy,*** in an article I wrote, entitled *"The Coming Real Estate Market",* I stated how our country's economic recovery could negatively impact the stability of commercial real estate markets. As you probably know, most of the availabilities that exist in today's national office and industrial markets have been around for a while. And, even though much of that space is being offered for short term sublease, many landlords have until recently, shown little concern, as companies occupying those spaces remain obligated to pay rent until their leases expire or, as long as those companies stay in business! A combination of reductions in cash flow resulting from surplus space reverting back to landlords, investors moving away from real estate and back to more liquid investments as stock markets strengthen, and rising interest rates, could have a destabilizing effect on commercial real estate values over the next 12 to 24 months. The anticipated silver lining is an economic recovery with corresponding job growth that is significant enough to encourage companies to absorb much of the available space that exists today.

Recent and Current Trends

Prudent landlords have refinanced their real estate debt to reduce monthly debt service costs for the purposes of both protecting themselves against future financial downside events and to increase current profits. Although many say the economy is beginning to show signs of gaining traction, commercial real estate, being a lagging indicator of economic change, has not yet seen a marked increase in demand nor substantial absorption of available space for lease, both of which are essential to a real estate recovery.

Meantime, the commercial mortgage backed securities industry is watching as total US commercial loan balances delinquent by more than 60 days have increased to $3.4 billion in 2nd quarter 2003 from $2.8 billion in the 1st quarter 2003, according to Fitch Ratings and the Wall Street Journal. As such, new companies are springing up to invest in under-performing and non-performing commercial loans, and funds have been established by well-heeled investors to acquire financially distressed properties around the country.

Why Should Corporate Tenants Care?

When a corporate tenant restructures its lease based on better business or financial terms, their landlord must honor those terms...right? The answer is: ***Maybe!*** More specifically, depending on the precise terms contained in the lease documents. Occupying space in a building where a landlord defaults on its mortgage due to unexpected decreases in rental income and then loses the building to the lender could place a tenant in the position of having to deal with transitions between owners, trustees, and the like, over extended time periods. More importantly, depending on whether or not the tenant succeeded in achieving a well-written "non-disturbance agreement" as a component to the lease restructure, it is possible that when the lender takes over the building it might not have an obligation to honor the tenant's lease and could terminate it. Such a scenario could make for potentially difficult operating scenarios, forcing management to focus on unexpected and disruptive critical issues, which could negatively impact employee productivity, operations, and corporate profitability.

How Do We Protect Our Company?

First of all, know who you're doing business with. Find out what your landlord has been doing over the last couple of years. Answer the following questions:

- *Has the landlord restructured leases and retained tenants in your building and in the rest of his or her portfolio?*
- *Have tenants relocated from your building, significantly reduced space, or gone out of business?*
- *How have those events affected your building's occupancy levels?*
- *Will your building experience large amounts of simultaneous lease expirations that could negatively affect your landlord's financial strength?*
- *Has the level of service or landlord / property management responsiveness dropped-off?*
- *Does it appear that the landlord may be cutting back on quality to reduce operating costs?*
- *How does what our landlord has accomplished compare to what's going on in the local market?*

Don't just secure statistics and spreadsheet answers, but seek an interpretive understanding of how these and other issues can come into play to help you improve your knowledge, so you can protect your company by making intelligent choices.

Even with quality information, it may be difficult to fully understand the financial implications your company's transaction could have on your landlord, no matter how well you know him or her. Your real estate advisor should be able to guide you as to the likelihood of achieving practical terms that ***create flexibility, and greater profitability for your company under a lease restructure***, without putting undo burden on your landlord. No company wants to make its landlord rich, but putting him or her in the poorhouse could be a lot worse for your company, and keeping him or her in business could yield positive benefits! As they say, *"The devil you know, is better than the devil you don't."*

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Andrew B. Zezas, SIOR, is Relationship Manager, Strategist, and President & CEO of Real Estate Strategies Corporation, Publisher of "*Business, Profits and Strategy*", a monthly online publication read by thousands of business, financial, and real estate executives nationally, and, is the author of two new real estate books, The CFO's Guide to Understanding Corporate Real Estate Transactions and The CFO's Guide to Hiring the "Right" Real Estate Service Provider, both of which will be available shortly at www.thecfosguide.com.

Mr. Zezas is well-known for his ease and informative style of public speaking, and has given talks, presentations, and has lead educational programs for business, professional, government, and trade associations, including the Building Owners and Managers Association, American Management Association, the U.S. Postal Service, RealComm, Society of Industrial and Office Realtors (SIOR), and others. Andrew is National Chairman of the SIOR Tenant Representation Specialty Practice Board, and is a licensed real estate instructor in Texas and Indiana. He can be reached at 908 245 5999 or via email.

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