

“Is Your Company Generating Too Much Profit for Your Landlord?!”



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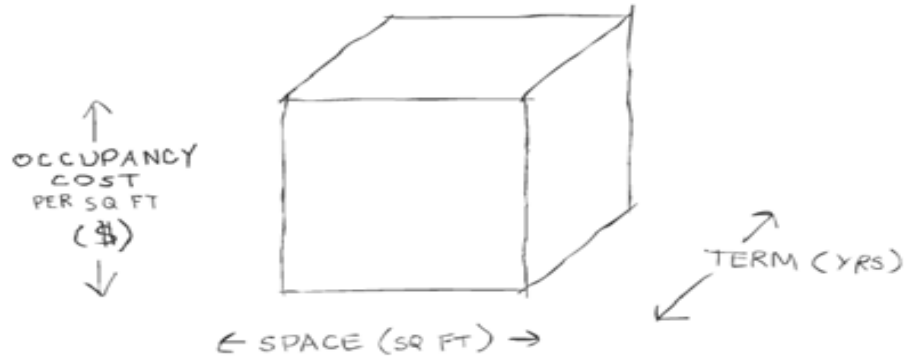
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When renewing or renegotiating office space leases for your company, have you ever considered how construction allowances, free rent, operating expenses, real estate taxes, and other landlord-paid costs impact his or her profits? Well, given how those profits could affect your real estate costs, if you haven't considered them, then perhaps you should. Some landlords will have you believe that due to the high cost of securing a tenant and completing a transaction, they don't make much profit on individual leases. In some cases, that may be true. However, if landlords could not generate acceptable profits on most transactions, the real estate industry would likely collapse and thousands of landlords would quit the business.

I am certainly not suggesting that landlords are not entitled to profits. After all, profit and capitalism are what makes the world go around. And, neither do I intend to offer an opinion as to how much profit a landlord, or anyone else for that matter, is entitled to. But, your company may have a very different opinion. And, keep in mind that how a landlord does business, the returns he or she seeks, how their buildings are financed, how they negotiate, and the specific costs associated with particular transactions will vary.

Lease Renewals

In many cases, initial leases require substantial investments of capital on the part of landlords. Interior construction allowances (also known as tenant improvement allowances), building upgrades, free rent, advertising, professional fees, permits, operating expenses, repairs, property taxes, and more, very often serve to reduce landlords profits. The landlord will also bear the financial burden of heating, and maintaining vacant space, as well as, lost rent (downtime) while he or she seeks a new tenant and, in many markets, while it constructs the space for that tenant.



Compared to an initial lease transaction, renewals typically don't place the same financial burdens on landlords. Renewing tenants rarely require anything close to the same interior construction allowances as new tenants, and other transaction costs tend to be smaller, too. Seldom does downtime exist between the original lease rental payments and those associated with a renewal. Most often the landlord will only be responsible to make minor upgrades to a renewing tenant's premises, such as a coat of paint, the installation of new carpets, and some repairs or changes. Landlords count on tenants' renewals and expansions to create lower cost transactions that will generate higher profit margins.

Here's the math:

New Tenant Transaction Costs (projected for 10 year lease*)	Renewal Transaction Costs
TI: \$25.00	TI: \$10.00
Marketing: \$1.00	Marketing: \$0.00
Free Rent: \$10.00	Free Rent: \$0.00
Downtime: \$20.00	Downtime: \$0.00
Commissions: \$10.00	Commissions: \$10.00
Misc.: \$5.00	Misc.: \$5.00
Total: \$71.00	Total: \$25.00
	<i>Differential (Additional landlord profit margin): \$46.00</i>

* Actual costs will vary from market to market and from transaction to transaction.

Gone are the days, at least for now, when a tenant could move into one of many new buildings where, as a result of aggressive new construction financing, the rental costs in the new building would be substantially lower than those of in-place renewal alternatives. And, contrary to what often occurred years ago, seldom will competing landlords absorb a tenant's remaining lease obligation in its former location as an incentive for the tenant to relocate to the landlord's competing building.

Moving a company has become considerably more challenging, time consuming, disruptive, and costly for tenants over the years, especially given the complexities of technology and equipment. Companies not seriously considering relocation will typically wait too long to address real estate. Accordingly, landlords can be well positioned to take a hard line in renewal negotiations and as a result, can often win on some or many levels. And, because of the burdens placed on tenants when relocating, most of which do not exist when tenants renew leases in-place, most landlords seek to exploit that opportunity to extract rental premiums from renewing tenants.

Missed Opportunities

Another source of landlord profit is how operating expenses, maintenance, and property taxes are treated under a renewal transaction. Escalations of these expenses can be carried forward into a lease renewal, thereby increasing a tenant's actual occupancy costs, if they are not addressed as part of an overall financial negotiation. These landlord profit centers are often overlooked by renewing tenants who only take a "reduce our rental rate" approach, or when these items are negotiated away by landlords, thereby creating a windfall for landlords.

When a Square Foot is NOT a Square Foot

Building measurement has been, for the longest time, a source of many real estate industry jokes. A few years ago, a New Jersey architect sent Christmas presents to the local brokerage and landlord communities. The gifts were rubber rulers. Everyone got the joke because the definition of how real estate is measured is often fluid, with a square foot having multiple definitions, if you can believe that!



Here's the point: When measuring space, would it be fair to measure to the inside surface of a wall, to the middle of that wall, or to the outside surface of the wall? Considering that exterior walls can easily be two feet thick in older buildings, this could pose a real financial issue for both tenant and landlord. And, how should you account for vertical penetrations such as an atrium, air shafts, and so on? What about columns and heating units that protrude from walls and take-up floor space?

Although standards of measurement exist such as those written by [BOMA](#) and other real estate organizations, landlords are not obligated to employ any particular method. Many landlords employ proprietary methods of measurement, and in many leases no method is clearly defined, making it challenging to validate the dimensions of one space versus another. Since rental rates are most often calculated on a square foot basis, not being able to accurately assess the exact square size of a space is tantamount to handing extra money to your landlord.

Additionally, if your company has grown since executing its initial lease and has taken more space in the same building or complex, especially for those companies who've seen rapid growth, the likelihood exists that the additional space may not be accurately measured. An important note here is that rarely are spaces under measured in the tenant's favor! Such calculation errors most often work in favor of the landlord and can certainly create additional landlord profits. In such instances, the tenant who pays for more space than it really occupies, in effect, pays a higher rental rate than the rate to which it agreed.

Services, Fees, and “Promoter” Landlords

It is important to understand how your landlord conducts business. Does the landlord also provide construction services? Do they provide cleaning services, property management and leasing services, maintenance services, trash and snow removal, landscaping, or other services? If they contract with other companies for these services, does your landlord mark-up those services to include an additional profit margin?

Many landlords today, including both privately-held companies and Real Estate Investment Trusts (REITs), are structured differently than traditional landlords. In some cases landlords are actually “promoters” that employ little of their own capital to acquire real estate, preferring instead to utilize funds from investors. Promoter landlords very often aren't owners, but utilize real estate investments by others as vehicles to generate fees, like commissions, property management fees, construction fees, service mark-ups, and so on. This breed of landlord most often works to maintain the property and to increase its value in the hopes of generating high returns for the investors while participating in the property's future equity appreciation. Tenants in buildings operated by promoter or fee based landlords, often experience higher operating costs than those that occupy space in buildings run by more traditional owner-landlords. When considering renewing a lease, investigate the structure of your landlord's business to fully understand its potential impact on your company's future occupancy costs.

We'll leave, we really mean it this time!

Prior to lease expiration, most tenants tell their landlord that unless they receive favorable renewal terms, they'll relocate. Landlords hear this all the time, and most often dismiss such comments as nothing more than posturing and idle threats. Landlords typically pay less attention to a tenant's words, and more attention to a tenant's actions. Is the tenant company growing? Are they contracting or changing how they conduct business or occupy space? Are they calling for repairs and service more often? Do they seem dissatisfied? Have they engaged a real estate broker or advisor? Landlords that really pay attention recognize the signs that could cause them to lose a tenant. Unfortunately, some landlords don't pay close attention to their tenants, and sometimes miss what are obvious opportunities to secure a beneficial transaction.

Old fashioned landlords think that because a tenant has occupied their building for a period of time, has paid rent, hasn't complained much, and hasn't expressed hatred for the landlord or the building, that the tenant must love being in the building, will never leave, and will therefore, recognize that paying a higher rental rate during a renewal transaction is somehow justified. We've always found this belief system to be inaccurate and the sign of a disconnected landlord.

Do We Really Need a Real Estate Broker to Renew Our Lease?

Companies that don't have an in-house real estate department often don't have the available resources to redirect their executives away from important initiatives to run real estate projects. Accordingly, most companies engage a real estate service provider to advise them as to the best alternative...renew, relocate, purchase, or otherwise. By not engaging a real estate professional to negotiate a renewal transaction, a company telegraphs to the landlord that either:

- it probably isn't focused on relocating, doesn't wish to spend too much time on real estate, and will most likely renew, or;
- it may be exposed by not being advised by a real estate expert, and a transaction could result in added profits to the landlord. In either case, the tenant loses!

Ask yourself some questions.

- If you don't engage professional assistance, how will you know if the terms the landlord proposes are, in fact, competitive to the current market?
- Do you really think that you can simply make a few phone calls and understand the subtleties of the local market to the extent that you can fully protect the financial and operational interests of your company?
- Are you willing to bet that you won't make a seemingly minor mistake that could actually cost your company tens of thousands, hundreds of thousands, or even millions of dollars in added real estate and operating costs?
- Are you certain that completing a transaction without the benefit of professional advice wouldn't negatively impact your company's operational, technological, and cultural needs?
- What about those issues that extend beyond rent, like operating expense clauses and interior improvement allowances...are you adequately versed in such issues to protect your company?
- What are the best ways to restructure rights and options in your lease, such as early termination, expansion, contraction, purchase, etc...has the market on those issues changed in your favor or against you?

If, in fact, your company has the expertise necessary to answer the above questions accurately, then perhaps pursuing a lease renewal without engaging a real estate broker or advisor will result in your securing the terms to which your company is entitled. Only you can make that determination.

Some companies choose to leave non-financial issues to their attorneys. Remember that although your attorney may certainly be experienced in real estate matters, your attorney is a knowledgeable "legal" advisor and should not replace a business or real estate advisor anymore than a real estate advisor who understands the law should act as your attorney.

Your attorney, your real estate advisor, and your other service providers should work together as a team to create an impenetrable force that will provide your company with diverse protection in securing the optimal business, financial, operational, real estate, and legal terms that will support your company's overall objectives, not just satisfy your real estate needs.

Landlords love to negotiate directly with their tenants because no obstacles, such as the tenant's real estate brokers or advisors get in the way of driving-up the landlord's costs or cause erosion in the landlord's profits, as a result of the tenant's advisor insisting on competitive market rents, financial and business terms.

Some landlords suggest to renewing tenants that if the tenant employs a real estate broker or advisor in a renewal transaction, that the tenant will have to pay a higher rent to accommodate the commission costs associated with that broker or advisor.

The reality here is two-fold:

- 1.) The most important issue is that the landlord knows the job of your broker or advisor will be to achieve the best terms for your company. That means your broker or advisor's job will be to take money out of the landlord's pocket (see above) and place it firmly into yours. And, as you can imagine, the landlord, being a profit motivated entity, would prefer to retain the greatest amount of profit possible. That's also why many landlords hire real estate brokers...to take money out of tenant's pockets and drive up the landlord's profits. So, shouldn't the sides be even?
- 2.) Suggesting that the tenant's use of a broker will add financial burden to the transaction and raise the tenant's rental cost is nothing more than a tired and weak tactic on the part of a landlord to deter a tenant from engaging professional assistance.

Sophisticated landlords recognize that most renewing tenants engage real estate brokers or advisors to negotiate on their behalf, and welcome that approach. This has been a common practice for the last twenty years. It's not only paying commissions that some less savvy landlords seek to avoid, but rather, it is the realization that when a tenant engages a broker or advisor to represent it in renewal negotiations, the landlord will be forced to compete for the tenant's business fairly and without advantage. Quality landlords see this approach as actually being good for their ability to secure a realistic transaction with a tenant.

Landlords also recognize that the advisor or broker's job is to represent the interests of the tenant, which could cause the landlord to lose the tenant to a competing building. Given the sometimes immense profit margins that are built into the landlord side of renewal transactions, it is unrealistic for anyone to suggest that the necessity to pay the fee of a real estate broker or advisor will create an undue or unreasonable financial burden, and that the tenant would have to pay higher rents as a result.

In some cases, landlords will suggest that if the tenant engages a real estate professional to negotiate its renewal other than the broker or advisor the tenant employed for the original lease, that the tenant will be responsible for the financial burden associated with the landlord having to pay two commissions. While this may be true, in most instances this is not the case. For the last twenty years, in most markets throughout the country, landlords have protected themselves against this exact circumstance by including language in the commission agreements they sign with brokers that precludes the landlord from having to pay the original broker if the tenant engages a new one.

Even if the landlord did not protect itself and does have an obligation to pay two brokers, that burden really belongs to the landlord, not the tenant, since the tenant, in most cases, would not have participated in creating that agreement, and should therefore, not be responsible for any added costs. The business terms the landlord offers to tenants must be competitive with the local market, irrespective of the landlord's costs of doing business. Otherwise, the tenant will likely take its business elsewhere. Again, sophisticated landlords understand this, and welcome it.

Take the Blinders Off and Look Around

Even if your company's objective is to renew its lease, taking a renewal-only approach without considering the possibility that competitive buildings could provide more attractive opportunities may be short-sighted.

Some brokers depict landlords as evil and only interested in taking unreasonable profits from their tenants. While every industry has some bad apples, in most cases in the world of corporate real estate, this perception is false. As the landlord and development industries consolidate, high quality professional landlords have become commonplace. Savvy landlords recognize that tenants have become more sophisticated in their approach to lease renegotiations and renewals, and that in most cases tenants elect to engage experienced real estate advisors to protect their business and financial interests.



Like your company, landlords are in the business of generating profits. However, professional landlords recognize that a realistic approach to negotiations will not only create profitable transactions but, can create long term relationships with tenants that renew for extended time periods and result in even greater profits over the long term.

Playing to Win!

Keep one thing in mind: When you're playing basketball or any other competitive sport, you don't ask the other team to treat you nicely and simply give them the ball in the hopes that they'll let you win. This is exactly the case when companies enter into lease renewal discussions without engaging real estate professionals to represent them. They put their trust in their landlord...the opposition, who sits on the other side of the court, and who showed-up to win the game. That means that while they may treat you fairly, they still seek to win, and will work toward that result. Treat your lease renewal the same way. In order for you to win, you must build the best team available, select the right players, set your strategy, and practice. An important component of winning this game is to first make certain that you are playing a team that respects fair play, understands the game, and will let you have the ball when you've earned it. Only then can you play to win. Build your team, select your strategy, and...play to win!



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