DENVER BUSINESS JOURNAL

From the November 18, 2005 print edition

Lease renewal rates still can favor tenants

If there's one common element among virtually every office tenant I've ever known is that they hate to move. Tenants just like to stay where they are once they've put down roots.

The average tenant relocates its office only once every 10 years, and even that is probably too often for most. Since the average office lease spans three to five years, it's clear that a good many tenants out there favor renewal over relocation. And why not?

Moving is an expensive hassle even when everything runs smoothly. Costs can reach $4 to $5 per square foot or more, and the disruptions to any given company's operations can be difficult to measure if things do go badly. Nevertheless, relocation is part of any company's lifecycle, and sometimes, a necessary evil.

Eric Gold

Renewals offer the tenant a very attractive path of least resistance. There are usually no disruptions to the company's facilities or operations, and the process can frequently boil down to little more than paperwork. At least that's the perception tenants have.

Unfortunately, this path of least resistance can also end up costing a tenant more money than a complete relocation. Sometimes, much more.

The problem lies primarily in the mindset of the average tenant. By and large, tenants are conditioned to expect less and pay more when it comes to renewing their leases. Landlords know this all too well and use it to their advantage when a tenant's lease comes up for renewal. That's what landlords are supposed to do. Their interests lie in keeping their buildings leased at the highest rates and lowest operating costs possible, regardless of market conditions.

On the other hand, landlords in this particular market have been offering any number of freebies as incentives to attract new tenants.

Remember that car-buying frenzy last summer? GM touched it off by offering "employee pricing," which Ford and Chrysler quickly mimicked. Before long, almost every manufacturer, foreign and domestic, countered with multiple, incentive-packed offers to attract new buyers. They had to do this, of course, because the market demanded it.

Those car manufacturers remind me a little of landlords right now. They've been upping the incentive ante for years by offering free rent, parking, furniture and a host of other goodies to woo new tenants. But when it comes to renewing existing tenants, they've been offering next to nothing. Why? Because tenants simply don't ask for more than what they already have.

This gets right back to that mindset issue. Tenants who are committed to renewing will quite often announce those intentions to their landlords well before expiration, thereby stripping away any possibility of negotiating leverage. Oftentimes, this is nothing more than an emotional reaction on the part of the tenant. It can also be a very costly mistake.

Tenants become attached to their spaces, their buildings and their neighborhoods. And a tenant can also forge an emotional attachment with its landlord whom it regards as a "friend." I suppose this is human nature, and let's face it, most of us spend far more time at work than at home. So any given tenant ensconced in its space for three or four years usually won't rock the boat when it comes to asking for renewal perks.

It is my experience that the majority of tenants, even in this favorable market are thrilled to renew without a rent increase, and positively overwhelmed if even modest extras like paint and carpet are thrown into the package.

This is astounding because rental rates are based solely on what the market will bear. So an existing tenant may renew at its current rate of $24 per square foot, for example, while a new tenant in the suite across the hall is paying $18 per square foot with six months' free rent, free parking for its executives and 20 free workstations, in addition to a generous improvement package.

The average tenant Relocates its office only once every 10 years, and even that is probably too often for most.

Again, tenants are simply of the mindset that if they signed their lease three years ago, rates must have gone up, just like everything else in the economy. After all, that's the way it works if you lease an apartment or a condo, right? Office leases, in fact, are structured far differently and can include some fairly complex language, much of which affects tenant costs in one way or another.

The lease is what defines the cost of the company's space -- its second largest fixed expense behind payroll. And yet, day in and day out, tenants continue to underestimate its importance.

Remember that example of a $24 per-square-foot renewal rate versus an $18 per-square-foot new lease rate? That's a difference of $6 per square foot per year multiplied by the tenant's square footage over the life of the lease. That could end up accounting for a significant chunk of change. And that doesn't even include incentives that the renewing tenant could have missed out on, or additional costs like increased operating expenses it could have avoided.

The point here is that landlords don't want their tenants to move out any more than tenants want to move out. It costs the landlord plenty to replace a tenant, so it behooves them to retain as many tenants as they can for as long as they can. That is, until the market changes in their favor.

We are edging our way slowly into a landlord's market. Class A buildings in metro Denver are finally showing positive absorption. Most of those nice incentives are starting to disappear, and lease rates are beginning to edge up in some submarkets. But long-term leases with tenant-favorable renewal rates are, in fact, possible in this market. Tenants must make themselves aware of what is happening in the market, and how to take advantage of changing conditions before it is too late.

ERIC GOLD *is president of Sheldon-Gold Realty Inc., a Denver-based commercial real estate firm specializing in office, flex and warehouse space. Reach him at egold@sg-realty.com or 303-741-2500.*