COMMERCIAL LEASE LAW INSIDER®

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The Practical, Plain-English Newsletter for Owners, Managers, Attorneys, and Other Real Estate Professionals

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Real Estate Roundtable Spent $780K Lobbying Fed

The delinquency rate on commercial property loans pooled together into investments—estimated at around $750 billion—hit nearly 3 percent in the second quarter, almost tripling from where it was at the end of last year, according to Reis Inc. The Real Estate Roundtable, which represents commercial property owners, has responded to the U.S. commercial real estate market's worst crisis in two decades by spending $780,000 in the second quarter on lobbying for federal assistance for the troubled industry.

A July filing with the Senate's public records office reveals that the Real Estate Roundtable spent the money lobbying on the Federal Reserve's lending program for the commercial real estate industry and other issues dealing with the credit crunch and federal rescues of the financial sector. The group has spent $1.5 million so far this year on lobbying lawmakers; the Fed; the U.S. Departments of Energy, Labor, Commerce, and Treasury; the Office of the Comptroller of the Currency; the Environmental Protection Agency; and the Securities and Exchange Commission.

FEATURE

Upgrading During the Downturn to Attract, Retain Tenants

As the recession wears on and continues to affect commercial real estate, industry professionals' instinct is to rein in spending, cut back to only essentials, and try to maximize profits. So it is surprising that real estate experts are recommending that commercial property owners invest in building upgrades to add value for current and prospective tenants, and offer lease incentives, such as two months rent-free, to fill empty space. What seems like splurging actually is a very good business decision that *you* should think about making, too.

Down Economy Is Right Time to Upgrade

Using the time when business is slow to make both common area and mechanical systems upgrades is beneficial in two ways: Improving aesthetics attracts new tenants and retains existing ones, while lowering building operating costs benefits your bottom line.

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PLUGGING LOOPHOLES

Protect Universal Space: Draft Lease Provisions with Degrees of Control

In today's market, more tenants are leaving their leases early if their businesses are in trouble. Consequently, owners that are left in the lurch with broken lease agreements and a sudden loss of rental income must be prepared to quickly turn over tenants to fill vacant space. Creating "universal space," which is all purpose and, therefore, easier to re-rent immediately, is a solution that saves time and money.

Configuring your building with a universal space design eliminates the need for—and significant cost of—renovations to transform a space that was customized for the previous tenant's use into something better suited to the needs of a new tenant.

Whether you are deciding how to configure the space in your newly constructed building or in a second-generation building that you are overhauling, it is crucial to draft your lease to plug loopholes

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Upgrading During Downturn (continued from p. 1)

Much of the rationale for upgrading in a down market is about competitive positioning, not about replacing an outdated fixture or material with a more modern one—although aesthetics are a key part of an upgrade. You should think of the big picture if you're hesitant about making expenditures when everyone else appears to be pinching pennies: When the market does improve, your building will be better positioned than those owned by your peers.

Strategize to Pick Up Additional Occupancy

Upgrading can work well for owners that have recently purchased or are in the process of purchasing buildings, not just those that already own a property. Ken Boyle, managing partner at Hanover Real Estate Partners, a privately held real estate company that owns various types of properties across the country, says that the company sticks to a strategy when it acquires new properties.

Hanover's game plan: If it finds a Class-B property in a location that would attract Class-A tenants, the company buys the property and upgrades it to have the standards of a Class-A building. This strategy is equally useful for owners that already own their buildings, not just those who are going through an acquisition. "When the economy turns down, you'll see a lot of tenants move from Class-B to Class-A properties," notes Boyle. Tenants that previously couldn't afford better space are taking advantage of deals.

However, tenants with a budget that allows them to move to a Class-A building for the same rent that you are charging for your Class-B building can be swayed to choose your space. "If you improve the premises by upgrading your property, you can pick up additional occupancy by grabbing tenants from lesser quality properties," Boyle adds. Class-A improvements may attract Class-B tenants that are on their way up.

Attracting tenants is only one consideration for owners, though. Especially now, upgrading properties builds tenant loyalty and tenant retention. "It's very important for current tenants to see that their building owners are active and still putting money into their buildings despite the economic downturn," says Boyle. "It shows that the owner is still very viable and still has funds to maintain and upgrade the premises."

You can reduce the risk that your tenants will move to a "better" property, even if they can get a deal on it. When tenants see improvements in their existing property, they're more likely to feel that they're better off staying—even though they're paying the same rent as they would if they moved to a discounted Class-A property. This is because the product they are paying for—your building—is improving.

Take Advantage of Aggressive Pricing

Although competing with other properties for occupancy should be a huge motivating factor in upgrading your property, there are several other benefits to doing it during the recession, even if your goal is to simply do routine renovations. One of the biggest cost-savers is lower-than-usual construction costs. This is a prime time to secure better pricing with contractors and vendors; most are willing to negotiate. In fact, some contractors are taking on projects just to keep workers busy. Be aware that you will not be able to get the same low prices once the market bounces back.

Making capital improvements now will put you in a better position than your competitors *after* the industry bounces back: You won't have to go through construction periods while business is good and occupancy is full, or pay full price for construction materials and labor.

➤ *Protect Yourself in Upgrade Negotiations*

When attracting or retaining tenants using upgrades that have not yet been made, always document them in the lease between you and the tenant to avoid getting into trouble if a project isn't done exactly as promised. The following tips can help you avoid being held to upgrades that you later cannot perform the way the tenant specifically expected you to.

- Keep lease terms as general and flexible as possible, advises Toronto real estate attorney Stephen J. Messinger, Esq., of Minden Gross LLP.
- Give a ballpark idea of the timing—that is, a start and an end date showing that the work will be done relatively soon. "You can't start upgrades just a few months before a tenant moves out," says Messinger. For example, the clause could state: "The owner and tenant agree that upgrades will start on or about Nov. 1, 2009."
- Include a *force majeure* clause, which will excuse you from performing your obligations if the failure to start or finish is caused by contractors, suppliers, carriers, bad weather, or natural disasters.
- Include your intentions for the upgrades, instead of concrete promises about the final product. This keeps things flexible and protects you if you need to make any changes. For example, a clause could state: "In consideration for renewing/entering into this lease, the owner is intending to make certain upgrades or improvements along the following lines: [*insert description*]. The tenant acknowledges that, while the owner's intentions are set out above, the owner has the right to make any or all of these changes as appropriately as it wants to within reason and to its own specifications."
- Finally, whenever possible, don't promise to use specific materials, colors, or design aesthetics.

Approaching an Upgrade: Outshine the Competition

How you approach an upgrade will largely depend on the size of your property and the budget you are working with. "You need to focus on your building's strengths and weaknesses," says Bill Caulfield, director of asset management at Hanover, where he oversees the company's extensive real estate portfolio. "Look at what the competition has," Caulfield advises. "You're looking to outperform them."

Assessing other properties and making upgrades accordingly is part of Hanover's strategy. "If they have a carpeted lobby, we put in tile. If they have Formica countertops, we use granite," Caulfield says. "Focus on making the look of the property nicer and outshining the competition," he stresses.

When it comes to allocating your budget for an upgrade, concentrating on what will provide the best return on your investment is key. "The biggest bang for your buck today is green improvements," says Boyle, "because in addition to improving the overall appearance of the property, they also add extra value." Green savings are desirable for tenants and owners and fit every budget; changing standard light bulbs to energy-efficient ones is a small, but money-saving investment, while bigger budgets might allow for system upgrades that result in bigger savings. Modernizing building systems may not be a visible upgrade, Caulfield points out, but improving the operational side of the property is still valuable—everybody is interested in saving money.

"People are conscious now about being energy efficient, so in addition to getting a nice office, you get lower operating costs than in a non-upgraded, non-green building. And a building that has lower operating costs typically has higher tenant retention rates," Boyle adds.

Marketing Improvements

Because the main goal of making changes is to outperform the competition—and attract and retain tenants as a result—people need to know about new improvements and what your property can offer them that others can't. So, should you talk about your upgrade in your marketing plan?

"Each owner has to approach it differently," says Caulfield. Before

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Hanover makes improvements to buildings it owns, it comes up with renderings of its plan, sends them out, gauges the reaction it gets, and adjusts the plan accordingly. "We don't just go out within a vacuum and switch to granite, for example, and then find out that we missed the mark because that's not what people want," he notes. Starting the process with renderings to make sure there is a ready market for the property you are creating should be step one of your marketing campaign.

Later, you can get the word out through brokers. Offering brokerage incentives is one way to directly advertise improvements to prospective tenants. For example, hosting monthly luncheons for area brokers to ensure that they are familiar with your building and any recent upgrades keeps the property memorable and more likely for your brokers to talk about when working with clients.

Incentives Are Making a Comeback

Traditional marketing methods like renderings and spreading the word through brokers sometimes are not enough, especially when a prospective tenant is more worried about saving money in the short term, and less concerned about upgrades that will spread out savings over time. To secure leases with investment-grade tenants that will be with you for the long haul (or at least for their full lease), you may need to provide incentives for them to go with your space over others.

"With the decline in commercial property, owners must differentiate themselves from the competition," explains Caulfield. "You need to provide tenants with real incentives to move from their existing properties to yours. How you do that is through temporary rental reduction, initial free rent, or giving the tenant an allowance for improvements to its new space in terms of a certain dollar amount per square foot." But make sure that your incentives don't take away the value of renting the space for you, he cautions.

Initial rent reductions on the first one, two, or three months are great incentives for owners to offer because they keep rental rates the same for the owner after the reduction period is up—although you might give up some money those months, you won't have to lower the regular monthly rent for the entire lease. And they offer the tenant a better overall value because averaging in months of free or reduced rent at the beginning of the term lowers the overall, long-term cost.

Other trends in incentives include paying for improvements to a tenant's space that normally it would be responsible for paying for out of pocket, including buildouts. Even buying furniture or new stationary to reflect the tenant's business address are smaller scale incentives being offered.

Even if an owner is not offering an outright incentive, larger tenants, especially those taking up big portions of the building, are coming to their owners with their own proposed incentives, mostly asking for building upgrades and amenities, like on-site gyms.

"Tenants are trying to negotiate every aspect of the lease, even if it isn't about money," comments Boyle, who says that lease negotiations are taking longer overall because when the market goes down, tenants realize they have more time before they lose the property to another bidder. "Negotiations are less imperative; they don't have to act today," he says.

Don't Use Incentives to Your Own Detriment

Incentives can be a big factor in closing a deal with a desirable tenant, but they are not always a good idea. Incentives can work against you when dealing with tenants that are not creditworthy. "You don't want to throw away good money on incentives you are throwing at them. You have to have tenants that are able to withstand a downturn," says Caulfield. He recommends that owners take a much closer look at tenants' credit before offering an incentive. Giving free rent or amenities doesn't do any good if a tenant goes bankrupt or moves out before the end of its lease, he points out. "Incentives that help in the long run are useful only if the tenant is *there* in the long run."

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