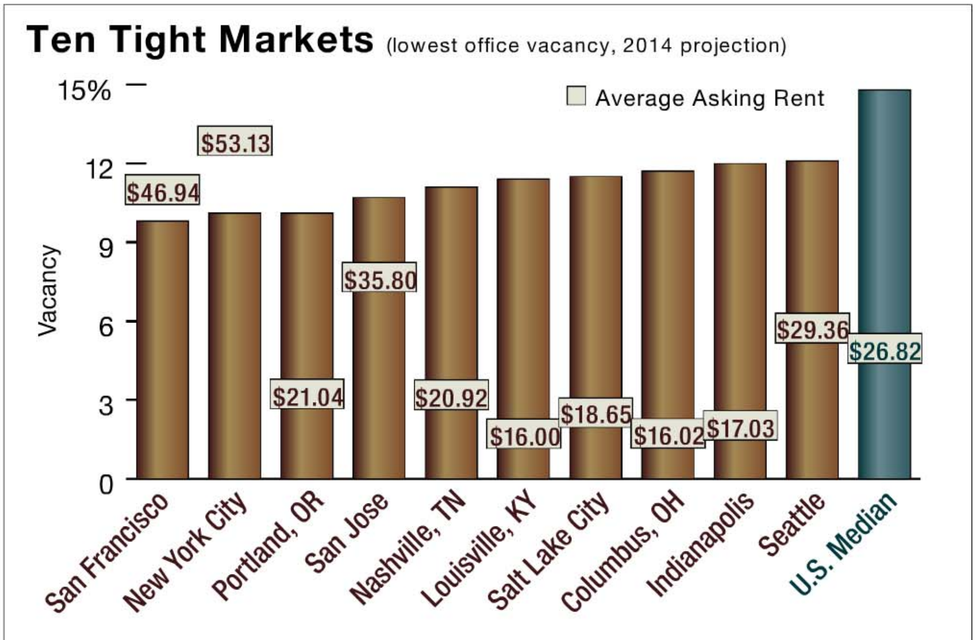
To Stay or To Go?

Tighter Office Markets Squeeze Tenants' Choices, but Retention is No Cinch

By Paul Rosta



Source: Marcus & Millichap Real Estate Investment Services Inc., 2014 National Office Report

Office tenants seeking to renew leases today often find a much different climate than they did just four or five years ago. In many locations, owners now enjoy a distinct edge. A projected 2.8 percent year-over-year increase in office-using jobs will boost demand, according to estimates by Marcus & MIllichap Real Estate Investment Services Inc. Meanwhile, the increase will coincide with only 56 million square feet of new product coming online, less than half of the 135 million square feet of demand. Several years of economic expansion have filled much of the space vacated during the recession. All in all, office tenants on the verge of renewal decisions face a 160 basis-point drop in vacancy nationwide and a 5.5 percent price hike on average, Marcus & Millichap projects.

Still, the owner's apparent edge in tenant retention comes with caveats. The striking contrasts among major U.S. office markets illustrate the widely varying challenges of retaining tenants today. The trend toward open, collaborative workplaces that foster creativity has implications for renewals as well as new leases.

"The result is that many renewal tenants want to completely rebuild their spaces to reflect this new trend," explained Cory Kristoff, a Los Angeles-based vice president for asset management with Swig Equities L.L.C. "Therefore, renewing a tenant can sometimes be similar in cost to placing a new tenant in that space."

The Takeaway

- ✔ In many locations, renewing tenants face rising prices and fewer choices.
- ✔ Demand for sustainability and tenant improvements may make retention more challenging in softer markets.
- ✔ Tenant-retention decisions require balancing the costs of incentives vs. backfilling space.

Even in a major market like Kristoff's hometown, landlords do not necessarily have the upper hand. "In L.A., it's definitely more of a tenant's market, with almost 19 percent vacancy," she said. "Landlords are competing for deals and offering rates and (tenant improvement) allowances that don't make much sense just to get their buildings leased. It certainly makes it challenging to renew tenants." Five-year leases are probably the most common for midsize tenants in Los Angeles, and 10-year deals are the norm for larger tenants, Kristoff adds.

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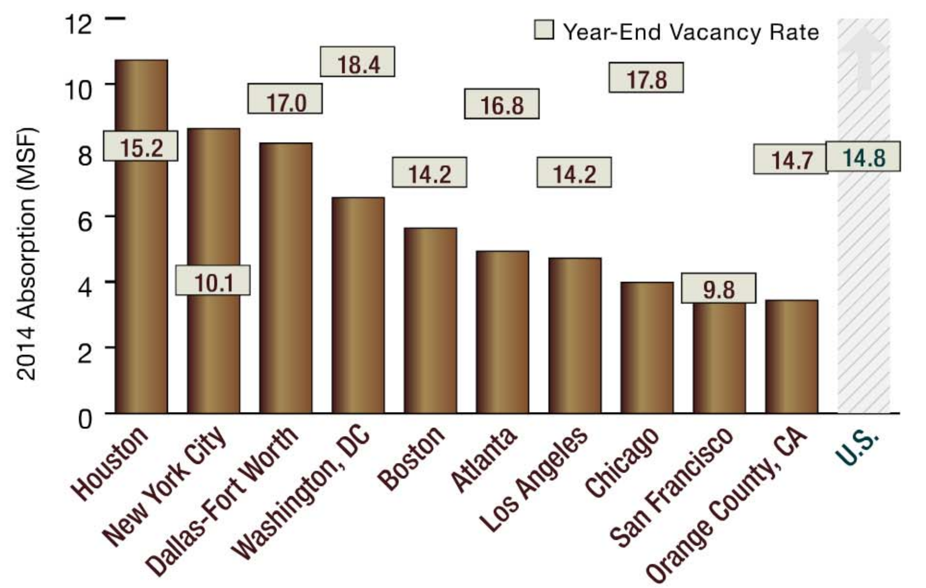
In some thriving office markets, tenants may be in for sticker shock. In Houston, asking rents are increasing as much as 40 percent compared to existing leases. In some submarkets, vacancy is in the low single digits. For office users seeking to move or expand in Houston's 55 million-square-foot downtown, finding space is a challenge. "The bigger the block (required), the fewer the options," reported Michelle Wogan, an executive vice president for Transwestern who advises both landlords and tenants.

Whereas short-term leases were commonplace in Houston five years ago or so, "today, I'm seeing three- to five-year renewals for the tenants that don't have the need for expansion," Wogan reported. Fast-changing market conditions can prompt landlords and customers to part ways rather than try to strike a new deal. In submar-

Space Sponges (highest office absorption, 2014 projection)



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kets that can bear dramatic rent hikes, tenants may opt for less pricey space. Investors who acquired a property a few years ago may decide that some of the tenants they inherited "may not fit the mold of being a Class A tenant," Wogan explained.

Because landlords in Houston have the upper hand, owners have the leverage to tell their tenants, "We'll talk early renewal, but it's not going to be at today's rates," explained Wogan's colleague Brett Williams, a vice president in Transwestern's Houston office. Also at issue in the Houston office market is the rise in assessed property values; they have increased more than 50 percent since the recession for some properties in Harris County. Owners are passing along the resulting property tax hikes to their tenants.

Though this raises the risk of friction with customers, Williams reported, "tenants are aware of (the tax increases), and the property management community has done a good job of educating tenants." Managers are also informing tenants that rising property taxes will cause prices to go up even if the tenant decides to move.

Wogan's team recently completed an 18,000-square-foot lease renewal for an office tenant in Houston's Galleria district. "We were able to overcome the increase in rent by accommodating (the tenant's) space needs," she explained. In particular, Transwestern helped to offset the price increase by arranging greater flexibility to expand than is available to most of the property's tenants.

Penciling Out

Though retaining a tenant is usually more cost-effective than backfilling space, owners and managers should often consider each option as a lease expiration approaches. "If the tenant is in good standing and is an asset to the tenant roster, we will do everything we can to renew them to avoid the downtime, extensive capital for new improvements and any free rent period," Kristoff observed. "But it comes down to economics; the deal has to make sense on paper."

INDUSTRIAL STRENGTH
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Offering an $85-per-square-foot tenant improvement allowance on a five-year renewal at below-market rates and throwing in free rent does not pencil out, she pointed out. "Sometimes you just have to let go and hope you can backfill the space at higher rents when the market improves."

For most office tenants, too, staying in place is better than the alternative. Moving exacts a toll in time, capital and energy. "Unless a tenant is looking to upgrade their image, they like to stay put," noted Cindy Milka, director of business development for Alter Asset Management. If a client decides that its current location is no longer suitable, Alter will try to match the tenant with one of its other local properties. "When someone is working to upgrade their image, we will try to dig in a little deeper with that tenant," Milka explained.

In this respect, best practices in tenant retention apply in stronger markets no less than they did at the depths of the recession. Laying the groundwork to keep good customers must start years before renewal discussions. "The front line is very important," Milka noted.

Alter assigns a team member to oversee building systems, and that person can glean valuable insights about the factors that influence a tenant's space needs. If a building's engineer or technician notices major changes—the office seems to be either thinning out or getting more crowded, for example—that could be a tipoff that the space fits the tenant less well than it used to.

Other issues that can influence retention include much-discussed trends that have come to the forefront in recent years. The demand for open space configurations, sustainability and proximity to public transportation can either give landlords additional selling points or nudge tenants toward properties that seem to offer those qualities.

Of course, addressing tenants' concerns quickly and professionally from day one goes without saying, along with taking the lead in discussing renewals.

When lease expiration is 18 or 24 months away, "you don't want that tenant to be calling someone else," Milka asserted. "I want that call to come to me." CPE