

NEGOTIATING



the Renewal Option

By Steve Bergsman

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With an improving economy and lack of new construction since the Great Recession, a lot of metros have evolved into a landlord's market, which will make exercising a renewal option more difficult.

"In a tenant's market, the tenant will have the leverage and strength to make a deal the tenant favors, but in a landlord market, space has gotten tight and a landlord can let go of tenants with rents below market rate to bring in new tenants who will pay more," observes **John Culbertson, SIOR, CRE, CCIM**, founder and partner at Cardinal Real Estate Partners LLC in Charlotte, N.C.

The renewal option always favors the tenant so landlords who suddenly find themselves in the driver's seat in regard to any new lease deals are likely to play hardball when it comes to negotiating renewals. As a broker for a tenant, it doesn't mean you have to sit back and take what is offered, but you will have to work a little harder to secure a better renewal option for your client.

"Since the renewal option is not a benefit to the landlord, the landlord is not going to want them, which means in the improving commercial real estate markets, they will be tougher to negotiate going forward," notes **Jeff Nickol, SIOR**, senior vice president at Fischer and Company, Atlanta, Ga.

There are two ways to deal with a renewal option: at the time the option comes due and when the initial lease is signed. Let's look at the latter first because a lot of tenants who have been in a space for the last five to seven years on a shorter lease are facing that tough decision, The Clash decision of "should I stay or should I go."

"If we are in a market that is exploding and you have a tenant client that signed a deal four years ago as the country was coming out of the recession, that tenant took advantage of an extremely soft market and locked in very low rates," says **Curt Arthur, SIOR**, managing director for Sperry Van Ness Commercial

Advisors LLC in Salem, Ore. "And if the tenant locked in a continuation of the low rates through the renewal period, the tenant has it made in the shade."

Obviously, the landlord will not be looking at a renewal deal favorably and will try to make it difficult for the tenant or will want to bring the renewed lease to market rate.

"If a tenant has good credit strength, the tenant should be able to negotiate a lease at a certain percentage under fair market value," says Arthur.

"But if your landlord still says your rent is going to be higher if you renew then you have to say to your client, "you have to treat this like a new deal. We know you don't want to leave, but we have to go out and examine what's available in the marketplace."

NEVER UNDERESTIMATE THE VALUE OF A CREDIT WORTHY TENANT

Bruce Isaac, SIOR, CCIM, senior vice president with NAI Isaac Commercial Properties, Inc. in Lexington, Ky., recently completed a renewal

for Johnson Controls, which wanted additional lighting installed. The landlord didn't want to commit to the additional expense, but as Isaac says, "we found a middle ground with the landlord."

More often than not a broker has to go out to the market, then outline the options available to the tenant. Once that is done, when the tenant has been educated about the market, a couple of things happen. First, the landlord knows the tenant is seriously considering other options, and, secondly, the tenant understands the options available in the market.

"A lot of landlords are very cocky," Arthur notes. "They think they have the tenant under their thumb, but once they figure out the tenant has engaged a broker and is truly looking at alternative space, they get a little nervous. It's always cheaper to keep an existing tenant. The last thing a landlord wants is a vacancy loss."

►► "THE BEST WAY TO INSURE FAIR TREATMENT, OR AT LEAST A FAIR NEGOTIATION, ON A RENEWAL OPTION IS TO ADDRESS THE POTENTIAL FOR A LEASE RENEWAL WHEN THE ORIGINAL CONTRACT IS WRITTEN."



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The broker has to convince the landlord there is a high probability that the tenant is going to relocate to get a better deal, reiterates Culbertson.

SOMETIMES THE PERCEIVED REALITY BECOMES REALITY

“I’m working with a client right now that has been in the same building for 36 years and now the lease is up. The landlord is thinking these guys will never move,” says Culbertson. “The tenant had no reason to relocate but decided to go through the process I suggested and is now seriously considering relocating. The tenant liked another space better that was considerably closer to the decision maker’s home. And they realized they were paying too much rent all along.”

On occasion, in markets with significant swings in rental rates (largely coastal regions), the landlord might prefer to replace an existing tenant with a new tenant who will pay more money, says **Tim O’Brien, SIOR, CCIM, LEED AP**, president of O’Brien Commercial Real Estate LLC in Indianapolis, Ind.

In most markets, however, O’Brien points out that, “if the current tenant leaves, that space will have to be recapitalized for tenant improvements, leasing commissions, and vacancy loss, among other things. It is almost always more expensive to replace the tenant than to retain them.”

In most cases, you, as a broker, will have to leverage the market, O’Brien adds. “I’m certainly going to be transparent with the landlord and tell them if the most viable alternative is, for example, \$0.75 a square foot less than what the landlord proposed.”

O’Brien is currently negotiating a renewal option for a client where the landlord proposed a lease rate that O’Brien thought was above market. “We felt that the market stayed constant and might even have declined, so competitive rates would have dictated a reduction,” he says. “The market confirmed that, and we are trying to finalize that deal now. I do believe our final rent will be a constant as opposed to the increase proposed by the landlord.”

The key to helping negotiate a renewal, and this doesn’t change whether you are representing a landlord or a tenant is having “encyclopedic knowledge of the marketplace,” says Arthur. “When you know every single deal that is getting done, when you know the existing inventory, you put yourself in a hugely advantageous position.”

Recently, the state of Oregon hired two national brokerage firms to represent the state in all lease renewals. Arthur was called in to represent some landlords. “I’ve been engaged in a dozen of these negotiations so far,” says Arthur. “These are large deals of 20,000 to 100,000 square feet and the landlords are typically in secondary and tertiary locations and don’t know what to do.”

Arthur was able to show there was no competitive space in these markets and where the state wanted a 20 percent reduction in rent, he was able to keep rents at or above current rents. “We have never had to give steep discounts,” he says.

EARLY IS BETTER

The best way to insure fair treatment, or at least a fair negotiation on a renewal option, is to address the potential for a lease renewal when the original contract is written. Although these contractual items can legally get thrown under the bus if one is not careful.

Here’s what generally gets negotiated at lease time. A renewal option is included, but most landlords will not want a specific future rate, preferring to tie the renewal rate to the Consumer Price Index plus a floor, says Isaac. “If you have escalations (of lease rates) during the initial term of the lease and it escalates to, for example, \$18 a square foot, even if the CPI goes down, the new lease language will typically state that the rent will not go below the \$18 per square foot (floor) unless the market has dropped substantially, in which event, the tenant would be in a position to renegotiate the rate or relocate.”

Secondly, the landlord will typically want the renewal at 100 percent of market rent, although 95 percent may be a fairer negotiating point, because the tenant is staying in the space. The landlord will not have any downtime and little or no fit-up.

Thirdly, the landlord will try to be general, not specific, says Isaac, “requesting the option rates will be negotiated at the future time, when both parties have a better idea of what a market rent will be and instead of picking a number now that may or may not reflect market rent at the time of renewal. The tenant, on the other hand, may prefer to negotiate a specific number in the option so the tenant would know exactly what rent to plan for in a future budget.”

Yes, the landlord will try to tie the renewal option to the CPI and will try to put a floor on the renewal, Nickol concurs. “The landlord will say, ‘OK, I will give you a five-year deal to renew, it will increase by the CPI and we will put a floor on. In other words, the rent will not go down. We do not do those deals and we discourage our tenants from doing those kind of leases.’”

If nothing else can be negotiated, just leave the discussion for when the lease comes up for renewal. Otherwise, everything has to be defined clearly in the lease.

Many contracts have a clause that says a renewal option is available as long as the tenant is not in default. “That word ‘default’ has to be defined, Nickol explains, because a company could be in a monetary default of no consequences or the landlord can push his tenant into a

default position. As an example, a default provision in the lease says the tenant cannot park trucks in the back of the building. If the tenant has been parking trucks in the back then the landlord may declare the tenant in default. Also in the renewal option, timing, and method for the tenant to declare the renewal has to be defined – and paid attention to.

Recently, Nickol was working in a strengthening market and saw where a tenant had sent an affirmative notification of its renewal option, but the landlord said it was not going to allow it. The notice provision in the lease said the notification had to be sent Certified Mail. The tenant sent the notice regular mail.

A good broker doesn’t let that happen. Lease transactions can be as long as five, seven, or even 10 or more years and experienced and knowledgeable brokers should keep in touch with their clients during the lease term so when important trigger dates arise, such as exercising the renewal option, the broker can not only alert his or her client, but also take the opportunity to discuss the various alternatives that might be in the client’s best interest.

As the broker, you would want to be involved in any renewal option discussions you originally negotiated in the initial lease. **Robert Listokin, SIOR**, executive vice president of

Colliers International in Fort Lauderdale, Fla., always tries to craft the original commission agreement to provide for a fee should the tenant renew. Not all landlords will buy into that unless the broker is active in the negotiations to renew.

On the initial move-in, always try to be as specific as possible with your option language. Remember – the renewal option nearly always favors the tenant regardless of how it is written. The more specific the better. That would include an exact dollar amount for tenant improvement and a predetermined rental rate, says O’Brien. “If the tenant is paying \$18 a square foot and the landlord proposes \$19, I’m ok with that because it is very specific. If we deem it above-market come renewal time, we’ll simply renegotiate and bring the market to bear.”

Renewal options are tough considerations for landlords, because they are constructed to favor the tenant. That kind of tenant leverage is lessened in an improving economy where commercial space tightens and lease rates rise. Some landlords prefer to roll the dice, expecting a higher paying client, but most would rather keep an existing tenant. It gets expensive for everyone when an existing tenant moves out and a new tenant moves in. Negotiate for your tenant early and comprehensively. ■



SIOR's ROBERT LISTOKIN'S INCLUSION TIPS FOR THE RENEWAL OPTION

1. NOTICE PERIOD: Language in the lease agreement will state that in order to exercise the option to renew, the tenant must notify the landlord in writing by a specific date or risk losing it. The tenant typically desires as short a time frame as possible; the landlord as long of a time frame as possible. What is typical is approximately six months. Make certain that the right is exercised in a timely fashion. It is vital that the broker notify the tenant as many tenants wind up missing the trigger date.

2. PREVAILING MARKET VALUE: The base rental rate in the initial year of the new term is usually either fixed or tied to the prevailing fair market value. If it has been negotiated that the future rate will be tied to FMV, then the language should include an appropriate and reasonable methodology to resolve conflicts about what exactly the prevailing market rate actually will be at that time. More often than not, this detail is worked out between the landlord and the tenant, however, should a conflict arise, the fairest way to resolve the situation is with some means of arbitration, where either local brokers or appraisers are engaged.

3. MANY OPTIONS: If possible, always try to negotiate more than one renewal option, although the length of the option period(s) are typically commensurate with the length of the initial lease term.

4. REDUCED PERCENTAGE: In the event that it is agreed that FMV will be used to determine the new option base rent, it is neither unfair, nor unreasonable, to attempt to negotiate that the new option rent should be tied to a "reduced" percentage of FMV, as opposed to full FMV, i.e. 90 percent or 95 percent. If necessary, the landlord should be made aware that by retaining an existing tenant as opposed to

having to re-lease the space to a new tenant, they will likely realize significant savings in the form of no downtime, minimal tenant improvements, and reduced leasing commissions. In return, the renewing tenant should in some way share in these savings.

5. TENANT IMPROVEMENTS: Although the renewing tenant is likely not to require significant improvements to the existing space, it is still prudent to attempt to negotiate a reasonable refurbishment allowance when the term renews, e.g. \$5-\$10/square foot, in order to replace carpet, paint and complete other minor upgrades/improvements.