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Beware the Rental Rate Spike

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FROM HOLLAND'S TULIP BULB FRENZY IN 1634 TO THE DOT COM BUST OF 2000, WE ALL KNOW THAT BUSINESS, EQUITY AND REAL ESTATE MARKETS GO THROUGH AMAZING CYCLES.

Usually economic downturns can be a real benefit for office tenants when landlords are desperate to fill their buildings. But business owners and corporate real estate executives throughout the country can be assured of one thing this year: Us office rents are on an upward trajectory, and won't be coming down any time soon.

Today's national office leasing market differs dramatically from previous cycles. Commercial rental rates and vacancy levels usually lagged the overall economy – when business boomed, employment soared; tenants leased more space, supply became short and rental rates rose. Developers built more buildings and supply increased. Then, when the economy dipped, rates dropped and the cycle repeated itself for many years.

Here's why the 2007 office leasing market is really different:

1. Supply is limited because developers are reluctant to construct new office buildings. There's a long lead time from blueprint to occupancy, and developers fear getting stuck with excess office space in a cooling economy. And new construction costs are sky high with competition for resources from China causing a scarcity of concrete and steel.

2. The high cost and risk of new construction is driving the smart money to purchase existing office buildings, while the limited supply has driven up prices as institutional investors seek a stable investment.

3. When building ownership changes hands, rental rates rise because a new owner needs to recoup its purchase price by asking high rents. Another reason, especially true in California, is that property value is reassessed when it changes hands, meaning higher property taxes, which are passed on to the tenants. In a soft rental market, a tenant can shop for lower rates in another building. But with short supply, those choices disappear.

4. In many US central business districts, Class "B" and "C" office buildings have been converted into residential condominiums. Driving demand for downtown condos are aging baby boomers selling their large family homes to live in revitalized cities. These condo conversions have further reduced the stock of office space for lease, driving up rental rates.

5. Tenant improvement dollars from landlords are dwindling due to increased construction costs. In a tight market

landlords don't need to offer this, nor such concessions as free rent or moving cost reimbursement.

6. Tenants' costs for insurance, electricity, heating oil, and taxes have all gone up. Because these costs are factored into the rent, overall rates are climbing higher.

These factors indicate that US office rental rates now operate independent of the economy. If there is a downturn, rental rates will likely remain high in most cities.

So, what is a tenant to do?

Those entering the market in the next 12 to 24 months need to exercise market discipline and savvy. If your current rent is below market, you may be able to use some leverage with the landlord, but be sure to take a tenant broker with you to the table. Tenant brokers do not represent landlords, which insure that you get the best no-conflict advice.

Many landlords find it attractive to get an existing tenant to renegotiate for a longer term lease, even at a starting rent that may be below the prevailing market rate. This "extend and blend" arrangement is a win-win for both parties. The tenant avoids the high cost and hassle of moving to new space, or of being squeezed at even higher market rates when the existing lease expires.

The landlord keeps a known and reliable credit worthy tenant, gets a higher effective rent over the entire lease term, and saves on the high cost of improving the space for a new tenant. Plus, the landlord won't lose rent while marketing the space, and avoids the cost and hassle of marketing.

As office markets grow stronger in 2007, and office development capital stays on the sidelines, tenants entering the market in the near future must choose between adopting a proactive approach to their space needs or risk running out the clock with very few options in hand.

The time to contact your tenant representative is now.

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