

The News

Bargaining chip tilts from tenant improvements to free rent

BY KATHERINE CONRAD

In a break with past downturns, landlords are offering free rent rather than lucrative tenant improvement packages to lure companies to sign a lease.

The shift reflects the current downturn in the commercial real estate market that began last year when the value of tenant improvements, or TIs, was expected to climb as bargaining power shifted from landlords to tenants.

Tenant improvements can range from the basic paint and carpet to a build-out of individual offices. The price tag can range from as low as \$5 a square foot for minor improvements to \$100 for private offices to \$200 or more for clean rooms.

But that was before cash got scarce and lenders got picky.

"Tenants are hearing how the economy is going, and they can't understand how landlords are not lining up to hand them amazing deals," said Dave Vanoncini, manager of GVA Kidder Mathews in Santa Clara. "Many landlords seem to be constrained by the high prices they have paid for projects in the last few years."

Randy Gabrielson, a broker with Cornish & Carey ONCOR Commercial, said, "Unfortunately, now the pot is not as full as it once was. It's easier to give free rent."

Mike Field, director of real estate for the Sobrato Organization, said one reason landlords are reluctant to give cash for TIs is because "We don't know the solvency of tenants."

The questions to ask are: How well are you doing, and will you be here next year?

Given the concern, Field said, "Do you

want to shell out significant TIs? No. Will you give free rent? Probably."

Free rent throws the responsibility of building out the space back on the tenant. But even that can be problematic.

Nancy Morse, a veteran with Grubb & Ellis Co., said suddenly she must gain a lender's approval for tenant improvements.

"In the 21 years I've been in business, TIs have never been scrutinized like they are today," she said. "Sometimes if the bank doesn't approve the financials of the tenant, the deal points have to be restructured for the risk involved. And that may kill the deal, causing the tenant to go elsewhere."

For the deals that are done — and there are a few — landlords are lowering rents, lowering the TI package and signing only short-term deals that frequently include free rent for six months and sometimes as long as a year or more.

"If the space is vacant, and you're not getting rent anyhow, it's easier to do than write a check for tenant improvements because cash is hard to come by," said Joe Lewis, president of Orchard Commercial, whose company controls 8 million square feet regionally.

There's a downside, however. Lewis said that landlords will say they have signed a tenant who's paying \$2 a square foot for two years. But if one year is free, then the effective rent is \$1 a square foot.

Lenders aren't fooled, he said.

Sometimes both sides get lucky, as was the recent case of a law firm in Palo Alto.



Randy Gabrielson



Joe Lewis

Given the huge expense of building office space to accommodate law firms — all those individual private offices — a generous TI package of \$100 to \$200 a square foot is needed before a firm can move. But in the current market, that can be tricky.

Gabrielson said he knows law firms in Menlo Park and Palo Alto that are waiting for space already built out by other firms. Such a situation occurred when McDermott Will & Emery LLP relocated to 85,000 square feet in Menlo Park vacated by the now-defunct Heller Ehrman LLP. Gabrielson said that McDermott's space in Palo Alto has piqued the interest of another firm, which he did not want to identify.

"For Class A office space, the offer is \$40 to \$50 above a warm shell, and it's not enough," Gabrielson said. Tenants expect the landlords to pay, but, Gabrielson said, they "don't have it."

Lewis said the market is currently plagued by a misleading and ultimately harmful perception.

"The perception is that landlords are desperate, that there is great distress, that vacancy rates are climbing and rents are falling," Lewis said. "The reality is somewhere in the middle. There's not distress everywhere."

"We've been through this period of easy credit, where you could get credit if you fog a mirror," Lewis said. "Now everybody is concerned about who will go broke and who will not. The whole world is becoming more prudent."