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In landlord's market, it's payback time

But it's not all doom and gloom for tenants, experts say — research and soul-searching can help alleviate costs

TERRENCE BELFORD, Special to *The Globe and Mail*, Tuesday, February 20, 2007

OFFICE SPACE VACANCY RATES have see-sawed down, giving landlords a distinct upper hand when it comes to the thousands of leases about to be renewed in the next three years. And, after seven years of a tenant's market, observers expect they will be looking to raise renewal rates significantly to recover what they might have given up to keep their buildings leased when office space was plentiful and tenants scarce.

In fact, those facing renewal for another 10 years may face paying a premium of 10 to 20 per cent above what new tenants will sign for, says Randy Borron, vice-president of office leasing at Cushman & Wakefield Lepage Inc. in Toronto.

The reason? Landlords know that 85 per cent of office tenants and 95 per cent of industrial tenants renew leases rather than face the hassle and expense of finding new premises and organizing a move, says Stan Krawitz, president of Real Facilities Inc. of Toronto, a company whose specialty is providing turnkey accommodations to tenants seeking office space.

"Landlords are smart fellows," he says. "Even if a tenant comes to them saying he plans to move, landlords know the odds are overwhelming that the tenant is just bluffing in an effort to gain an advantage when it comes to negotiating a new lease.

"In fact, my view is the worst thing you can do is start lease renewal negotiations by threatening to move."

So what can tenants do to tip the balance in their favour in lease renewal negotiations? Lots, real estate experts say.

Start by understanding the market, says Ray Wong, national research director for CB Richard Ellis Ltd. In Toronto, for example, he says overall office vacancy rates are to drop to 8.1 per cent this year from 9.2 per cent last year; Montreal will remain about the same in the 11.7 per cent range; and in Calgary, office vacancy rates are predicted to rise only marginally to perhaps 2.4 per cent by the end of next year.

Even Vancouver — with its much smaller component of head offices — is enjoying what is definitely a landlord's market. There, vacancy rates will drop to 6.4

per cent by the end of the year, Mr. Wong says. He adds that the bulk of available space is in the suburbs. Almost all downtown building sites have been snapped up by condominium developers.

Nor is there a great deal of relief in sight, says Paul Morse, senior vice-president of office leasing at Cushman & Wakefield Lepage. While three major new projects have been announced for downtown Toronto, at least half that space is already spoken for. What is left amounts to perhaps 2.5 million square feet of available space and that will not hit the market until 2010.

"You can expect the landlord's market to continue into the foreseeable future," he says.

Tenants are advised to analyze their own space needs, then do the research on specific landlords and, most important, hire a professional adviser, says John O'Toole, executive vice president of CB Richard Ellis.

"Successful negotiations are not easy," he says. "They demand lots of time, effort and tons of research. The goal is to create a strategy that puts the landlord at market risk and not yourself."

That is where companies such as Real Facilities come in, Mr. Krawitz says. His 16 full-time and contract staff have represented tenants needing as little as 5,000 square feet to as much as 450,000 square feet over the past seven years.

"Understand the last thing landlords want is empty space," he says. "That means they have to pay operating costs and taxes out of their own pockets, which can severely impact their own bottom line. Taxes on core properties in Toronto are the highest in the land."

Market risk involves more than just a single building; consider a landlord's entire portfolio, Mr. O'Toole adds. Tucked away in the suburbs might be properties with high vacancy rates even if core properties are operating near 100 per cent occupancy. Winding up with more empty space might persuade the landlord to cut a very favourable deal.

Use this research and the help of an expert to figure out what Mr. O'Toole calls the landlord's "flinch factor."

"That is the renewal rate below which the landlord is willing to see you leave," Mr. O'Toole says. "Anything above that and he is likely willing to have you stay rather than face the cost of finding a new tenant and carrying the costs of empty space."

At the same time, self-examination is vital, says Cushman's Mr. Borron. "Many companies have changed dramatically in the 10 years since they last signed their lease. You have to ask yourself: Do we really need to be here? Will we need all this space 10 years out?"

What all the experts agree on is tenants should start their research well in advance of the day when they must inform the landlord they plan to renew, usually 12 months before the expiration of a lease.

"The most common mistake is leaving the planning too late," Mr. Krawitz says. "Time works in favour of tenants; it gives more options"

Adds Mr. O'Toole: "For a company looking for 50,000 square feet or more I would say three years is the bare minimum when it comes to research and planning."

David Bowden, president of Canadian Brokerage Services at Colliers International, offers a couple of other tips. Office space vacancies move in about 10-year cycles and rents can vary by as much as 250 per cent from the bottom to top of any single cycle, he says. Try to predict when the next tenant's market may take place and negotiate a lease that expires during that period.

He also says that leases negotiated in times of high vacancy rates usually include all sorts of extras, inducements to get a tenant to sign, such as options to take extra space or to downsize. If they are no longer needed, then the landlord may be happy to trade those clauses in favour of a better deal on the base rent.

Can tenants save? Most certainly, Mr. Krawitz says.

"In seven years, we have never had a situation where we did not save a client and in some case those savings have been considerable."