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**SPECIAL REPORT**

**THE RENEWAL GAMBIT**

**Playing the Renewal Game to Win**



**CBRE**  
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## THE TRUE WORTH OF RENEWALS – SURVEYING THE LANDSCAPE

In surveying the current market, office tenants are seeing great uncertainty due to the global credit crisis and the resulting market-driven increases in sublet space. Along with the dichotomy of rising availabilities and rents that have increased dramatically over the past two years—only to have recently begun declining—this uncertainty is expected to continue for the foreseeable future as the economy sits on the precipice of a recession. Against this background, with capital expense costs having spiked and now facing an unpredictable future, the temptation for a tenant to renew a lease is strong. Landlords are fully aware of this market dynamic and understand completely that they commence any renewal negotiation holding the high ground of experience and market knowledge, often resulting in their profiting disproportionately at the tenant's expense.

## SEIZING THE HIGH GROUND

Tenants who negotiate their own renewals seldom fail completely. They usually gain some concessions, though they may have little idea of their true worth or how much more they might have gotten, as landlords in the current market are far happier to grant greater concessions than to lower rents. The brokerage professional can balance the negotiation field on behalf of the tenant, whose inherently weaker position in comparison to the landlord's is undermined further by attempting to renew a lease directly without experienced guidance.

## WIN-WIN TRAP

Consider a simple case. Company ABC's current facilities are adequate for the next 10 years, so it can either renew in place or relocate to comparable space. Company ABC's real estate executive goes out into the market to examine comparables, both as relocation alternatives and to establish a context for his current landlord's offer on a lease renewal. If he finds comparable space renting for roughly the average rent per sq. ft., he may calculate that the landlord could renew Company ABC's lease at

a lower-than-current rent based on what he will save in costs for a work letter, free rent and possible market risk due to downtime while finding a replacement tenant. Given this scenario, the tenant's offer seems fair. But the landlord offers a new lease at a rent higher than the cost of the comparable space. When Company ABC protests, the landlord states, "Well, you can move. But your space across the street will cost you more than what I'm offering as rent by the time you figure in the costs of moving, IT, new furnishings and an above-standard build-out, not to mention the lost productivity and all the headaches. At the rent I'm offering here, you save in real costs. So we both come out ahead."

## REAL WINNER

The problem with this "win-win" scenario is that the landlord collects the winnings for both sides. He wins by avoiding the capital costs he would have incurred to secure a new tenant—work letter, downtime and marketing costs. Then he wins again by renewing Company ABC's lease at an above-market, premium rate without taking the commensurate risks in the marketplace or providing anything of value to his tenant.

## MISTAKES

The first mistake was to think that, because there was no operational need to relocate, lease renewal was essentially just a straightforward administrative matter. Relieved not to have to address all the operational, logistical and cost issues associated with moving, managers typically feel that they have come out ahead already, for themselves and for shareholders.

The second mistake was to enter the situation without a clear strategy. Because the company did not see the lease renewal as an opportunity to gain a competitive cost advantage, it did not commit adequate resources to the transaction. By underestimating the magnitude of the economic benefits that could be extracted from a "routine" renewal, the company missed a major cost-reduction opportunity.

The third mistake was failure to understand the economics of the renewal situation from the landlord's perspective. Landlords determine their required economics based on myriad factors, including: their asset cost basis; required returns to debt and equity capital; the effect of ongoing economic conditions on real estate market activity; the unique features of their market segment; their competitive position in that segment; and the mix of tenants, rental rates and lease terms in both their buildings and portfolios.

In addition to these factors, there was the company's understanding of the business dynamic involved and of its relationship with the landlord. Did Company ABC understand the nature of the game it was engaged in with the landlord? Did it even understand that there was a game and that it was a player? Or just how much the stakes were? Well, the landlord understood.

That was the fourth mistake. Even if it had known the game had started and that it was a player, Company ABC did not know how to play the game. It didn't know the rules, strategy or tactics. The tenant might be the star of its own industry, but they are rank amateurs on the landlord's turf.

### **UN-LEVEL PLAYING FIELD**

Lease renewals are not conducted on a level playing field. The landlord is in the real estate business and the tenant is not. This sounds self-evident, but it has important underlying significance that a company's real estate decision-maker should understand. The successful executive thrives and survives because he has a unique understanding of his customers and their needs and wants. He has an extensive and sophisticated information network to gain market intelligence and other important data. And he has developed the means to use this information to create value for his company.

The landlord's chief survival skill, given the inefficiency of real estate markets, is his ability to collect information in an unstructured environment. He knows from a

variety of inside sources when a tenant is considering moving out, and he knows from real estate market sources whether a tenant is scouting relocation alternatives. Because the landlord is in the game every day and the tenant plays only once every five, 10 or maybe even 15 years, the landlord knows better than the tenant what the realistic alternatives are.

His second advantage is that all the moves in the game are second nature to him, while the novice tenant may miss both the kickoff and the final gun. Over the years, the landlord has learned all the classic tenant moves and bluffs. He knows company review and approval processes and their timelines. He knows how long companies take just to decide to think about moving.

Because the landlord has superior information and understands the game's strategy and tactics, as well as the fact that the game is already underway, he usually gains an unbeatable lead at the outset. He convinces his tenant that scoring is based on the tenant's opportunity cost of relocating, not on the landlord's opportunity cost of finding a new tenant or tenants to replace his lost income. Both views are legitimate, but only one wins for the landlord.

The landlord's third advantage is that he knows his bottom line. He knows precisely the renewal rate at which he becomes economically indifferent to his tenant renewing or going out in the market to find a new tenant. Few tenants know the landlord's bottom line or even their own.

Typically, when tenants do have objectives they wish to achieve in a renewal, they are loosely sketched as a "below-market" renewal rate or, even more generously, a rate lower than the cost of moving. In the first instance, the tenant makes the landlord a gift of what he would have had to spend and risk in securing a new tenant. In the second, the landlord's cup truly runneth over.

Tenants can “win” at the renewal game. While the landlord has some clear advantages, what is important is that lease expiration and relocation expose the landlord both to significant lease-up costs and to market risk. The tenant who understands this and knows how to take advantage of the landlord’s vulnerability can capture for himself and his shareholders what otherwise will be a major windfall for the landlord.

### **A GAME PLAN FOR TENANTS**

The first reality that the tenant must accept is that extracting maximum value from a lease renewal is not necessarily quicker or easier than finding, negotiating and moving into new space. Depending on the company’s needs and objectives, it may involve all the costs and logistical headaches of a move—the key difference being who pays for achieving the objectives. For example, a company’s space may no longer work, even though its building’s image and location are ideal. There may be qualitative, environmental, operational, flexibility and other issues that can and should be resolved in a renewal.

The objective of a renewal strategy is to shift the market risk to the landlord. The tenant’s strategy must be to put the landlord in the market in search of a tenant, as opposed to allowing the landlord to put the tenant in the market. This is essential to maximizing the renewal opportunity, because the landlord is counting on staying out of the market.

For the landlord to perceive himself as being “in the market” and at risk for continuing rental income, he must be convinced there is a high probability of losing his existing tenant. Until he is convinced that his windfall is lost, he will gamble, playing out a familiar game in which he has developed a high level of skill.

For the tenant to win, the tenant must be willing to enter a long, complex process that requires commitment, confidentiality and, above all, credibility. The essential components of a successful renewal strategy include:

**Time:** Landlords know how much time it takes companies to make decisions and how readily they defer action. The “window” must open early enough to convince the landlord that there is in fact enough time to make both the decision and the move. For projects of any significance, the process should begin at least two years prior to lease expiration; for especially large projects, even more time is required.

**Objectives:** To avoid making an unfocused and unproductive attack on the landlord’s income stream, the tenant should clearly define his objectives under a renewal. These can be defined in terms of rental rate, escalations, options, services, renovations, construction, signage or any other components of value.

**Understanding the Landlord’s Position:** There are no “universal” landlords, no matter how homogenous they may seem to tenants. They vary greatly by types of investments, portfolios, personalities, financial and non-financial objectives, and risk profiles. An entrepreneurial developer has different objectives than a REIT or a pension fund. Foreign landlords have perspectives different from those of domestic landlords, even if they are in the same line of business. Highly structured and joint venture landlords add another dimension of complexity. Buildings have different lease expiration schedules, debt and equity maturities. Landlords have different hold periods and may have different perspectives on the relative importance of income versus asset value.

**Credible Dissatisfaction and Motivation:** The landlord will not respond to a threatened move that is not grounded in some need that his building does not meet. He must be convinced that the tenant seeks—and is intent on finding—something that a competing landlord can provide. This dissatisfaction has to be carefully crafted and developed or the landlord will see through it.

**Credible Market Search:** The tenant must develop alternatives and make the landlord aware that he is pursuing them. Landlords understand that corporate inertia works to their advantage; an aggressive market search by a seasoned real estate professional from outside the company hierarchy is strong evidence that the threat to move is real, primarily because it signals upper management's willingness to consider a wider range of alternatives.

Much of this may sound as if it should lie within the capabilities of a company, but it rarely does, due to the inherent nature of the renewal environment. A company is most effective when acquiring space, which takes place in an environment much different from that of a lease renewal. In an acquisition, the company's real estate executive enters the market with the full force of the company behind him. The landlords he deals with usually have no long-term, intimate contact with the user group and will be forced to compete on price

with other landlords. In a renewal environment, the smart landlord will have formed as many relationships as high in the company hierarchy as possible to dilute the real estate executive's authority.

The bottom line is that the real estate executive often does not get the full company or user group support in a renewal gambit that he would get in an acquisition situation—and the landlord knows this.

### **CONCLUSION: THE BROKERAGE PROFESSIONAL ADVANTAGE IN RENEWALS**

The importance of strong outside support to plan and execute a renewal strategy cannot be overstated. A sophisticated third party brings knowledge of the players, their economics, their tactics and their vulnerabilities that company executives have neither reason nor mandate to develop. Leveraging this knowledge and expertise levels the playing field and increases the likelihood of a true "win-win" result for all parties.