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Landlords Are Now Seeing Red In Low Rates, High Concessions

By John C. Wilson



Earlier this summer, the major real estate firms released their 2003 mid-year figures on vacancy and availability rates. Across the board, the results were not too encouraging.

Vacancy rates, both direct and sublease, are up in almost all the submarkets. Additionally, many submarkets are realizing tremendous amounts of negative net absorption. The question on everyone's mind is, of course, when will the market head into its recovery? But before that question can be answered, it must be determined that the market has hit its bottom and is ready for the upswing.

As with most changes in the market, the recovery will not be heralded by a single sign. More likely, it will be a congruence of signs that, taken together, point in a positive direction.

The emergence of "negative recapture" is one such sign that would appear to indicate that the market has indeed reached its floor and is ready to begin its climb upwards.

A general rule of thumb for almost any situation is that "something is better than nothing." This has been the driving principle behind many recent subleases, where sublandlords are saddled with a surplus of space and are looking for tenants to reduce the load. This particularly has been the case in the high technology and telecommunications sectors, which experienced tremendous growth dur-

ing the late '90s but have since been forced to downsize in both employee headcount and real estate space.

For these companies, real estate is still a major line item on their income statement. To reduce this expense, companies would often take a very low rate per square foot, simply to have a positive impact on the bottom line. However, in recent months, tenants seeking to get more than simply low rates have also begun increasing requests for concessions, including free rent, furniture allowances, move allowances and facilities improvements. Taken together, these concessions and rate reductions have caused some sublandlord companies to decline these sublease offers.

Simply put, when the sublandlord runs the numbers across the full length of the lease, the rental rates do not justify the investment in concessions necessary to get the deal signed. It makes more sense to hold onto the real estate and find a more appropriate investment for the money that would otherwise go into the concessions, such as reinvesting in the business.

Negative recapture is when a company decides to take the short-term loss rather than a long-term loss with the concessions, from the summation of a sublease. Something may still be better than nothing, but sublandlord companies are now realizing that some deals are simply not worth doing.

What created this environment is primarily the dramatic increase in sublease vacancy rates. In a healthy commercial real estate market, sublease vacancy rates would run around 10 percent of total vacancy. Such was the case during the year 2000. However, the current rates are running from three to five times that rate. For example, the sublease vacancy rate for the Route 128 office market, as of mid-2003, is just over 30 percent of the

total vacancy rate.

The Interstate 495 office market is experiencing an even higher percent of sublease square footage, at just over 45 percent. The current direct and sublease vacancy rates are threatening the levels seen in 1991, which is widely regarded as the apex of a deep and long real estate depression.

With companies needing to reduce this amount of excess space, tenants have been in the driver's seat, getting both low rates and also getting tremendous concessions. Lately, however, many companies have begun refusing leases that do not result in positive income over the duration of the lease.

For example, a technology company in the Interstate 495 market may have signed a 10-year lease at \$28 per gross square foot. A potential sublessor offers \$15 per square foot, but also demands concessions that amount to \$25 per square foot over the course of the lease.

While the "something is better than nothing" adage could certainly apply, the technology company runs the numbers and determines that it could better use the funds to buy back its own stock or invest in a new process that will streamline product delivery. The last time the market witnessed this level of negative recapture was in the early 1990s, after the market had absorbed a large amount of Digital Equipment Corp. and Wang space.

The implication of negative recapture for the overall market is positive. It shows that the pendulum may be swinging back in the right direction, towards a recovery. Individually, however, tenants, landlords and sublandlords each will realize a slightly different impact from the situation.

The Bright Side

For tenants, it is still clearly a positive market. There remains a plethora of excess

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space. Tenants should, as always, seek to get the best deal available. Concessions will still be available, as will some very low square foot rates. However, another adage may be in play: you can't keep your cake and eat it, too. Tenants are well-advised to bear in mind the aspects of negative recapture, that sublandlords will continue to bend, but not until they break. This is particularly true given the fact that a good deal of the prime, ready-for-occupancy locations have already been leased. Tenants may now find it harder to achieve both low rates and high concessions.

Landlords and sublandlords both are faced with offering space at lower rates than they

would like. However, with negative recapture as a sign, the winds of change may soon be blowing in their favor. Landlords and sublandlords do realize slightly different effects from negative recapture. Sublandlords have, for a while, been in a better position than landlords. Due in part by necessity, sublandlords have been able to make lower offers and therefore lease more space than landlords. In the current market, the lead has shifted more to the landlord, especially in the case where the sublease space is not in "plug-and-play" condition.

The landlord has the flexibility to provide lower rents and greater concessions. Real estate is their product. A technology sublandlord, how-

ever, must decide whether to spend money on its product/company or on real estate. That decision will usually go in favor of the business. An additional point is that rental rates should not go much further down, if at all, which can be seen as neutral or positive to the landlord.

Ultimately, negative recapture should be viewed as a positive indication for the market overall, in that it portends that the market has reached its bottom and the recovery must not be far behind. In the near-term, tenants, landlords and sublandlords should bear in mind the implications involved in order to maximize their leverage and receive the most favorable results possible. ■