MORE LEASE AGILITY? THERE'S LITTLE NEW UNDER THE SUN

By John Salustri

Don't be fooled by the buzz. This isn't a new day of corporate occupier demand, and what we're seeing isn't a revolution. It's part of an evolution, even if that evolution is accelerating, thanks in large part to the rapid rise of technology and the generational shift toward a millennial-dominated workforce. But supposedly, new-fangled ideas such as coworking and collaboration have been with us for decades, and service providers have been addressing the evolving need of the corporate occupier - using these very concepts - the entire time.

The essential need is never-changing: "Everyone is still trying to manage and reduce cost, and real estate office leases specifically are the number-one fixed cost that almost every operation has on their balance sheet," says Beth Moore, Americas Agile Real Estate Practice leader for CBRE. "It's their biggest contingent liability."

As always, "there's tremendous pressure on firms to reduce costs," she continues, "and one way to do that is to create as agile a real estate platform as they can, with a focus on contraction rights, expansion rights, termination rights, and a lot of flexibility around how they can manage an asset that generally isn't very agile."

The problem, she says, is also one of evolution. "The statistic that drives CFOs crazy is that anywhere from 50 to 60 percent of the seats in a given office on any given day sit empty," she says. "That means that people are either working within the office somewhere else, working outside the office, or traveling on business." Underscoring the evolutionary point, she adds, "that's been the historical math for the past 10 to 15 years."

Happily, along with the problem, Moore also outlines a solution: "Companies are trying to harvest some of that vacancy. If they can find ways to deploy people in a more agile way, working from home two days a week or working in unassigned setups, they can bring that 40 percent occupancy up to 60 or 70 percent. That's a meaningful gain."

The More Things Change . . .

While many of the tools of agility have advanced (can anyone say Knotel?), the mission remains very much the same. "What we've been doing for a long time is educating our clients and implementing thoughtful workplace design strategies that provide greater flexibility," says Moore. "We've done it for our own organization in our Workplace360 initiative. So, workplace strategy isn't a new concept. What's interesting around flexibility now is the commitment to term."

This means options, and in addition to the rights listed above, options mean coworking choices that allow tenants to expand or contract as market conditions or corporate need dictate. Keep in mind, along our evolutionary theme, that Regus is a nearly 30-year-old company, and WeWork, while of a newer pedigree, is eight. The proof of their models comes in the plethora of cutely named me-toos that have sprung up since, names such as LiquidSpace and Industrious, most with varying takes on the concept of workplaces for hire.

Jeff K. Johnson, SIOR, president of Black Commercial Inc./NAI in Spokane, agrees that little is new under the sun. "In many respects, the demand today isn't much different from what it was 30 years ago, certainly not in Spokane." Except, that is, for two major differences. "First, there are more startups, which fuel the demand for flexibility without being bound to long-term leases.

Second, coworking has been recognized as a quick way for expanding firms to build a presence in a locale or test the local-market waters."

Long Live the Long-Term Lease

Despite the plethora of new working types, the traditional long-term lease is doing just fine, thank you. "Virtually any large relocation project we work on today is likely to culminate in at least a 15-year lease," says Bob Chodos, SIOR, vice chairman of Newmark Knight Frank in Chicago. "And therein lies the reason these other platforms are gaining traction with a number of end-users."

One such reason is the advent of new FASB accounting standards for leasing, which will send CFOs scrambling for ways to get real estate off their books before they go into effect over the next two years. So, yes, he says, "firms are starting to question the logic of some of these long-term commitments, but across our market in Chicago there are an enormous number of leases happening that have or will involve commitments of 15 years or longer."

"In our market, for long-standing local firms, it's common for them to renew for 10 years," Johnson agrees. "They want that stability."

Moore agrees and points out the relative ease of the long-term. "When you're making long-term commitments like a 10-year lease, which makes sense for a lot of companies, it's a decision that involves a lot of stakeholder input. You don't want to re-engage the market every two or three years." Yes, she adds, "the long-term is here for the long haul."

If there is a change, it comes in a more aggressive "attempt to negotiate termination options for all or a portion of the leased premises, in tandem with contraction rights for a smaller increment of space, say a floor or half a floor," Chodos says, "depending on how large the commitment is. They all want expansion rights and rights of first refusal on more space as well. They're trying to create an accordion scenario, if you will, to make these longer-term commitments more agile."

But landlords aren't tagging along easily. "There are many owners who won't agree to termination or contraction rights on an anchor-tenant lease," he says. "They say they can't finance them." If termination or contraction rights are given, they tend to be after year 11 on a 15-year deal.

"Landlords will usually get no less than 12, but no more than 18 months' notice of intent to terminate," he says, "so these options put them in a difficult position. However, if granted, there will most often be a recovery for the landlord of the unamortized expenses invested to secure that tenant, expenses such as TI allowances, rent abatements, commissions, and legal fees. There might even be a penalty worth one to three months gross rent as well. Landlords don't make it easy for a tenant to exercise termination rights."

They do so, obviously, at their own risk. "If they don't cooperate, they risk losing the tenant to a landlord who will provide what they're looking for and concessions that might offset them having years left on an existing lease," says Chodo. That could mean that the inflexible landlord "is left to refill that space if the tenant moves on. That often exposes that landlord to 12 to 18 months of carry while a replacement tenant is secured, and then they have new TI allowances and commissions and abatements." And it all starts all over again.

Working with Coworking

Smart landlords and space providers are embracing the coworking trend to avoid that very scenario and keep the customer satisfied. In fact, CBRE research reveals that in a typical building, the sweet spot for coworking space is about 20 to 30 percent. "If an owner provides any more," says Moore, "they risk reducing property value. Any less, and they may not be able to sufficiently address need."

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The growing presence of coworking firms in the market (23 percent annually since 2010, according to JLL) also provides terrific farming opportunities for third-party space providers and landlords alike. As a coworking tenant outgrows its temp spaces and seeks a more permanent residence, the expectation (the hope?) is often that it will take that space in the same building.

But, as Johnson points out, the farming opportunities are not limited to one location. "I look at coworking spaces as a place to go and find growing tenants," he says. "There's a Regus office right across the street, and I've told my brokers to get to know the Regus manager. If they have members that now need larger space, we want to be there to help them make that move to a more permanent long-term location."

One hand washes the other, of course. "Likewise," he says, "we let them know about the small tenants we might not be able to place."

So while there is really nothing new under the sun, there are lessons to be learned for all parties, occupants and providers alike, as the evolution continues. "We're both students and teachers when it comes to the subject of workplace flexibility," says Chodos, whose firm is actually an investor in the Knotel coworking brand.

"This landscape is dynamic," he says, "and we need to understand those dynamics and provide a number of potential solutions, analyzing them on both a qualitative and quantitative basis for our clients."

But then, wasn't client satisfaction always the mission? ▽

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LONG-TERM LEASES & FLEXIBILITY

The need for greater lease flexibility does in no way negate the usefulness of that industry stalwart, the long-term deal. What is changing, however, is the occupant's approach to making that lease more amenable to expansions and fluctuations in that tenant's market or its organizational strategy.

Here, according to CBRE's Beth Moore, is what occupants are interested in now to make that accommodation possible:

"They're choosing assets that have flexible space as part of their building stack," she says. "So we're seeing a lot of landlords shift their building stack to include one more amenity floors and coworking spaces, anything that provides greater flexibility."

Increasingly, she says, occupants are changing how they view their space needs, making it less about square footage and more about headcount. Moore calls it, "The cone of uncertainty. It's a matter of understanding the over/under of an occupant's headcount projections and having the options to support that."

Finally, in this age of the consumerization of the workplace, "Really thoughtful companies are taking a dedicated approach to their workplace strategy and design," she says. "They're getting employees involved in the process and, as a result, designing environments that support multiple space uses and worker types--all enabled, of course, with great technology and service."