



THE RENEWAL GAMBIT

Playing the Renewal Game to Win

CBRE
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Companies that congratulate themselves for renewing leases to avoid the cost of relocation should put an ear to the wall to find out if the landlord is celebrating too. Usually, he has more reason to celebrate than his tenant does because he captures most of the value of a renew-in-place decision.

Most companies that renew leases pay a premium for the convenience of not relocating, when they should be getting a discount that reflects the savings that the landlord realizes from their decision to stay.

While tenants and landlords both may gain from a lease renewal, tenants can and should capture most of the economic benefits. This is not easily done, however. The landlord holds the high ground, has better field intelligence and is a veteran and victor of many similar battles. To defeat him, the tenant must develop a superior strategy and execute it in unfamiliar terrain with green “troops.” Strategy development requires detailed analysis of the landlord’s economic position and his defenses. Execution requires careful planning and a high level of discipline, with “special forces” support at the command and field levels.

Win-Win Trap

Consider a simple case. Company X’s current facilities are adequate for the next ten years, so it can either renew in place or relocate to comparable space. Company X’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 \$45 per square foot, he may calculate that the landlord could renew Company X’s lease at about \$30, based on what he will save in costs for a workletter, marketing and debt service while finding a replacement tenant. Since the continuity of rent also shields the landlord from any market risk, \$30 seems fair.

Landlord's Costs to Replace a Tenant

But the landlord offers a new lease at \$48. When Company X protests, the landlord shrugs, "Well, you can move. But your \$45 space across the street will cost you \$60 by the time you figure in the costs of moving, telephones, new furnishings and above-standard build-out, not to mention the lost productivity and all the headaches. At \$48 here, you save \$12 in real costs. So we both come out ahead."

Space:	50,000 RSF
Market Rental Rate:	\$27/RSF net (\$45/RSF gross)
Tenant's Renewal Rental Rate:	\$30/RSF net (\$48/RSF gross)
Operating Expenses and Taxes:	\$18/RSF (\$15 cost to landlord during down time)
Debt Service:	\$12/RSF
Lease Term:	10 years
Workletter Value:	\$35/RSF
Marketing Costs:	\$8/RSF
Down Time (Marketing and Build-Out):	12 months

Revenue and Cost Components	Landlord Revenue (Costs) with Renewal	Landlord Revenue (Costs) with New Tenant
Market Rent (\$27/RSF net)		\$13,500,000
Renewal Rent (\$30/RSF net)	\$15,000,000	
Down Time (12 months)		
<i>Lost Net Rent Revenue</i>		(1,350,000)
<i>Debt Service</i>		(600,000)
<i>Operating Expenses & Taxes</i>		(750,000)
Workletter Value (\$35/RSF)		(1,750,000)
Marketing		(400,000)
Total Revenue	\$15,000,000	\$8,650,000

Benefit Available to Tenant at Landlord's Break-Even: \$6,350,000

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 — workletter, brokerage commissions, down time and marketing costs. Then he wins again by renewing Company X’s lease at an above-market, premium rate without taking the commensurate risks in the marketplace or providing anything of value to his tenant.

The landlord contributes nothing to the transaction, yet he pockets over \$6 million in economic benefits created by Company X’s decision to renew in place. What can the company do about it? Probably little but console itself with the knowledge that perhaps 85 to 90 percent of the companies that renew leases in place are equally generous with their landlords.

Or, it can rationalize that it really saved \$12 a foot in effective rent by not moving. This is especially tempting if Company X knows that a competitor also has recently leased space at a \$48 rate. That rate might sustain Company X’s competitive position, but it certainly begs the question of why Company X would surrender a competitive cost advantage to its landlord instead of seizing it for shareholders.

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, both 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 agree to rent property at rates based on the interaction of several factors: their asset cost basis; required returns to debt and equity capital; current and expected levels of economic expansion or contraction and their effects on real estate market activity; the unique features of their market segment; their competitive position in that segment; and the mix of tenants, rates and terms of the leases in their buildings.

In addition to these factors, there was the company’s understanding of the situation and of its relationship with the landlord. Did Company X 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 X did not know how to play the game. It didn’t know the rules, strategy or tactics. Most companies that try to play against their landlords find they are as ill-suited for the contest as they would be wearing ice skates in a footrace. They might be the stars of their own industry, but they are rank amateurs on the landlord’s turf.

Unlevel Playing Field

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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 corporate executives should understand. The successful corporate 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, ten 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.

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Because the landlord has superior information and understands the game's strategy and tactics, as well as the fact that the game is already under way, 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 to secure 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

Extracting maximum value from a lease renewal is not necessarily quicker or easier than finding, negotiating and moving into new space.

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 must 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 very 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 renewal strategy are:

- **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, time enough 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 very 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 is no "universal" landlord, however 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.
- **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 senior-level real estate professional from outside the corporate 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's real estate department, but it rarely does, due to the inherent nature of the renewal environment. Real estate departments are 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 corporate hierarchy as possible in order to dilute the real estate executive's authority.

The threat of relocation must be very real to the landlord. Given the landlord's ability to sell the idea that a renewal is more about the tenant's opportunity costs to relocate rather than the landlord's costs and risks to replace the tenant, even the most adroit real estate executive can find himself in a weak position on his own turf. The bottom line is that the real estate executive often does not get the full corporate or user group support in a renewal gambit that he would get in an acquisition situation — and the landlord knows this.

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 corporate real estate departments have neither reason nor mandate to develop. An important requirement of such a third party is senior standing in his profession. A landlord who hears that a junior-level consultant is researching the market for his tenant will not give a threat to move the same credibility that he will if he hears that a senior broker from a leading real estate firm is working the market. Landlords know that senior real estate people have learned not to spend time on situations where they do not have management's full support and where there is little likelihood of a transaction developing.

What Is It Worth?

How much value can you extract in a renewal? It depends on the market, the landlord and the skill and art of the players on the tenant's side. You should get everything the landlord can give up without going underwater.

Tenants who negotiate their own renewals seldom fail completely. They usually gain some concessions, although they may have little idea what they are worth or what they might have gotten. The problem is that because they let the landlord set up the situation to the tenant's disadvantage, the landlord gives up only enough to make the tenant feel good. They may never know that what feels like a pretty good deal to them feels absolutely wonderful to the landlord.

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