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Question of the Month: What are the current market rents and what is achievable for specific deals?

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With Daylight Savings Time changing the clocks ahead, giving us more daylight at the end of the day, activity levels in commercial real estate tend to pick up some after the winter doldrums. But for the past five years, this uptick has not been as noticeable. Occupancy expense has been under scrutiny and downward pressure since before the inception of the Great Recession in 2008/2009. There are many components to this trend. Among them is the impact of mobile technology - allowing more people to work more productively outside the office. Many firms will no longer assign an office to an employee who is not on premises at least three days each week. In addition, the size of workstations is tightening up, again because the technology has gotten smaller, thinner and more mobile. We have three clients moving in 2014. The first is going from 96,000 s/f to 69,000 s/f, the second from 37,000 s/f to 20,000 s/f and the third from 12,000 s/f to 7,000 s/f. On the other hand, we currently only have one client looking to expand their office footprint.

On the operating side, we are seeing rising real estate taxes, utility costs as well as snowplowing this nasty winter. Tenants only care about gross rent - their total "all in" expense each year. While traditionally landlords focus on net rent with all expenses being passed through to tenants. But as office markets have tightened in all but the top 10-12 largest cities, landlords are willing to make concessions to either keep existing Tenants or recruit new ones. On the other end, lease term is under siege - no one is signing long-term leases for office space (10 years or more). If they do, they negotiate early termination language so they might be able to choose to exit in seven years (by paying some premium or unamortized costs). This tactic has become the norm to the point that Landlords no longer protest, after all - seven years is better than none.

So, the office sector is still under stress as new technologies have firms rethinking the need for space. This trend will likely continue as firms grind out excess costs quarter after quarter due to the fact they have little opportunity to raise prices. The same is true for manufacturing for the most part. Managing costs is the rule of the day. So, the result is that landlords are agreeing to rents that stabilize their income rather than risk pushing rents and losing tenants. Their hope is that some form of inflation returns and rents will be able to be increased somewhat to make up for a flat 3/4 decade (from 2008/9 through 2014 and most likely 2015).

The most robust commercial real estate sector continues to be multifamily. Much of the enthusiasm for this sector comes from the ability to raise rents annually. While that ability comes and goes with supply and demand, overall it is generally positive. My daughter lives in DC and for three years she has confronted the sales team in her apartment complex's management company by researching alternatives and digging out what deals others are getting. Ultimately, her monthly rent rate has gone up, but concessions on cable TV, high-speed Internet, utility rebilling and a few cash cards have helped her hold her rent within 1% to 2% year-to-year. She and I are amazed at how many others shrug their shoulders and agree to pay the proposed rent from the get go.

At Norton Asset Management, our job is to help both landlords and tenants learn what current market rents are and what is achievable for specific deals at a specific time. When representing a significant Tenant with good credit, this task is easier than with small tenants with less credit history. But none of these deals are easy because there is still a big gap between the expectations of both parties. Landlords feel they have given up too much for too long and now is the time for them to begin to claw back some of their anticipated rents. Yet at the same time, tenants feel they are under cost pressures and cannot give up more rent. So the gap in expectations remains. Ultimately, the market prevails, large vacancies and motivated competing landlords will help tenants get good pricing. In New York City and other markets, the landlords benefit from low vacancies and other landlords not wanting to provide concessions. Ultimately, both these markets will come into balance. In New Hampshire, it will involve older obsolescent office buildings being converted to other uses, thus reducing supply. In New York City, it will be by new construction, adding to supply and giving tenants more choices (a.k.a. competition).

Bill Norton, CRE, is president of Norton Asset Management, Manchester, N.H.