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Market change: Look forward and try not to think backwards when it comes to market rent

July 11, 2008 - Appraisal & Consulting

One of the key components of value is market rent. Market rent where existing tenants renew is often set by arbitration.

This article will discuss the very important subject of rent arbitration and in particular focus on the wide gaps that are developing in the market place. Finally, I will present my own views on the current volatility of the market and provide basis for the unique conditions that I believe those in the real estate industry now face.

Rent Arbitration

Many leases contain clauses where tenants hold rights to renew and thus extend the term of their lease.

Traditionally, notices to renew are given six months to one year in advance. Time frames are outlined for hiring appraisers or arbitrators and time frames are often set for reaching a decision.

Some lawyers like to place very tight conditions on the arbitration/appraisal process. Others wish to control the quality choice of arbitrators and then give them broad latitude.

More often than not, arbitrators are given a daunting challenge. Leases in and of themselves are forward looking documents with renewal terms starting a number of months in the future. The typical technique employed by the arbitrator involves using comparable rents. The problem is that comparable rents are those being achieved at about the time of the arbitration, and do not reflect the most likely condition during the terms of the lease.

Comparable rents work fine and have successfully defined "fair market" when conditions have been relatively stable. They look back at what has occurred and rely on those rents going forward. At the present point in time, conditions are so volatile that market change can take place in as short as a two week period.

Arbitration Under Volatile Market Conditions

Market surveys are one of the arrows arbitrators consider in reaching a decision. To use the city of Boston office space as an example, through Q1 2008 our markets were in a nice recovery with 12 quarters of positive absorption. A number of recent leases were available for study. This article is written on June 22nd, close to Q2 release of market statistics. As of Q1 2008 there were some 4,000,000 s/f of vacant space on the market. At a CoreNet meeting I attended on June 19th, a market pundit suggested 750,000 s/f of new space availability for Q2 2008 which is huge. By itself this is 19% of vacant space and 1% of the total market. A 1% change in one quarter can send shivers throughout the industry.

If arbitrators must set rent some months in the future, they are faced with a quandary. If the arbitrators must establish a rent as of a future date based on current transactions, it may well be substantially different by the time of the actual date or lease renewal. If lease language allows, they can wait, bracket rent around what is happening at the start date of the renewal with a landlord recovery of any short fall after the period. I have seen cases where sticker shock over rent levels has caused tenants to not renew, continue to negotiate and carry space on a 'tenant at will' basis. For small space users, there are 50 or more options available. Landlords asking tenants to vacate carry a high risk of long down time with substantial brokerage and tenant improvement costs.

Summary

To tenants planning ahead for the next three to five years there is concern. One tenant stated "Frankly, I am not at all confident that I can hold the company together and accept such a huge increase." Like this tenant, I have not been as uncomfortable as I am now since the June 1990 to January 1991 market free fall brought about by our banking collapse. Market fundamentals I believe continue to deteriorate.

This time around, my discomfort is the anti-gravity approach of the Federal Reserve. The true rate of inflation is running 10% to 12% rather than the 3% to 4% suggested by the CPI. These statistics are commonly referred to as shadow statistics and are readily available on the internet. I grew up under the concept of adding the rate of inflation to a safe rate of return to reflect the true measure of return on capital.

Inflation regretfully I see swallowing the federal fund rate policy as it ripples through our economy.To try to set market rent with the volatility we now experience is an equally uncomfortable task. Gaps between landlord and tenant perspectives have widened. We recently were involved with a lease renewal that started at $34.00 per s/f and in the week of June 10, 2007 was accepted at $27.90 per s/f.

Rents within buildings where a tenant may be located are part of the equation but it is the world around that building that I believe to be the key factor. The next several years I believe will be a sifting out process as we all adjust to the new realities to which we now are exposed.

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