Short-term leases: Good or bad? Only time will tell who is right and who is wrong - by David Skinner

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I was standing in the lobby of LifeTime Fitness and thinking to myself, “Wow, this could be the last time I ever work out at LifeTime ever again.” It was the end of the day and my workout buddy was trying to figure out if it was safe to be there. Apparently there was something going around that some people who I had never met were getting quite sick. Was this domestic terror threat, some sort of hoax, was it totally legit, or some combination of all the above? We finished lifting and we had no idea that March 16, 2020 was going to be the last day of what we knew as normal for years. Things may never be the same.

Why do I bring up my last sane memory before the West’s response to COVID changed the world, maybe forever? Perhaps it is because I am writing during the three year anniversary week of COVID. Perhaps it is because when we feel like we have been here before, what do you do? You look back and you remember what you did that helped the situation and what you did that didn’t help the situation.

What does this feel like in the past? It reminds of the beginning of the international response to COVID which left us all feeling lost and exposed. But what can we learn? This is the real question. How can we take what is happening now and use the past to help us interpret the present and future?

Here is one trend that I would like to discuss: shortened lease terms, and my opinion of the logic contained herein.

One of the elements to the commercial real estate business that we saw over the last three to five years has been the explosion of lease rates all over the Greater Boston marketplace and beyond. Suburban cities like Stoughton, Framingham, or even a place like Brockton that has historically had less tenant interest than the their counterparts like Woburn or Medford are now seeing two to three times rent growth over the last few years. This has caused the sale prices to explode, but it has also had an unintended consequence—that of more recently suppressed sale values. As I am doing my tenant representation work in the industrial world, it is far more difficult to get lease proposals at a 10-year term. These shorter lease terms are very common in high-value areas closer to Boston, but in the suburbs it was commonplace for a landlord to want a long-term lease and the tenant to want the shorter term. More recently, landlords are quite reticent because they still see either the real or perceived value of the length of the term to impact their future sale value. Let me explain.

Rents have been rising, and that is scientific fact. Right now, the value to any buyer is the ability to raise rents in the future in the “mark to market” approach where the property is purchased with the idea of what the building would rent for now, if it was vacant. This approach was famously employed by the Enron executives during their meteoric expansion. I encourage you to read more about that company elsewhere. It is a fascinating story, but I digress. This “mark to market” approach does not work if a tenant signs a then-market but now-dated lease rate and is locked in for 10 years. Because buyers are not spending money on a five cap purchase, they need to see the value-add component to a sale. This is why a five or seven-year lease with options going into the future at market rents are so valuable to landlords now. This is also a concern for tenants because they know that the market rent could go up and outpace their ability to pay the rent, leaving them homeless after five years.

Now how does this relate to our initial conversation? Many companies borrowed aggressively and continued expanding their businesses when the future was uncertain back in 2020. Many industries had banner years, including commercial real estate. However, it seems that on the brink of an economic retraction, proposing short-term lease rates assuming that companies will certainly want to renew the options in five years seems short-sighted and too risky. Time will tell who is right and who is wrong, but if things continue the way they have been, there could be a lot of empty real estate in five years and a number of tenants looking for some more cost-effective options.

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