COMMERCIAL REAL ESTATE

Lease rate is above market at renewal time – so now what?

By Allen C. Buchanan
Contributing columnist

Recently, I've encountered several situations involving an occupant paying an over-market rental rate. The occupant's desire is to remain in the building and renew his lease. But there's a problem. Storm clouds are rumbling on the horizon, and a faceoff between owner and occupant is quickly approaching.

So now what?

First, let's first determine how the over-market rent occurred.

Leases originated before the financial meltdown of 2008 were inked at the prevailing market rents. Those rents were at a high-water mark.

Most, if not all of the leases contained annual rent escalators that increased the rates over their terms. Shortly after the crash of 2008-2009, market rates plummeted.

So hypothetically, if a lease signed in 2008 had a five-year term, gold! When renewal time rolled around in 2013, occupants were pleasantly surprised the market had moved in their favor and now rates were cheaper than they were paying. In many circumstances, owners gladly renewed occupants at reduced rates to ensure the owner's cash flow would continue, albeit at smaller amounts.

However, if the lease's term was seven to 10 years, the opposite was true. Occupants have paid rent in excess of market rates for the term of their lease and now face renewal in an overheated rental market. Ouch!

Owners, who were eager to renew leases at cheaper rates in 2013-2014, are now quite bullish and unwilling to budge on their renewal rates. The resulting tug of war between owner and occupant plays out something like this:

Owners point to the vacancy for industrial buildings in Orange County — 98 of every 100 are occupied — and say a better spot will be hard to find. Oh, by the way, rents are increasing as proven by recent lease comparables.

Occupants quickly counter with the fact they have faithfully paid an above-market rent for the term of their lease and consequently deserve a break in the form of a rent reduction.

Owners return the argument by reminding their occupant of the cost, disruption and inefficiency of moving.

Occupants respond with the owner's cost of originating a new lease — down time with no rent, free rent with a new occupant, potential upgrades required by the new tenant, real estate fees, etc.

Now a standoff akin to Wild West saloon gunslingers ensues.

The man who draws first generally wins.

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