

NEGOTIATING LEASE RENEWAL RENT RATES

CPI, Fixed, or Something Else?

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Determining mutually agreeable rental rates and terms in Lease Renewal Options (“Options”) is a true art in our business. In an office or industrial lease, a broker truly demonstrates his or her negotiating skills and creativity by matching the client’s needs to both market conditions and the parties’ respective tolerances to achieve the ultimate “win-win” solution for both landlord and tenant. Here are some key points to consider:

1. Fixed Escalation Rates v. CPI: Fixed escalation rates are appropriate when market conditions are stable and appear likely to remain so for several years, depending on the initial lease term and how far into the future the renewal period runs. In a three-year lease, the renewal period comes sooner than in a 5- or 10-year lease. The shorter the initial lease term, and the more economically stable the market, the more likely it is that a landlord will agree to fixed escalation renewal rents. However, if the lease term is seven years or more, and there is uncertainty about the future, a potential solution is *the lesser or greater* of fixed rates or CPI rates of inflation. In our current low interest rate market, few landlords want to tie their future cash flow to CPI rent increases.

Therefore, accommodations between the parties should be made.

2. Fair Market Value (FMV) Rent Rate: Since this determination will be a future negotiation, it is critical to specify **both** the definition of FMV rent and the mechanism or process by which FMV rent is determined if the parties cannot agree. This will ensure that virtually no ambiguity is left to either party’s future interpretation. It is recommended that you include in the process an agreed-upon, impartial third party or arbitrator as a tie-breaker if landlord’s and tenant’s claims or their separate experts’ opinions of FMV rent differ. Use a fair rate for calculation when the determination in the future is to be made. For example, is 95 percent of FMV appropriate?

3. Other points to consider: Does FMV include accounting for TI allowances, free rent, or other concessions being offered by competing properties and absent from renewals?

Is there a minimum amount for the rent renewal rate? For example, “in no event shall tenant pay less than the current net rental amount” or similar language may be included.

4. Variable or Stepped Rent Increases: In situations where the tenant may be

a start-up entity, or may have less than stellar credit, and the landlord is willing to roll the dice by leasing space to the tenant (especially those with heavy capital improvements in the leased space), variable rent rate increases may be appropriate. For example, landlords may seek to front-load higher rent rate increases into the renewal period when the landlord believes the tenant may be financially at risk. By the same token, in a competitive market, where supply of available space meets or exceeds demand, the landlord may protect against losing a tenant by keeping the rent increases low, flat, or even back-loading the rent increases into the later stages of the renewal term.

Bottom line: landlord and tenant should, as the lease is being negotiated, project each other’s needs as much as possible at the time of the renewal to ensure that the agreed-upon renewal will be in the best interests, and at the most mutually agreeable terms possible, for both parties.

5. Include Inducements to Renew: Since the parties are working in the present to set terms for a future negotiation, a tenant representative should strive to include in the renewal option other inducements to stay in place. Examples include free rent, TI upgrades (new

carpeting, paint, technology upgrades, lighting retrofits, etc.) and other items that give comfort to the tenant who would then be less inclined to relocate. Similarly, the landlord hopes to avoid the downtime and costs to re-tenant space, so it is in the landlord's best interest to provide some incentives (free rent, allowances for furniture or technology upgrades, etc.) to the tenant to keep it happy and in place. All of these items should be considered when crafting the lease renewal clause during the initial lease negotiations.

As a final takeaway, keep in mind that every situation and specific market condition and dynamic will inform the parties as to the challenges and opportunities presented when the renewal terms are first negotiated and structured. Tenant and landlord brokers should be mindful of, and prepared for, the impact of those factors upon the parties they represent, and use that knowledge constructively to create the most compelling lease transactions for their respective clients. The reward also comes with a lease renewal commission, strategically addressed and protected in both the commission agreement and in the lease. ♥



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