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Will Short-Term Leases Dominate the Office Sector?

From the PrivcapRE webinar
“Death of the 10-Year Office Lease?”

Sonny Kalsi
GreenOak Real Estate

Will Silverman
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Rising demand for creative space is pressuring landlords to deliver more to tenants. But while demand for amenities and the accompanying tenant improvement costs are increasing, landlords are holding the line on lease duration.

The Panelists

Sonny Kalsi
Founder and Partner,
GreenOak Real Estate

Will Silverman
Managing Director,
Group Head of Investment Sales,
Hodges Ward Elliott

PrivcapRE: Let's cut to the heart of the issue: Is the 10-year lease in jeopardy thanks to the growth of smaller, newer firms and co-working spaces?

Sonny Kalsi, GreenOak Real Estate: I really don't think so. Clearly, some trends in the last several years—I'll call it the WeWork effect—have been creating options for tenants. But by and large, in major markets in which we operate, there's still a strong preference on the part of tenants, and surely on the part of landlords, to have some duration to their leases.

Will Silverman, Hodges Ward Elliott: I think it's still very much alive. If tenants were to express an overwhelming preference for the shorter lease term, which many do, lenders would have to be on board, otherwise there would be a substantial correction in property values because you wouldn't be able to finance as aggressively.

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Why is there such a focus on the lease being 10 years? Will, you talked about lender requirements but is it also down to rising tenant improvement [TI] costs being incurred by landlords?

Kalsi: When you think about the capital costs involved with [many office buildouts for tenants], what's required in a B+ or better building, they're pretty significant. So as the landlord, I sure want to have some duration there to offset some of those costs.

Silverman: I would liken it to $200 ripped jeans. In order to achieve the true aesthetic that people are really looking for, it's really hard to get that patina organically. With respect to co-working and creative space, those buildouts can look a little bit raw, but there are a lot of materials there. There is a lot of glass involved in that. And the amenity spaces they have in the centers of each of those floors are actually pretty rich.

So how do landlords even underwrite some of these newer, smaller firms given they haven't been in business for long?

Silverman: Investors are feeling like they're sort of walking a tightrope because a lot of them are fearful. A lot of these tenants haven't existed for the amount of time that's equal to the forward commitment in their lease. You have three-year-old tenants signing 10-year deals. As a landlord, that's got to give you a little bit of pause.

Kalsi: That's why something like WeWork has been so well received. It's an aggregator and it is helping disperse, if you will, the credit risk of those underlying tenants by pulling them together and providing, certainly, better credit. You can have a whole debate about WeWork's credit, but it's clearly better credit than any of the underlying tenants beneath them. And so that disintermediation, they've addressed a big need.

Are investors conceding a significant part of the technology, advertising, media, and information leasing market to co-working spaces like WeWork?

Kalsi: We've thought about it, and at the end of the day, we're not sure it's worth it. From the standpoint of the credit risk you're taking, how you think about how you build out and manage space for such small tenants, our view is it's not worth it. You're on a treadmill with shorter-term leases. Your net operating income yield on cost might look somewhat attractive, but your net cash flow yield on cost, between paying the brokers and then paying for your tenant improvements, you're always on a treadmill.

Silverman: There's an arbitrage here. There's an old trope in the retail business. Whenever there's a super expensive store on 5th Avenue with a really, really high rent, people always say, "Well, I suppose that maybe they're not making as much money on the store, but some of the rent is in their advertising budget." These types of tenants,

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–Sonny Kalsi, GreenOak

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they're using their real estate space, albeit rented space, as a recruiting tool.

Tenants are willing to pay up if the landlord is deemed to be delivering the style of experience that they want, with a building that has outdoor spaces available to tenants, a gym, etc. Workers are actually willing to, in many cases, accept a little bit less money or work slightly longer hours to work in these well-amenitized spaces. To the extent you can get people to take less money by paying more rent, you're not paying payroll tax on the additional rent. So you've accomplished recruiting without having to spend more money, which is terrific.

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>
> –Will Silverman, Hodges Ward Elliott

In terms of office buildouts, what's GreenOak's strategy? What are tenants asking you for?

Kalsi: We're seeing more tenant requests for what I'll call a complete buildout. A lot of them are in a position to do it themselves. But they don't want to deal with it. They'd rather see it amortize into their lease. Partly it's because if they are in an industry where their cost of capital is perceived to be high, they view this as something that's going to be more easily provided by a landlord. In a lot of our buildings, we will be able to borrow the TIs that we put into something. And clearly, our cost of capital for that is going to be lower than some tech firm's venture capital is going to cost them. If that means we can get a higher base rent and we're comfortable with the credit, it's a good tradeoff.

What's the minimum amenities package that you think you can actually offer today to attract tenants?

Silverman: Anything that you would find in a modern apartment building or a hotel as an amenity is probably something that you will get a nice response to in an office building—things like gyms, bike rooms, outdoor space. I don't think it's indispensable, but it's a very important thing to have. There's a convergence of uses, and people are spending more and more time at the office.

Kalsi: For tenants in New York City, as an example, cool has become much more important than it used to be. If you think about those factors, which ultimately come down to cost, for sure tenants are asking for more. If you want to build out space with a concrete polished floor and exposed ceilings, that's more expensive than dropping down carpet and dropping a ceiling. So base rents are moving up and have consistently moved up for the last few years. Tenant improvement allowances are moving up as well, and that's very much driven by tenant expectations.

Are we in the midst of an amenities craze where tenants are asking for too much?

Silverman: I don't think so. This is a secular shift in preferences in the way people engage with space. People find a lot of things desirable and these aren't just millennial preferences. These are things that a lot of people like.

Kalsi: No question that all these things are important. But in New York, if you're talking about providing substantial tenant improvements, you want some duration on that lease. And something has to give. If all of a sudden, tenants in New York are coming to us and wanting five-year leases, we're not going to give them that kind of work letter. We can't afford to. It doesn't make any economic sense to do it, regardless of what rents are. ■