Focus

Tenant Issues

Avoiding 'DUH Syndrome' in negotiating new leases

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During lease negotiations, both sides often will fall victim to the "DUH Syndrome." That is they can't see the forest for the trees.

This recently happened during the lease negotiations for a branch office of a major global telecommunications company. The existing branch office was in a Class "B" building, in an inconvenient area, and suffered an inefficient layout. All are good reasons for seeking new space.

The company's branch manager and area real estate manager located space in a new Class "A" building in the heart of the business district. The new space was more efficient, so even with a higher rental rate it was less per month. The real estate manager also knew the company's financial strength allowed it to borrow money at rates below the landlord; therefore, he had the company pay for the tenant improvements in exchange for a lower rental rate. To be flexible, the company got a three-year lease rather than the five-year term the landlord wanted.

It sounds like a great deal. The branch manager was happy, the employees were happy, the landlord was happy, and the real estate manager was happy. However, the bean counters at corporate weren't happy and said "no." The present value of the savings over the three-year term didn't justify the cost of moving and the tenant improvements. This deal became victim of the "DUH Syndrome."

Here's a remedy. While the company's cost of borrowing is lower than that of the landlord's, what the real estate manager didn't consider was the company's opportunity cost for those funds. That's the return the company would make on the money. Yes, the company avoided paying the 10 percent per year that the landlord would need to amortize the tenant improvements. However, it gave up the opportunity to earn 16 percent a year on those same dollars. Paying for the tenant improvements reduced the rent, but not enough to offset the company's opportunity cost on the funds used for the tenant improvements.

Many executives fall into the flexibility trap, thinking a three-year lease is more flexible than a longer-term lease. The questions they often forget to ask are will they be in business in three years, what will be different then, and would it cause them to move. While doing the financial analysis over a three-year period is logical, it is not real world. After three years, the company would still need a branch office someplace. So a more realistic analysis would be for six or nine years, assuming one or two lease renewals before moving. This gives the company more time to capture the benefits of moving into the new space. A better real estate plan would be a 10-year term with a cancellation clause or a three-year term with two three-year renewal options.

Another tip would be to amortize the tenant improvements for a six-year period. Of course, this assumes a three-year lease with two three-year renewal options. If the tenant doesn't renew then the balance is due. The benefits: lower monthly rental payment to the tenant because of the longer amortization period, and no money tied up in tenant improvements. The landlord gets a credit tenant and creates an incentive for the tenant to renew.

The "DUH Syndrome" can strike anyone at any time. The cure is to take the time to step back and re-examine the situation.▲