Manhattan Office Tenants Poised to Seek Mid-Lease Rent Cuts

By John Covaleski, Commercial Real Estate Direct Staff Report

A small number of Manhattan office tenants have managed to negotiate rental rate reductions - even in the middle of their leases - and tenant representatives say such activity could increase in the coming months as the city's office market weakens.

And if many tenants succeed, it could throw a big monkey wrench into the metrics that lenders and investors use to value properties.

Tenants paying what suddenly have become above-market rates under leases with less than three years of remaining term are the key candidates to renegotiate, according to the representatives.

They said remaining lease terms of about three years are short enough to make landlords at other properties willing to lease to those tenants at reduced rates and to pay off the remaining rent obligations for the space those tenants vacate. And the terms are long enough to prompt the tenants' existing landlords to consider reducing rents. They otherwise could face substantial costs in building out the departing tenant's space for use by others.

"There are landlords that will capitulate for less than market rents in order to minimize their downside as the market moves further," said Gregg Lorberbaum, principal and founder of Centric Real Estate Advisors, a facilities-use consulting and tenant representation firm in Manhattan.

What would force landlords' hands is the rapidly declining Manhattan office market, where the amount of available space is increasing, while demand from the main tenant base - financial services - has been shrinking as a result of the banking-industry crisis.

The market's 5.1 million square feet of leasing activity in the third quarter was one of the lowest quarterly rates in recent years and 31.6 percent below the market's historical average of 7.4 million sf, according to Studley Inc. The availability rate, which includes direct and sublease space, grew 70 basis points to 8.9 percent, and Studley has projected that it will reach 13 percent by early 2010.

The average asking rent increased 1.3 percent to $70.20/sf, but Studley noted that the average was skewed upward by the $105/sf asking rent at one building delivered in the quarter, the 1.1 million-sf 11 Times Square in midtown. If that property were excluded, the market-wide average rent would have dropped by 90 bp.

The third-quarter results are in stark contrast to the steady declines in availability rates and increases in rents that the Manhattan office market had experienced for several years prior to mid-2007.

"Until this year, Manhattan landlords were able to step up and say they would be charging $100-plus/sf for rent. Now they are telling tenants, 'Let's make a deal,'" said a prominent investment-sales broker, speaking anonymously.

Tenants paying above-market rates under leases with less than three years of remaining term account for about 20 percent of New York's 100 million-sf inventory of class-A space, according to Lorberbaum. His firm is representing three clients in lease renegotiations, which compares to no business in that area two years ago, and he expects to add more such clients.

Some of that activity may come from businesses that are having trouble remaining operational in the weakened economy and will want to reduce their rents and other costs in order to survive.

"The market always has a certain percentage of tenants with marginal businesses that will try to reduce their rent costs in an effort to stay in business," said Stephen Sunderland, a principal with the tenant representation and facilities use consulting firm, Optimal Spaces. "But now firms are facing possible shutdowns for all sorts of added reasons - they are profitable but have credit lines that are frozen or clients are not paying bills - and they'll be looking to renegotiate rents," he said.

To be sure, landlords' ability to reduce rents is constrained by their covenants with lenders. James Meiskin, president of Plymouth Partners, another tenant representation/facilities-use consulting firm, said that means that tenants renegotiating leases have to make the case that new terms would be less costly than losing tenants.

He estimated that the costs to replace a tenant could range from $50/sf to more than $100/sf, which could include the costs to re-build existing space. New York City has by far the nation's highest office building costs, according to Reed Construction Data.

Meanwhile, Manhattan's office-market fundamentals are generally believed to have worsened significantly since the third quarter because of intensified problems in the investment markets and the financial-services sector. That sector has accounted for 25-30 percent of Manhattan's leasing activity.

Property & Portfolio Research Inc. in October updated its metropolitan New York office market forecast to predict the vacancy rate would increase to 17.6 percent in 2010 from 12 percent before reversing itself. In July, it had projected the vacancy rate would peak at 13 percent.

Sunderland noted that a client in financial services who had signed a term sheet for a lease in September sought to renegotiate those terms in October after the stock market took a beating. The landlord agreed to increase the free rent period in the lease to eight months, double the original amount.

"The fact is that in this market, brokers for landlords are calling back and saying they will do whatever it takes to get a deal done," he said.

In an indication of how accommodating brokers and landlord have become, Cohen Brothers, owners of three midtown office buildings, last month began offering prospective tenants one year of free rent if they leased either a full or half floor for at least 10 years in either of their buildings.

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