# Perspectives

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## Three Things Office Tenants Should Know in a Time of Market Volatility

It's natural to wonder what's going on with the economy and what's next for your business. So, when it comes to leasing your office space, you could be asking a variety of questions. But we're going to narrow it down to three facts you should find out as you search for space or look at signing that renewal.

### Landlord Loan Maturity

Debt is the lifeblood of much of the commercial real estate market. Illustrating that fact: banks represent 54% of the overall $5.7 trillion in the commercial real estate market, according to a Reuters report. Used correctly, debt enables real estate owners to maximize returns and free up capital to invest in other opportunities. However, with interest rates rising at the fastest pace we've seen in 35 years, many owners are facing serious challenges when forced to refinance as their notes come due.

First, it is important to know most commercial real estate loans have terms shorter than their amortization period, resulting in a balloon payment at the end of the term. With the record-breaking velocity of interest rate increases, many owners with loan terms expiring over the next 18 to 24 months are staring at the harsh reality that their investment doesn't work in today's debt market.

However, this doesn't just affect the ownership groups. Tenants must understand both their risks and opportunities in a market that will likely experience increased volatility in the next 18 to 24 months. Below are a few thoughts we have for tenants to consider.

## How to Protect Your Company

One way to protect your company is by knowing who the lender is early in the process and understanding where you and your landlord stand with that lender. There are a couple of ways to go about that. First, if you have a Subordination Non-Disturbance Agreement (SNDA), this helps to ensure your lease can't be terminated if your building is foreclosed on.

If you aren't familiar with an SNDA, here's a quick (and broad) explanation: an SNDA is a three-party agreement between a lender, a commercial tenant and the property owner. We recommend tenants, especially those that occupy a large portion of their building, seek an SNDA as a condition before entering into a new lease or a renewal. The primary effect is that the lender cannot terminate a tenant's lease should the property be foreclosed on.

We also suggest inquiring about the landlord's debt maturity early in the lease negotiation process. We recommend requesting lender and loan information from the initial request for proposal. It is important to understand other lease expirations in the building, as well. If a large percentage of the tenant base has leases expiring in the same period, this gives tenants leverage in negotiating or renewing their lease if the landlord's debt is coming due.

## What to Expect in Negotiations

Another thing to keep in mind is what to expect in lease negotiations. Unsurprisingly, tenant improvements (TI) will be harder to come by as landlord debt is more heavily scrutinized. Landlords will have a harder time financing TI allowances, meaning tenants will likely get a higher allowance if the improvements are designed in a way that can benefit the building or future tenants rather than just your company's unique needs.

Creative concessions, such as free rent and unique TI allowance structures, will be a beneficial way of bringing down effective rates for both sides. Taking advantage of concessions like free rent is a win-win by lowering the effective rates for tenants while enabling the landlord to maintain their desired rents and subsequent building value on the back end.

It is critical to keep in mind that deals will move slower, and lenders will be much more involved during a recession (or even when a recession appears imminent.) In commercial real estate, in particular, approach any transaction expecting it to take longer than expected. This is especially true with lenders keeping a very close eye on office loans; meaning you can expect their involvement to delay approvals and produce last-second surprises.

## The Upside: Opportunities

Knowing your landlord's debt situation enables you, as the tenant and owner of your business, to make the most of your lease negotiations, giving tenants significant leverage. One opportunity to seize is right-sizing with a blend-and-extend.

This occurs when a tenant extends its lease - sometimes years before the lease expiration - to expand, contract or negotiate necessary TI. The tenant can modify its space or lease terms to improve their bottom line in exchange for the landlord securing additional time on a lease from the tenant.

While every situation is unique and every landlord is in a different position, having an advisor with the right knowledge base on your side is invaluable. This is where a team like Citadel Partners provides valuable insight as a tenant navigates the complexities of their real estate occupancy decisions while offering ongoing advisory services throughout the process.



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