From the Puget Sound Business Journal
:http://www.bizjournals.com/seattle/stories/2010/03/22/focus15.html

SUBSCRIBER CONTENT: Mar 21, 2010, 9:00pm PDT

COMMERCIAL REAL ESTATE

Now's the time for tenants to lock in better terms

Office Space

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Guest columnists

The commercial real estate market in the Puget Sound area now presents a window of opportunity for creditworthy tenants looking to lock in lower rents, expand or contract, upgrade their space or obtain other concessions.

Lease rates have been declining for about two years and landlord concessions — free rent, tenant improvements, additional parking, etc.— are at an all-time high.

The supply of office space in the Seattle and Bellevue markets increased by 4.7 million square feet in 2009. During the same period, tenants, including Washington Mutual, vacated 2.4 million square feet.

Vacancy is likely to reach more than 20 percent in Seattle and high teens in Bellevue by the end of the year. Thus, tenants hold powerful negotiating leverage in a softening market as multiple landlords compete for the same occupants.

The lack of long-term capital for commercial real estate development, coupled with the resilience of Seattle's diverse economy, will set the stage for rents to begin rising again, probably in the latter part of 2011 and beyond.

The CoStar Group, a national commercial real estate analytical firm from Bethesda, Md., is forecasting that by 2014 the average asking rents in Seattle will increase by more than 35 percent from a low expected to occur during the third quarter of 2010. CoStar is predicting that over the next four years, Seattle will have the highest percentage increase in office rents of any of the top 20 metropolitan areas in the country.

Tenants would be wise to consider lease terms beyond the standard five years in order not to be renewing as market rents peak during the next market cycle. Even tenants with two to three more years on their current lease should consider negotiating lease extensions now, trading lower rent now for a longer term.

The lower rent should reflect, at least in part, the cash saved by the landlord in not having to fund tenant improvements for a new tenant, which can be significantly higher than allowances for renewing tenants.

Another savings to consider is the reduction in property taxes paid by the landlord but reimbursed by the tenants. 2010 property taxes in Washington are based on assessed values as of Jan. 1, 2009, and 2011 taxes will be based on Jan. 1, 2010, values. Since assessed values should reflect market values, which have declined by more than 30 percent since 2008, tenants should expect landlords to carefully review and, if necessary, appeal assessed values.

Tenants should consider the bottom-line impact of property tax reductions — we estimate as much as $1 per square foot —and incorporate fair property tax expense stops into the lease.

In addition to locking in expected savings, tenants might look to reduce liability. Some landlords may forgo or cap personal guarantees where the tenant has a successful operating track record and good credit. A portion of the tenant improvement allowance could be used to fund a security deposit. Consider annual reductions in the amount of the security deposit or letter of credit if there are no material defaults.

Now is also a good time to seek broader assignment and subleasing rights, especially if the tenant anticipates a sale of the business. For example, the lease might limit the landlord's discretion to withhold consent to transfers of equity in the tenant.

In Washington, assignors remain liable unless expressly released. A lease can specify objective conditions under which a landlord must provide such a release.

As to subleasing rights, a tenant might consider whether sharing space with a vendor or customer could streamline operations and, if so, insist on the right to sublease to such entities without landlord consent.

Landlords hate to give concessions to existing tenants, and they will be reluctant to lock in rents for long lease terms at current rent levels. This is the year, however, when the tenant has the upper hand and landlords will be forced to face the reality of the market.

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