August 2005 Newsletter

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This is a multi-part article written to help unravel the myths behind commercial real estate statistics and highlight what is really important to understanding whatever commercial market you are analyzing…

Part II: Availability rates

In the last issue we discussed vacancy rates, how they are calculated, why are rates in the same markets quoted differently by the various commercial real estate brokers etc.

What should be viewed as the most important statistic or measure of the market is the **availability** of commercial space. Available space is what you can actually make deals on, be it for sale or lease. The total amount of available space is commonly known as the availability rate or should be called the availability index. Simply put, it is the amount of space "available" for lease, sublease or sale in a market, divided by the total inventory of space (occupied and unoccupied). ***For example, a market may consist of 100,000 square feet. Of that inventory, 10,000 square feet is vacant available and 5,000 square feet is available in 3 months from now. The vacancy rate is 10% and the availability rate is 15%.***

So how could available space not be calculated in the vacancy statistics? Take for example a landlord that lists space for lease that is not vacant. It could be he/she has a building under construction; the landlord will not wait until the property is completed to actively market the property. Another example is the landlord has a tenant that plans to leave when their lease is up, and in such a case, the landlord will most likely list the space for lease. There are instances where the tenant has a short renewal notification clause in their lease, 60-90 days prior to expiration to ***give notice of*** their intent to stay or leave. The landlord many times doesn't want to wait until the last minute to begin marketing the space as it leaves the landlord open to a vacancy risk. By marketing the property the landlord also puts pressure on the tenant to make a decision sooner rather than later. If the tenant knows the landlord may have lined up another tenant in its place, the tenant will have less negotiating leverage on the rental rate with the landlord if they intend to stay absent of any renewal clauses in their lease.

In these instances, the spaces will not be included in the vacancy rates, but they are definitely on the active market. To simplify, these spaces, though not vacant, can be considered competition in the marketplace. They are viable options for a tenant looking for space. In analyzing the market, you definitely want to see the availability rate in addition to the vacancy rate. And more importantly you want to know when those spaces or properties will be available. The reason this is the most important is because the timing of the availability is what is critical to your tenant or buyer. When do they need to be **in** their space? So even the overall availability index or rate can be deceiving depending upon the space users' requirement. If there are no properties or spaces that will be available when the tenant/buyer needs it, then it doesn't matter what the vacancy or availability rate is! It may as well be 0% for both!

Anyone who has gone through the leasing process knows it takes time to get a deal done. From a tenant's perspective, if it takes 9 months from start to finish in order for them to occupy the space, it really doesn't matter if the space is vacant today; it matters that the space is vacant when they need it. Actually if the space needs to be renovated to suit their interior

space configurations, the space needs to be vacant 90-120 days before the user intends to move in, thus allowing time for the construction, otherwise the space won't work.

From the landlord's perspective, the important aspect is whether their space is under a lease, be the space occupied or not. The landlord does not want to go a day without someone paying rent on his or her space, as that is revenue lost never to be recovered.

Lenders do care about the availability rate not only within a property they are underwriting for a loan, but within the respective market the property is located.
They require the landlord to provide their building's rent rolls, as this will show the lender when the leases in the building will be rolling over. This represents the "vacancy risk" for the landlord and subsequently for the lender. If any leases, especially if they represent a significant portion of the building, are due to expire within the term of the respective mortgage the lender will care. Remember rent paid is what enables a landlord to pay their mortgage.

Why should lenders care about the market's availability rate? The reason is if there is competing space to that of the property they are about to issue a loan, and the property has leases soon to expire, this circumstance provides the landlord with competition for his/her tenant. In the very least it will be used as leverage against the landlord on any lease renewal or new tenant lease negotiations. This in turn puts downward pressure on the rental rates the landlord is looking to achieve and perhaps impacts negatively on the mortgage. Most mortgages for income producing properties are based on the rental rates and length of the property's leases and quality of the credit of the tenants.

Just looking at the vacancy rate may hide the reality of the immediate market. This is not to say that a substantial vacancy rate won't portray a similar reality, however, there are instances, as stated above, that there is no correlation between the two indexes which is why both need to be analyzed.

Part III: Rent Rates

Rental rates quoted in most market reports are the **asking rates** in the market or sub-market being reported on. It is very hard to get the exact rates being paid, as that information is proprietary and most landlords and brokerage firms will not share that information. As a matter of fact it is contrary to all ethical standards for the information to be ***publicly*** shared unless permission was granted by the landlord and tenant. If the lease was publicly recorded then that is the only exception.

Rent rates can be quoted on 2 ends of the spectrum, which are full service and triple-net. Full service means all building expenses are included (taxes, operating expenses, utilities, etc.) Triple Net means no expenses are included, meaning the tenant has to pay those bills on their own. Though these are the 2-sides of the spectrum, there are all sorts of permutations in-between.

A full service lease is more convenient for a tenant, as the tenant can pay all its bills at once when it pays the rent. The 'rent' check the tenant pays to the landlord includes not just the rent but also all the expenses. On the other end, a triple net lease is more convenient for the landlord, as he or she does not have to worry about calculating expenses; it is up to the tenant. The reality for net leases is the tenant(s) are billed directly for various services by the vendors, including in many instances the real estate taxes. The tenant usually is required to provide the landlord and lender with proof of payment especially regarding the property taxes.

Regardless of what type of rent is to be paid, a tenant wants to know what the full service cost will be. That is, the tenant will have to pay for all these costs, so even if the landlord charges triple-net and it looks cheaper, the tenant will still have to pay for the expenses. For example, on a full service basis, a space may cost $30 per square foot. On a triple-net basis, that same space is $20. The $10 in expenses are still going to be paid by the tenant.

The landlord really cares about the triple-net rate (base), as that is his or her income. The expenses are

not part of the true income, as they are paid out to their respective vendor(s), be it the city or county for taxes or the utility companies for water, gas and electric or the landscaping service.

It is interesting to note that most tenants in the DC Metro area pay a 3% annual increase on their **FULL SERVICE RENT.** What's even more curious is that landlords are being paid the 3% increase on those expenses within the rent structure as well. This should **NOT** be the case. The landlord is protected by the 3% increases on the base net rent, which covers the increased value of the real estate from one year to the next. However landlords should not be generating income on the expenses by having tenants pay 3% increases on building operating costs, which are supposed to be "pass through" items. Most commercial full service or modified gross leases have an expense stop clause which protects the landlord in case expenses rise above the levels that were in place on the property at the time the leases were executed., Therefore the landlord is actually gaining additional income on this increase. A good tenant rep can negotiate out this aspect of the increase on the tenant's behalf.

Rent rates are a direct correlation to the vacancy and availability rates in a market. As vacancy and availabilities go up, rent rates come down. This is simple supply and demand. There are always anomalies in the market that can skew the numbers. For example, a large block of expensive space can be taken off the market and a large block of cheap space can be added. The vacancy rate can go down but the quoted asking rates can also go down in such a case.

Also, when a market report quotes asking rental rates, the report is pulling those numbers from the availability rate, not just the vacancy rate. That is, quoted asking rents are computed on all spaces available in the market. That being said, why would you only want to look at the vacancy rate in a market and not the availability rate? Market dictates price, and spaces available but not vacant are part of the market.

Part IV: Absorption Rates vs. Leasing Activity

Understanding market "Absorption" can be tricky but we'll try and simplify.

Simply put, absorption is how much space has been absorbed in a market. There is Gross Absorption, which is the total amount of space that has been moved into in a given time period. There is also Net Absorption, which are the spaces that have been moved into MINUS the spaces moved out of.

For example, a market is 100,000 square feet, and there are 10,000 square feet of move-ins and 5,000 square feet of move-outs. The absorption rate is positive 5,000 square feet. A strong market is generally said to have positive absorption, meaning there are more moving in than moving out. This can be deceiving, however.

What's more indicative of the health of a market is the leasing activity. That is, how much space is being leased over a given time? Leasing activity is different than absorption. While absorption focuses on when a tenant physically moves into a space, leasing activity focuses on when leases are signed. A lease can be signed in March but the tenant does not move into their space until September. When the tenant signs its lease, that event is included and reported as leasing activity. In September, when that tenant finally moves into its space, it is included in the absorption rate.

Leasing activity is just as important as absorption because tenants signing leases are what is driving availabilities. The more leases signed, the less spaces available on the open market, hence rental rate increases and the like. That is not to say absorption rates aren't important.

A good example is Arthur Anderson in NYC. The firm signed a lease for more than 700,000 square feet in Times Square for a brand new building. That space was removed from the market and construction began. The firm never moved into their space, as they went out of business. Absorption never happened. The space was put back on the market. Many will say

that is why absorption rates are so important, as this company may have signed a lease, but they never moved in. They are right, but it is not so simple.

Say Arthur Anderson would not have gone through their debacle and would have moved into their space. They would be moving into their space 2 years after they signed their lease. Though it is a positive that the firm is moving into their space,that does not necessarily mean the market is doing well now that there is positive absorption. It is important to know when Arthur Anderson signed their lease, because at that time in history, there was a reason for them signing that lease.

Both leasing activity and absorption are important in analyzing a market. However, there is an answer to what comes first the chicken or the egg. In every case, to accurately understand the health of any market, you need to know the leasing activity first, as leases must be signed before a tenant can move into its space. These in turn will impact the rent rates, vacancy rates, and availability rates.

Landlords and lenders focus more on absorption rates because they care more when a tenant moves into space and begins paying rent. Tenants should be focused more on leasing activity, because as leases are signed, space opportunities are getting thinner.

Landlords and lenders should care more about leasing activity because depending on if it is accelerating or slowing down it will impact their rent rates accordingly and it will illustrate what types of deals are being done in their market.

So for example, if a landlord has a large block of space in a building that he/she is not willing or unable to divide to accommodate smaller tenants, and the leasing activity shows only small deals being made in the market, the landlord will most likely wait much longer for a tenant than if he/she had decided (if the feasibility to divide were possible) to split their space for these types of tenants. And if that landlord sees other “available” space similar to their space, this too will have a major impact on both the length of time the space will remain on the market and the eventual rent they will receive. Lenders need or ***should be acutely*** aware of this, especially if the space can NOT be readily divided. The reverse can also be true, if there are only a few large blocks of space in a market, even though the leasing activity shows only small deals being made, once there is a tenant looking for a “large” block of space identified, the landlord will have the upper hand as there are so few choices. In this case the availability, vacancy and absorption rates will not matter. As was stated earlier... ***real estate is a matter of Supply and Demand as it relates to any one tenant’s or buyer’s particular need at any given time.***

Part V: Conclusion

In analyzing a market, one should take into account all factors and statistical models. No one statistic is more important than another. Rather, they are all intertwined. Rents will increase if there is less space on the market, and visa-versa. A large block of space coming on line in 6 months from now can have a major impact on a market, even if it is not part of the vacancy rate yet.

Lastly the importance of the statistics is relative to what the tenant or buyer needs in their respective market place. Statistics are wonderful tools to help guide what is going on in the market, but you can not take them at face value. This is true with any statistics be they economic or baseball stats for an individual player.

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Next Issue... non-profits, should they own or lease?