VIEWPOINT

IF YOUR BUILDING IS SOLD, WHAT HAPPENS TO YOUR COMMERCIAL LEASE?

PROTECT YOUR BUSINESS FROM NEGATIVE IMPACT FOLLOWING AN OWNERSHIP TRANSFER

Your building has been sold. As an office tenant, that phrase could cause shivers of uncertainty and concern. What does a change in ownership mean for your lease? If Your Building is Sold, What changes can the new owner make, and what rights to do you have as a tenant? Will you have to move? *Can you move?*

This guide addresses these questions to help inform commercial tenants about what to expect – and how to protect their business -- during a transition from one building owner to the next.

The Investors are Coming

A recent rush of investment has created high office turnover nationwide in second-tier markets like Denver, Portland, Miami, Phoenix, and Austin. Investors are sweeping into these areas (which historically have seen very low turnover) after turning their backs on the sky-high prices and low cap rates in the prime “Gateway” cities of New York, Chicago, and San Francisco.

These mid-sized markets are appealing not only for their lower costs, but also comparatively high rents, lower costs of living, the growing trend of urban living, and stock of available investment opportunities. Global law firm DLA Piper recently found that 78 percent of real estate professionals it surveyed agreed that non-gateway markets will come to the forefront of investment preferences in 2017.[1]

In Portland, Oregon, “institutional investors now own almost 60 percent of the Class A space in the central business district” according to the Portland Business Journal.[2] Denver has experienced similar numbers, with $12.9 billion in investment sales in 2016—a 23 percent increase year over year.[3]

If your office is in one of these “non-Gateway” cities, there’s a greater-than-normal chance you may face an ownership transition soon – if you haven’t already.

Exhibit 3-14 **Local Market Perspective*: Investor Demand**

Strong	New York - Manhattan	4.56	Denver	4.30	Nashville	4.21	Kansas City, MO	3.50
Improving	San Francisco	4.53	Dallas/Fort Worth	4.29	Washington, D.C. - District	4.21	Sacramento	3.47
Average	Boston	4.53	Portland, OR	4.26	San Antonio	3.62	Long Island	3.46
Declining	Austin	4.44	Oakland/East Bay	4.26	Minneapolis/St. Paul	3.61		
Weak	Los Angeles	4.34	Orange County	4.26	Indianapolis	3.61		

PWC / Urban Land Institute, “Emerging Trends in Real Estate, 2017”, page 58.

VIEWPOINT

CASE STUDY

A Fortune 100 technology company extended their lease by three years and agreed to a rent increase based on the owner's planned lobby renovation. The owner sold the building before any renovations were completed. The new owner set a 15 percent rent increase based on the same lobby renovation. As a result, the tenant is being charged a 20 percent rent increase on a lease extension compared to the rent charged only 12 months prior – due solely to new ownership with no other changes.

Tenants: How Could You Be Impacted When Your Office Building is Sold?

When a commercial office property is sold, the new owner has an expectation of returns on the property. While the new owner must honor the terms and conditions of an existing lease (in most cases), you may still face increased costs or changes to the building's aesthetics or function, based on the language in your lease.

You don't need to sign a new lease with the new owner, although the new owner may offer short term rent reductions or other concessions for tenants who extend their lease term or expand their square footage. When it's time to renew your lease, the new owner will likely raise rents to meet changing market conditions, boost profits, or in response to pressure from their investors.

The impact on you will depend in part on how much time remains on your existing lease.

- **Tenants with a lease end date that is 6-24 months out:** In this short-term situation, you are likely facing an increase in rent costs if you want to stay after your current lease ends. It is important to plan your future real estate needs and determine whether it makes sense for your business to stay (and accept a higher rent) or relocate.

- **Tenants with lease end date that is 25 months or more into the future:** You're stuck with your current lease, for better or worse. So, it's important to review your lease and ensure that you are maximizing the benefits and protections it provides you.

Expect Cost Increases

The most common impact to a tenant following the sale of a building is increased costs – either immediately or upon lease renewal. Some leases limit these costs, while others don't. Common clauses in commercial leases may allow the property owner to increase your base rent in response **increased costs**. These costs typically include:

- **Increased Property Taxes**
  Unlike residential property taxes, commercial property taxes are commonly passed on to tenants. A substantial increase in the value of one property can raise property taxes for others in the area – even if they're across town. While a single sale rarely impacts local taxes, several commercial property sales in a short period of time can have a significant impact.

- **Higher Property Management Fees**
  Property management will often change when a new owner steps in. If the new owner is a real estate investment trust (REIT) or a large institutional investor, which often have greater overhead, management fees can increase significantly.

- **Aesthetic Upgrades to the Property**
  To increase market appeal and potential profits, new owners often invest in capital improvements such as lobby renovations or exterior redesign. These costs can be passed-through to tenants, who will benefit from the improved space.

- **Other Capital Expenditures or Fees**
  Other capital expenditures may include transitioning the property's use. For example, if an office building has been underutilized, a new owner may choose to convert some of the space to industrial use.

When a new owner takes over, you may feel the impact in other ways as well. You may have to work with a different management group, and there may be procedural or operational changes within the building.

> "I get calls every week. Our members are not seeing [just] a 10, 15, 20 percent rise. Their rents are doubling, tripling, and quadrupling; and the economy is good, but they're not bringing in four times their revenue. It's basically forcing them out."[5]
>
> ***- Rebecca Melançon, Executive Director of Austin Independent Business Alliance.***

Your Building Sold. What Action Can You Take to Protect Your Interests?

When you find out that your building's ownership is changing hands, one of the first steps you can take is to make sure you are informed about the sale. Have you received a notice from your property manager about the sale? If so, did it explain how you may be affected? If you haven't received any information, these are the critical questions to ask so you can prepare the transition to a new owner.

STEP 1

ASK THESE QUESTIONS ABOUT YOUR BUILDING SITE

The building contact or property manager is a good resource for answers to the following questions:

- Will there be a change to the property manager? If so, who is the new property manager and what is their contact information?
- Is the owner local or out of the area?
- When is the transition expected to occur?
- What month will the base rent change?
- What are the plans for the building, such as renovations, and what is the timeline?

Armed with this information, you can reach out to a tenant-only commercial real estate advisor for guidance on your next steps.

Do I Need a Lawyer?

You may wonder whether you should contact a real estate lawyer now, but that isn't necessary at this point. A real estate professional usually provides their expertise free of charge (only receiving a fee as a percentage of any savings fund or if you end up requiring a new space). A lawyer can be quite expensive, and usually isn't needed until later in the process.

A real estate advisor can review the language within your existing lease in detail. Based on the language of the lease, they can explain how you may be impacted by the sale.

STEP 2

HAVE YOUR LEASE REVIEWED

A typical lease audit will look at:

- **The rights your new landlord will inherit:** Clauses that may have seemed harmless with your previous landlord could become problematic if the new landlord has different plans for the building.
    - *Example:* A clause that allows the landlord to bill you for capital improvements to the building could be expensive if the new owner plans extensive upgrades to the property.

- **Business terms:** Just because there is language in your lease, doesn't mean the landlord is abiding by it. A lease audit will look at business elements in the lease – such as common area maintenance charges - to ensure that the previous and new landlords are meeting these terms. It will also determine how much you can influence decisions that could lead to cost increases.

- **Financial audit:** This is the opportunity for your real estate advisor to deliver the most value to you (an attorney will not be able to provide a financial audit of your lease). A financial review of your lease will look at:

  - Charges including rent and other fees are consistent with the lease
  - Cost requests are accurate and legal with the context of the lease (asset management, property management, or other new operating expenses)
  - Identify what costs you may be exposed to
  - Explore whether the impact of potential tax increases can be limited

STEP 3

PLAN FOR THE FUTURE

Your future options will depend on how much time remains on your current lease.

Lease Ends in 6-24 Months: For shorter-term durations, the focus should be on assessing your future real estate needs. Your real estate advisor can guide you through an evaluation process that considers whether your business is expected to grow, shrink or remain the same over the next two to five years. Based on your operational and functional needs, as well as the anticipated changes following the building sale, you can determine whether it makes sense to remain in your current space or seek new space.

Lease Ends in 25 Months or More: A new landlord will rarely change an existing lease. However, you may have the option to "blend and extend," which allows a tenant to modify the terms of the lease in exchange for an early lease extension.

To ensure your interests are protected – whether you are on your way out or committed to a longer-term lease under the new owner – it's important to work with a commercial real estate advisor you trust to offer advice and guidance during this transition.

In the Market for New Office Space Now (or Soon)? Protect Yourself from Disruption in a High-Turnover Real Estate Market

As you read at the beginning of this guide, many tier-two metropolitan areas are currently seeing a glut of new investment and a large percentage of office building turnover as a result. For companies that are considering new office space soon, there are steps you can take to protect your business from the disruption that a potential ownership transfer can cause.

Find the Right Building, and Lock in Long-Term

The best advice for companies in the market for a new office lease is to find the right building for your needs – now and into the foreseeable future – and lock in your rates long-term. By tailoring your space to your business needs, you can stay in one place for an extended period.

Make Sure the Lease Protects Your Interests

A landlord may not agree to the requested lease language, but going into the negotiation process with knowledge about protecting your business from turnover disruption can be valuable.

A tenant-friendly lease should:

- **Minimize hold-over responsibilities** if you choose to remain in the space after the lease has expired
- **Allow sublease flexibility** so you have the freedom to sublease out part or all of your space if your business needs change
- **Limit restoration clause exposure to ordinary wear and tear** (If you vacate the space, what condition do you need to leave the space in? Ensure that you don't have to pull out cabling or remove other improvements the owner has made.)
- **Provide expansion options** that include the right of first refusal or right of first offer to expand
- **Offer termination rights** that will allow you to break out of the lease early if your business needs change
- **Include a non-compete clause** so you don't have competitors as fellow tenants
- **Place caps on operational expenses and/or controllable expenses.** These should include:
    - If LL hasn't billed for something, they can't look to bill more than 1-2 years later
    - Operating expense increases must be limited to less than 5 percent in a given year
- **Provide for tenant influence over building improvements,** such as common area renovations
- **Clearly identify holdover expenses and liabilities**
- **Include a SNDA** (subordination, non-disturbance, and attornment agreement) to protect you in the event of a sale, bankruptcy, etc.
- **Include a "quiet enjoyment clause"** to make sure your business can consistently use and enjoy your space without disruption

CASE STUDY

A TENANT WITH 132,000 RSF OFFICE HEADQUATERS WAS IN A BUILDING THAT RECENTLY SOLD

CRESA LEASE AUDIT FOUND

OF OPERATING EXPENSE SAVINGS

WITH A TEN-YEAR FUTURE MITIGATION OF MORE THAN

$5,000,000

DUE TO MONITORED ANNUAL ESCALATION INVOICES

VIEWPOINT

A good real estate advisor will ensure that your interests are protected in your lease – including language that will protect you in the case of a change of ownership.

Building asset sales can take anywhere from six to 18 months, and are heavily involved processes. Many tenant leases will have an estoppel provision, which requires the existing landlord to confirm the terms of the tenant's lease in effect prior to selling the asset. This is important so you know exactly what the new owner will see in the terms of your lease.

Managing a business is challenging enough without struggling with the impact from an unexpected sale of your building. While it's ideal to prepare in advance for the possibility of an ownership transfer by including tenant-friendly language in your lease, you also have options to minimize the impact to your business if your building is sold mid-lease.

1. DLA Piper, "State of the Market Survey," May 2016.
2. Portland Business Journal, "How Portland's 'Skyline' Towers are Keeping Fresh to Compete," July 28, 2017
3. Denver Business Journal, "Denver Moves Up List for Best CRE Investment Markets," March 9, 2017.
4. Star Tribune, "When Big Office Buildings are Sold for Big Profits, Property Taxes Increase," September 5, 2015.
5. The Institute for Self-Reliance, "How Rising Commercial Rents are Threatening Independent Businesses, and What Cities are Doing About It.", April 20, 2016

CASE STUDY

In Minneapolis-St. Paul, a series of highly profitable commercial property sales drove up valuations across the region. Now some area tenants are facing rent increases of 17 to 36 percent as a result. One property's assessed value shot up 35 percent this year – for one tenant that could mean an additional $20,000 in operating costs if their property taxes increase at the same rate.[4]

Learn More

Cresa's tenant-only real estate advisors can help protect your business from a current or potential change of ownership. Contact the Cresa office nearest you to speak to one of our expert commercial real estate advisors.