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REAL ESTATE

Office Tenants Face New Risks in Leases

By KENNETH D. LAUB

Our latest market studies show commercial rentals setting new records monthly, with $50 per square foot being quoted on a regular basis for prime midtown properties, and the few postwar financial district buildings with space available renting in the $30 to $40 a square foot range. Real estate values are also reaching new heights. The record $177 a square foot for the Pan American building last year has already been eclipsed, with 350 Park Avenue having fetched $331 a square foot. New construction is proceeding at a pace we have not experienced in a decade.

The current euphoria may well need a dose of business realism if history is not to be repeated.

Should the bottom drop out, those most directly

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affected will be the property owners, those who have billions of dollars invested in income-producing commercial real estate. Yet these same landlords are creating the conditions for their own demise by inflating occupancy costs to the point where they can barely be justified, if at all. Simultaneously, the governmental authorities responsible for the city's overall economic health are steadily eroding its attractiveness to business through a combination of rising taxes and declining services. The economics of leasing commercial space in New York City today have become qualitatively different from those experienced by tenants in the past.

Most common during the 1950's were short-term office leases, committing tenants to fixed rentals throughout the term. When space requirements grew and inflation became a factor, during the 60's, long-term leases became standard, and it became accepted practice for landlords to protect themselves against increasing taxes and operating expenses with "pass-through" escalation clauses. Among the benefits still enjoyed by tenants were improvements provided by the landlord, relatively uncomplicated projections of future costs, and sublease rights.

These conditions no longer prevail.

Periodic rent review has, in many cases, replaced the traditional fixed rental, adding to the difficulty of long-range forecasts. Without a crystal ball, a tenant subject to such a provision can project costs for only two, three or five years, when market conditions will dictate a new rent.

Landlord-supplied improvements have shrunken substantially or disappeared entirely. Many tenants are required to accept up to 10-year-old installations on an "as is" basis. Even in new buildings, where space is not usable without further investment of $20 to $30 a square foot, totally inadequate provisions for landlord-financed construction prevail. New tenants are often forced to encumber their credit lines, financing their own installations.

The profit potential of sublease and assignment rights have all but disappeared from the long-term office lease, these rights having been limited by the landlord's prerogative to recapture the space. Companies going through periods of expansion or contraction, or that need to relocate for other reasons, must bear the risk of financial loss because of a market downturn, while being denied the opportunity to profit from a rise in values. The profits formerly expected from subleases are reserved to the landlord.

Perhaps the most onerous component of the new economics of leasing, though, is rent escalation, which has assumed an impact equal to, and sometimes greater than, the base rent, as a factor in occupancy costs. No longer simply a source of protection against cost increases, escalation is now utilized as a hedge against inflation, and often an independent profit center as well.

Pass-throughs of actual operating cost increases have given way to wage indexes, wherein each penny per hour increase in the wages or fringe benefits for building service employees yields a cent to a cent and a half a square foot rental escalation, where the increase more realistically should be a cent to a cent and a half for several square feet. Assuming equal rates of inflation attributed to labor and other operating costs (which is not always the case), this innovation alone can add $35 to $70 a square foot to the cumulative cost of a 10-year lease during its term in excess of the amount necessary to cover operating expenses.

Many owners, contending that these "penny formulas" are insufficient protection against the rising cost of steam and building elec-

A Case Study

Year	Base Rent	Wage Escalation	Tax Escalation	CPI Escalation	Electricity	Total Rent	Occ'y Tax	Const. Am'n	Total Cost
1982	$40.	$1.35	$.32	$1.60	$2.16	$45.43	$2.73	$2.76	$50.92
1983	40.	2.85	.67	3.36	2.33	49.21	2.95	2.76	54.92
1984	40.	4.47	1.04	5.30	2.52	53.33	3.20	2.76	59.29
1985	40.	6.27	1.44	7.43	2.72	57.86	3.47	2.76	64.09
1986	40.	8.24	1.88	9.77	2.94	62.83	3.77	2.76	69.36
1987	40.	10.41	2.35	12.34	3.17	68.27	4.10	2.76	75.13
1988	40.	12.81	2.86	15.18	3.43	74.28	4.46	2.76	81.50
1989	40.	15.44	3.40	18.30	3.70	80.84	4.85	2.76	88.45
1990	40.	18.33	4.00	21.73	4.00	88.06	5.28	2.76	96.10
1991	40.	21.51	4.64	25.50	4.32	95.97	5.76	2.76	104.49

Source: Kenneth D. Laub and Company Inc.

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tricity, have instituted utility cost pass-throughs in addition. Yet any escalation, exceeding that produced by traditional actual-cost pass-throughs, is, by definition, plain and simple profit.

The most lucrative profit-generating escalation provision proliferating today is the indexing of future rentals to increases in the Consumer Price Index. Commonly known as "C.P.I. Escalation," these formulas are designed to increase the rent, or a portion of it, periodically, by the percentage increase in the C.P.I. during that period; the resulting charge is imposed either in addition to, or in lieu of, other forms of escalation. While there are myriad variations of C.P.I. Escalation, our studies indicate that its overall effect has been to provide the landlord with a profit bonus.

A simple case study will illustrate this. Assuming a 10 percent annual inflation, a tenant with a $35 a square foot base rent subject to full C.P.I. Escalation (in lieu of other escalations) will be charged $55.65 a square foot *in escalation* alone during the 10th year. If taxes and operating expenses for the building were $9 a square foot in the base year and also rose at a 10 percent annual rate, the aggregate increase would total $14.34 in the 10th year. The difference, $41.31 a square foot, represents profit, that would have been generated that year alone by the escalation clause.

Owners and lenders, who often make indexed escalation a condition for permanent financing, justify this practice as a means of protecting the purchasing power of cash flow from the ravages of inflation. We have done an extensive study of this subject, and are convinced that C.P.I. Escalation, except in unusual circumstances, invariably increases profit far beyond the amount necessary to protect purchasing power from inflationary erosion.

In addition to the economic burden of high rents and onerous escalations, tenants in New York City must now contend with four other factors that mitigate the positive benefits of locating in the city:

- New York City imposes a 6 percent occupancy tax on gross rentals (including escalations).
- The utility rates charged by Con Edison are the highest in the country.
- Real estate taxes have increased during the past two years. These taxes, while imposed on landlords, are passed through to the tenant.
- New York City corporate and personal income taxes are among the highest in the nation.
- The peculiar New York City method of measuring space adds 10 to 35 percent to the cost of a usable square foot, compared with almost any other area in the United States.

Let's take a look at a typical lease signed by a tenant for 10 years with indexed escalation provisons. We have hypothesized, rather conservatively, $40 a square foot as the base rent plus $2 a square foot for electricity, supplemented by amortization at 13 percent interest of $15 a square foot in construction costs, and increased annually by the following escalations:

- 1½ cents for each penny increase in the building employees' wage and fringe benefits package, with $9 an hour as the base and a 10 percent annual increase.
- Pass-through tax escalation, with $4 a square foot as the base and an 8 percent annual increase.
- C.P.I. Escalation applied to 40 percent of the base rent after the 1981 base year, assuming a 10 percent annual increase in the C.P.I.
- Electrical escalation at 8 percent annually after the 1981 base year.

The total cost to this tenant will surpass $100 a square foot in 1991, as escalation and occupancy tax combine to multiply the original $40 rent two-and-a-half times in 10 years. In other words, this tenant would be committing himself to an average of almost $70 a square foot annually throughout the term. It should be noted that while this is only a hypothetical package of terms for a postwar property, our analysis is based on conservative economic assumptions.

These new economics of leasing office space are startling, and unprecedented in the past experience of New York City-based space users. The optimism of landlords, though, should be tempered by the realities of corporate decision-making. Leasing decisions do not occur in a vacuum of upward cost spirals; rather, they are based on the total context of operating conditions. If the cost bubble is inflated much more, it may well burst.

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