



REDWOOD
PROPERTY GROUP

Leasing Terms

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Cancellation Clause

Sometimes New York City landlords will consider giving a tenant a “cancellation clause” or “early termination option”. Most of the time there will be a penalty attached to this option. Since a landlord is justifying the costs of renting a space by spreading the expense over the course of the lease, if the lease ends up being shorter, they would want to recover the appropriate portion of those costs.

The cancellation clause usually holds the tenant responsible for unamortized costs of buildout, brokerage commission, and rent concession and is typically only possible to be exercised on a given date, but sometimes any time after a certain date with a certain amount of notice.

The basic calculation is as follows:

Landlords Total Costs (Cost to build the space + Rent concession)
Divided by the lease term
Multiplied by the amount of time remaining on the lease at the time of termination
Plus the brokerage commission appropriated for the remainder of the lease

Here is an example:

The space is \$10,000 per month and the tenant signs a 10 year lease with a cancellation clause after 5 years and receives 3 months of free rent. The landlord spends \$120,000 to build the space.

Landlords Total Costs (\$120,000 + \$30,000) = \$150,000
Divided by lease term (10 years) = \$15,000
Multiplied by the amount of time remaining (5 years) = \$75,000
Plus the brokerage commission appropriated for the remainder of the lease (~\$15,000) = \$90,000.

Obviously, the less the landlord spends on the buildout, the less rent concession given, and the less time left on the lease, the less the termination penalty will cost.



Also, if your broker is willing to defer payment of the last portion of their commission and only conditionally accept payment if you do not exercise your termination clause, then you can eliminate that portion of the cost.

Depending on what condition the market is in at the time of the termination, there's a good chance it will be easier and more cost effective to sublet the space than exercise the cancellation clause, but it's still good to have in case the market tanks or just as a worst case scenario back up plan.

In rare situations, there will not be a penalty for a termination option (typically if they are not doing any build-out, giving any free rent, and they are only paying brokers if the option is not exercised).



Escalations

Escalations typically refer to annual increases the landlord charges to account for the rise in operating expenses, inflation, market increases, and profit.

A standard Manhattan escalation is 3% per year, but can sometimes be negotiated especially in a soft market. Certain landlords will ask for higher escalations (4-5%) and in certain instances I've seen a landlord charge a 4% increase, but not hold a tenant responsible for their proportionate share of real estate tax increases. So in that case, the tenant is probably better off.

On a longer lease, there is typically a bump, in addition to an escalation, around the 5-7th year.

Certain landlords won't require a fixed increase, but will instead adjust the lease annually according to the consumer price index (inflation). This is less predictable and not necessarily worse (depending on how the economy is), but is more dangerous. For example, if inflation spikes tremendously (e.g. 8%) in the second year of a ten year lease, you are suffering the consequences for the rest of the lease.

If a landlord requires CPI instead of a fixed increase, I usually suggest having the CPI limited or capped to for example, 5% (but obviously, the lower the better).



Extra Charges

Additional Charges:

Buildings usually add charges to base rent. The primary additional charge is electricity.

This is billed in one of three ways:

- 1) Direct – You pay your own electric bill (this is usually the most desirable)
- 2) Submetered – there's a meter in your space that belongs to the building (not the electric company) and they send you an electric bill along with your rent every month. They will often add a surcharge for this (for example: 5-10% on top of your usage)
- 3) Per square foot/per year: this is usually between \$3 and \$3.50 per square foot per year regardless of your usage. For example, in a 1000 sf space with the electric at \$3.50 psf, the monthly electric charge would be:

$\$3,500 \text{ per year} / 12 \text{ (months)} = \291

Other charges tenants are frequently held responsible for are water, sprinkler, sewer doorman, security guard, and garbage removal. These are usually billed as flat monthly charges.

For example, a 2000 sf office could have a \$40 water and a \$40 sprinkler monthly charge



Financials

Landlords need to see financial information from prospective tenants to determine if they want them in their buildings. The stronger a tenant is financially, the more attractive they are to the landlord. Typically, if all other aspects are equal, landlords will choose the tenant that is stronger financially. If a potential tenant doesn't have financials that are appropriate for the price space they want, a landlord will either: reject the tenant or ask for a personal guarantee.

Landlords also use a tenant's financials to determine the security deposit they will require for the lease.

The standard documentation requested is the first 3 pages of the last 2 years of the company's tax returns. If the company is a start-up or the tax returns are not a good indicator of the company's standing, a prospective tenant should include other information such as bank statements and statements certified by their accountants such as profit/loss, summary of assets, etc. (basically anything that is evidence you are a strong company).



Foot Traffic

An important factor for a landlord to consider is how many people are going to be visiting the prospective tenant. At first, some tenants may not realize why this would be a concern for a landlord.

Even traditionally prestigious medical users are turned away by most buildings because of the amount of patients visiting them.

The primary issue is the negative effect a lot of people coming to the building have on the elevators. For most landlords it's not worth inconveniencing (and potentially losing) the rest of their tenants to pick up a high foot traffic tenant. Most people are not happy waiting several minutes for an elevator and having to squeeze in there with a bunch of other tenants for multiple stops before it gets to the lobby or their floor.

Sometimes landlords will be more flexible on high-traffic users if the traffic occurs during off hours (like a college that teaches a class at 7 PM or on Saturdays).

Each landlord is different and some are much more open to considering high traffic users. This is one reason why you'll see a lot of doctors in the same building (that and plumbing access to small spaces).

Somewhat ironically, the buildings with the largest elevator problems are the ones that are most likely to accept high-traffic tenants. Since the owners that are open to considering tenants with a lot of visitors already have accepted other tenants with high-traffic visitors, sometimes the buildings with the most crowded elevators are most willing to exacerbate the problem.

Obviously, this can be more of an issue for tenants with visitors since their visitors/customers will get annoyed by the inconvenience.



Often a good solution for a high foot traffic tenant is a walk-up building, lower level space, or 2nd or 3rd floor space in a smaller building where there isn't as much of a disruption on the other tenants. Retail spaces are also an option, but come at a higher pricepoint.

If you're a high foot traffic tenant, your options will be much more limited than a standard office use like an accountant or hedge fund.

If you are one of the following businesses, landlords are likely going to be asking you a lot of questions about the amount of visitors you will have:

- Doctor or dentist
- Spa
- Hair salon
- Modeling agency (casting calls)
- Physical trainer
- Teaching facility/classroom
- Real estate office
- Fashion designer (sample sales)
- Dance studio
- Pilates
- Yoga Studio
- Karate



Full Commission

In New York City, landlords typically pay commercial brokerage commissions. If a tenant is ever looking to sublease their space, they should expect to pay a full brokerage commission unless they find someone to rent the space on their own.

It is expected that the outside/tenant's broker receives one full commission (100%) and the landlord's broker receives one half commission (50%). One full commission is typically calculated as follows:

- Year 1 - 5%
- Year 2 - 4%
- Year 3 - 4%
- Year 4 - 3%
- Year 5 - 3%
- Years 6-10 - 2.5% each

Each brokerage firm can have a different schedule, but they are usually a variation of the above schedule. Commission is usually paid on base rent only, not annual escalations. So for example, the commission on a 5 year lease is equivalent to 19% of one year for the outside broker and 9.5% of one year to the representing broker.

There are some brokers that will offer commercial spaces on a reduced commission basis, but most tenant brokers, especially good ones, will not take their tenants to properties that don't pay full commissions. Basically, if there are 5 properties that match their tenant's criteria and 4 of them are paying twice as much commission as the "cobroke" listing, why would the tenant's broker show the property that is only paying them half the amount?

If the landlord's (or overtenant's) broker finds a tenant without the assistance of the outside broker, then they receive one full commission.



Good Guy Clause

A good guy clause is a limited personal guarantee. The distinction between a good guy clause and a traditional/full personal guarantee is that in a good guy clause an individual's personal liability ends when the space is vacated. Therefore, if a company dissolves and the space is vacated, the individual is absolved of any further responsibility.

Good guy clauses evolved as a compromise between landlords and tenants in New York City and are now a standard component of commercial leases in Manhattan.

Landlords were having problems with companies going bankrupt, defaulting on their rent payments, and not surrendering the spaces. The eviction process can be very extensive and typically takes about 6 months.

In order for a landlord to feel secure they had wanted either 6 months security deposit or a personal guarantee from the tenant.

A good guy clause basically states that if a company defaults (for bankruptcy or any other reason), the individual that signed the good guy clause is responsible for the rent in between the default date and the surrender date (when the space is vacated). This way, if the company goes bankrupt, the tenant still has an incentive to vacate the space, but is not responsible for the remainder of the lease if they cooperate and "be a good guy".

For example, if Company X stops paying rent June 1 and Company X leaves June 1, the good guy is completely off the hook.

If Company X stops paying rent June 1 and Company X leaves July 1, the good guy owes the landlord rent for the month of June.



Good guy clauses usually, but not always, contain notice provisions (between 30 and 180 days) that can sometimes be negotiated.

Sample Good Guy Clause -

The undersigned hereby covenants and agrees that if there shall occur any default by Tenant in the payment of fixed rent or additional rent or any other charges set forth in the Lease, or if Tenant shall default in the performance of any of the covenants, terms, conditions and agreements contained in the Lease then the undersigned shall in each and every instance up to and including the Release Date (as defined below) (i) pay such fixed rent, additional rent and any other charges due and payable by Tenant to Landlord (ii) faithfully perform and fulfill all of such covenants, terms, conditions and agreements to be performed by Tenant as set forth in the Lease, and (iii) pay to Landlord all consequential damages that may be incurred by Landlord as the result of any default by Tenant under the Lease including without limitation all attorneys' fees and disbursements incurred by Landlord as a result of any such default and/or the enforcement of any of the provisions of the Good Guy Clause. The "Release Date" shall mean the upon which Tenant returns to the Landlord the keys to the Premises and surrenders possession of the Premises in the condition required by the Lease as of the expiration or termination thereof free of all tenancies or rights or claims of occupancy by Tenant or any party claiming through Tenant.



Holdover

A Holdover clause is common in a commercial lease. Basically it states that if the tenant does not vacate the space until after the termination date, they are responsible for a specific amount of additional rent. A holdover penalty is usually between 2 and 3 times the last (escalated) rent.

At first glance it seems like a high number, but keep in mind that it's hard to predict the real estate market. If a tenant signs a 10 year lease starting at \$10,000 per month with 3% escalations, they will be paying about \$13,000 per month at the end of the lease. If the real estate market has gone up 60% over those ten years (certainly not unprecedented), the tenant could stay in the space on a month-to-month basis at a below market rent indefinitely.

It's not unusual for a landlord and tenant to extend a lease for a few months after a lease for a rent that they both think is fair, but if the holdover penalty does not exist, the landlord is put in a bad position since the tenant has less of an incentive to be proactive or communicative about extensions.

The holdover penalty is also high primarily to discourage holding over and encourage tenants to be communicate if they need extra time, not to generate more profits for the landlord.

If one tenant's lease ends on September 30, and there's a prospective tenant that wants to sign a lease on the space for November 1, the landlord needs to be certain the outgoing tenant moves out on time or at minimum, tells him that they are not.

Holdover clauses can garner extra attention on below-market subleases.

Below is an example of a holdover clause:



In the event Tenant remains in possession of the Demised Premises after the termination of this Lease, Tenant, at the option of Owner, shall be deemed to be occupying the Demised Premises as a tenant from month-to-month, at a monthly rental equal to 200% of the sum of (a) the monthly installment of Fixed Rent payable during the last month of the term and (b) one-twelfth (1/12th) of the Additional Rent payable during the last year of the term, subject to all of the other terms of this Lease insofar as the same are applicable to a month-to-month tenancy.



Lease Deposit

During my first few months as a broker, I remember negotiating on a space in Midtown West and discovered the landlord's broker required a deposit (of about \$2000) from the prospective tenant in order to draft a lease.

I was disappointed and immediately asked if we could waive or at least lower the deposit amount. We ended up not seeing eye to eye on all the terms of the deal and never getting to the point of requesting a lease, but I walked away cautioning myself to be careful of bringing other tenants to the building because of the lease deposit.

A few years later I have instituted a lease deposit policy on some of my own listings. The vast majority of commercial landlords do not require any kind of deposit in order to send a prospective tenant a lease. So wouldn't I have a problem getting deposits from people?

Yes. Especially if they're not committed to taking the space.

The reasons for the lease deposit are easy to understand:

- An attorney will charge an owner to draft a lease (and for any subsequent comments/changes)
- Owners typically put any other offers they receive on the back-burner once they have agreed to terms with a tenant.
- Often they will even discourage others from looking at the space

So the owner is making some commitment to the tenant (and spending a little money) and without a lease deposit, the tenant is free to back out of the deal at any time for any reason. This would cost the owner legal fees and cause him to potentially miss out on other interested tenants.



By asking for a deposit that is refundable in the event the tenant finds the legal terms of the lease unacceptable, but not refundable in the event the tenant reconsiders, the landlord knows the tenant is serious before spending money on the attorney and turning away other prospective tenants. They also receive compensation in the event the tenant backs out.

There are a few reasons a tenant would be reluctant to provide a deposit:

- They're not sure they want the space
- They are deciding between more than one space and want to keep both in play
- They plan on negotiating further after they receive the lease (this is not considered an ethical practice and usually not tolerated regardless)
- Out of principle (since no one else is asking them for one)

The first three would all be good examples of how a landlord can use the deposit as a screening process. As far as the "Why should I have to give a deposit?" argument, a prospective tenant can usually appreciate the logic of why a landlord wants one.

They also gain some benefits. If a landlord has a deposit, the landlord is more confident about the deal, meaning they are less likely to show the space to others and are likely going to be more patient with the tenant. For example, if I didn't hear from a tenant for 4 days after sending them a lease, I'd assume there was something up with the tenant and encourage a landlord to pursue other offers. However, if there was a deposit, I'd likely feel okay about it and let the tenant take their time since they've already committed.

The key is that a tenant should decide they want the space *before* they get a lease, not wait to decide until after they get the lease.

Here's an example of a situation where I waived a deposit and lost a deal because of it. I had a small space at 36 West 44th street and two brokers submitted offers on the space with a couple days of each other.



Both tenants were willing to go very close to the asking price and in the range where the owner wanted to make a deal. The determining factor (as it usually is) was the track record of the companies and the amount of work each tenant was requesting.

We decided to go with the more established tenant that needed less work. We made the urgency of the situation clear to the broker and his tenant quickly signed the term sheet, but said he didn't want to comply with the deposit because no one else needed him to.

We didn't want it to be a dealbreaker so we moved on and I rushed our attorney to issue him a lease asap. After about a week of calling his broker and being told that the tenant will get back to us soon or that the broker is waiting to hear from him, the tenant finally admitted that was going to pass on the space and renew on his existing space unless we could drop the price from \$40 psf to \$25 psf.

Obviously, this was a ridiculous request and possibly an example of him planning to negotiate after he got the lease, rather than the surprise, last second development he made it out to be.

Obviously, my next call was to the other broker, but at that point, her (very serious) tenant had already locked up another space.

Had we stuck to our guns about the deposit, not sent the lease to the other tenant, and sent it to her (assuming her tenant would have complied with the deposit), we would have had the space rented (or at least had the first tenant's deposit as a consolation).

I finished another deal in the same building last week. It was for a small space and with an international company so the lease negotiations took much longer than usual. I did receive a bunch of calls from other tenants that seemed like potentially great fits in the meantime. Had there been no deposit, I probably would have



shown the space and presented any good offers to the ownership, tempting them to go with someone else or at least put more pressure on the other tenant to sign faster. Since we had their deposit, I just put them on a callback list and we ended up completing the deal without any unnecessary complications or added stress.

It's important to understand that even though there may not be another interested party at the time you request the lease, there could easily be one the following day pressuring the owner for the space. The more certainty you give an owner, the less likely they are to show the space to other tenants and consider other offers.

To give another example of how a lease deposit simplifies the process of renting a space, a few years ago I was representing a landlord and we had three good offers on the same unit. The market was beginning to spiral downwards and we were worried about making sure we got the space rented asap.

The owner decided to send a lease to all three tenants and see who followed through (or who followed through first). In this instance, the strategy actually worked as two tenants were unresponsive and one signed the leases immediately.

However, I was put in a very stressful position and the other brokers and tenants certainly did not appreciate the approach (understandably). We also ran the risk of one of the less desirable tenants signing the lease before our top choice.

If we had prioritized which tenants we wanted most and offered them the lease exclusively provided they gave us a deposit, it would have gone smoother, we would have gotten our first choice and we would have avoided pissing off three brokers and tenants while accomplishing the same goal.

As a broker, now I am happy when I see that a landlord requires a deposit on a space my tenant wants. This way I know they are renting the space as soon as they get the lease, rather than worrying if they are just jerking me around for a few weeks and I can avoid the potential embarrassment of telling a landlord my tenant has backed out of the deal after we've already had the lease for a week. Or the



irate phone calls from the landlord's broker demanding that the tenant compensate them for their attorney's fees or face a lawsuit.



Lease Out

Once a landlord and a prospective tenant have agreed to terms, the landlord will draft a lease and send it to the tenant to review, make changes (to the legal terms, not business points), and execute. This process can be immediate or can take months depending on the simplicity of the deal and how quickly the landlord, tenant, and their attorneys act.

On a straightforward deal for a relatively small space, the landlord will expect the tenant to sign the leases within a week or two. The landlord will be more patient if the tenant is actively asking questions or making changes to the lease than if they are unresponsive for a week and a half.

Typically, when a landlord will only send one tenant a lease at a time and will not entertain other offers while they are waiting for the signature. However, if the tenant is unresponsive or attempting to renegotiate the business terms, the landlord may revert to back up offers or encourage other tenants to look at the space.

If you are looking for space and your desired space has a lease out for signature, you are basically on hold. Sometimes tenants or landlords have a change of heart and it doesn't work out, but it's hard to predict how long it will take to know. The tenant with the lease can walk away from the deal the next day or drag it out for another three weeks then sign.

The best way to approach the landlord if you want a space that has a lease out is to send a strong offer to the owner and tell ownership that you are ready to move forward asap if there is a snag in the negotiations with the tenant with the lease. I would also send them reminders that you are still interested about once a week. This serves a couple functions:



- Let ownership know an attractive deal is on the table if they are having difficulty with the existing tenant. The landlord is more likely to reconsider taking a deal off the table with another tenant if they know they have something else to go with (rather than no one else interested)
- Keeps you fresh in their mind and let them know you are serious. Sending a commitment along with information about your company is different than having your broker ask them to let you know if something changes.
- If there are a couple people watching the lease hoping it doesn't work out, having your offer ready to go gives you an advantage on other interested parties. The owner will probably contact you first if there's an issue with their current deal.



Loss Factors

Loss factors are calculated by subtracting the usable area from the gross/rentable area and dividing by the rentable area. $(\text{Rentable SF} - \text{Usable SF}) / \text{Rentable SF} = \text{Loss Factor}$. Loss factors and usable sf are typically not disclosed by landlords.

The gross or rentable sf (before loss factor) is always the square footage advertised on a Manhattan office space.

The following gives a great background on loss factors:

LOSS FACTORS ARTICLE

Once upon a time, many years ago when twelve inch rulers were inflexible, a hypothetical New York City landlord stood in the vast 10,000 square foot hypothetical lobby of his eleven story hypothetical office building, watching his hypothetical tenants arrive for work in the morning.

The landlord had successfully leased the second through the eleventh floors to ten tenants, each occupying 10,000 square feet. As the landlord stood in his lobby that day, considering the rental revenue his building was generating, it occurred to him that even though each of his ten tenants was paying rent based on 10,000 square feet, no one was paying him rent for his beautiful lobby even though every tenant walked through it at least twice a day.

Nothing if not an opportunist, the landlord decided that when he built his next building, he would tell each incoming tenant that the rentable area on each office floor was 11,000 square feet, even though each floor would actually contain 10,000 square feet. If anyone challenged him on his measurement, he would explain that since each tenant uses his lobby, each tenant must pay for its proportionate share of that common area.

And that is how Loss Factors were made ...

Well, maybe that's not exactly how it happened, but it is true that at one time, there was a rational explanation for why New York City landlords insist tenants pay rent per square foot for space tenants don't really occupy. (1)

Fast forward to today and Loss Factors have become a market driven business term, as relevant to tenants as rent, free rent and tenant improvement allowances.

Whenever a commercial landlord decides to sell an office building in the current climate (an extremely competitive, heavily picked-over sales market where \$13.1



billion dollars worth of commercial property was sold in Manhattan in 2005 (2)), the first action taken by his sales agent is to increase the full floor Loss Factor to 25%.

Buyers of commercial property, particularly buyers of Manhattan trophy office buildings, generally don't question 25% full floor Loss Factors notwithstanding the fact that Manhattan office buildings come in all shapes and sizes with vastly different floor plate configurations, load bearing column density, width of perimeter HVAC convectors convector. Imposing a 25% full floor Loss Factor on an inefficient floor plate translates into asking a tenant to pay rent for a lot of inefficient square feet.

So you may be thinking to yourself, okay, a 25% full floor Loss Factor means that tenants actually occupy 75% of the rentable area in a recently sold Manhattan office building, right? Well, no, that's not really right. To understand how to measure and define office space in New York City one must first understand terminology.

"Rentable Area" represents the number of square feet based on which office tenants pay annual rent per square foot. Every landlord advertises vacant space based on Rentable Area but Rentable Area is only an approximation of the size of the premises.

The term "Usable Area", as it's commonly used in the NYC commercial real estate market, is essentially a misnomer. The Real Estate Board of New York (REBNY) guidelines for determining Usable Area were most recently updated in 1987 and recommend that landlords calculate Usable Area by measuring the entire floor to the outer facade of the building (often beyond the window line) and deducting only floor penetrations (e.g. elevator shafts, fire stairs, risers, etc.). According to REBNY guidelines, on a full floor basis, Usable Area includes electrical closets, fan rooms servicing the floor, janitorial rooms, bathrooms, load bearing columns and space occupied by perimeter convectors.

Loss Factors are the difference between Rentable Area and REBNY Usable Area (3).

Two other synonymous terms commonly used are "Carpetable Area" and "Assignable Area". These terms literally refer to the number of square feet on which a tenant can lay carpet.

On a divided floor landlords apportion common area hallways, bathrooms, electrical closets, slop sinks, fan rooms, etc. to the point where divided floor Loss Factors often rise well above 35% and Carpetable Area can be less than half of the Rentable Area.

So the market has all these terms for quantifying office space, some of which are more than a little misleading. What should tenants be aware of? Certainly, tenants should care a great deal about how much Carpetable Area exists in a certain premises since Carpetable Area correlates directly to how many bodies



can fit into a certain space. Rentable Area is crucial too since the number of rentable square feet correlates directly to the annual (and monthly) rent.

Tenants should be aware of Loss Factors and floor plate efficiency. Tenants would be wise to confirm that a Loss Factor in a certain building is consistent with market Loss Factors. (This can be established by having the tenant's architect compare CAD drawings from comparable buildings.) However, in the final analysis, tenants should concentrate mainly on how many people a certain space can accommodate and what the rent is going to be every month, Loss Factors notwithstanding. This is especially true since once it's been established that a landlord is not pushing the Loss Factor envelope farther than his neighbors, challenging his methodology for measuring office space is like pushing a string. One silver lining is that landlords provide tenant improvement allowances based on Rentable Area while contractors tend to submit construction bids based on actual costs of construction, irrespective of Loss Factors. In terms of tenant improvement allowances, one could argue that tenants actually benefit from a high Loss Factor.

In defense of landlords, I recall one situation in the mid 1980's when an owner refused to apply a Loss Factor to his vacant floors. Instead, he asked for a higher rent per square foot arguing that without a Loss Factor, his space was still less expensive than space being offered by competing landlords imposing high Loss Factors. Mathematically, he was correct. But tenants and many brokers didn't appreciate his logic and his space remained vacant until he applied a Loss Factor and lowered his asking rent.

The New York City commercial real estate market, like all financial markets, is susceptible to herd mentalities. As long as most landlords uniformly apply high Loss Factors, tenants' only option is to fight their way up the learning curve and understand NYC Loss Factors for what they are: a market driven phenomenon.

1) Some say the genesis of Loss Factors has more to do with the advent of central air conditioning and the transition from floor by floor air cooled air conditioning units to HVAC mechanical equipment on roofs or designated mechanical floors, causing landlords to apportion mechanical space to tenants' Rentable Areas.

2) According to Real Capital
Real capital

Wealth that can be represented in financial terms, such as savings account balances, financial securities, and real estate. Analytics, the following statistics apply to 2005 sales of Manhattan commercial properties worth a minimum of \$5 million: \$13.1 billion of total sales, 138 properties, 30.6 million square feet, \$426 average price per square foot, 5.24% average cap rate.

3 (Rentable Area less Usable Area) divided by Rentable Area equals the Loss Factor.

By David L Hoffman, JR

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N.B.I.

Short for "New Building Installation", this refers to when a landlord is providing a new build-out on a space for an incoming tenant.



Offer

If a tenant decides to rent a space, the first step forwards is submitting a proposal or offer. The proposal should include:

- Information about the tenant's business including website and financial information
- Monthly rent
- Lease term length
- Any work the tenant wants the landlord to complete
- Any rent concession
- Start date
- Security deposit
- Escalations
- Base tax year
- Additional monthly costs

Your broker can draft the offer and you can review it before they submit the offer to ownership. All offers should be non-binding . Unless time is of the essence or there is competition for the space, it is usually smart to send an initial offer that is a little too low to be accepted, but high enough to be seriously considered and garner a counterproposal.

There can be several rounds of counterproposals before an agreement is reached.



Prebuild

A “prebuild” or prebuilt space is a space that a landlord has renovated and built out in order to make it more appealing and readily available to a prospective tenant.

Typically, vacant spaces will remain in the condition the previous tenant leaves them. Once ownership receives an offer, the tenant will either request work to be done to the space, ask for free rent or a cash allowance (or “TI”) to do their own work, or move into the space as-is.

The advantages of the traditional approach is that ownership can build the space exactly how the tenant wants it and ownership doesn’t spend any money in the meantime. The advantage to the tenant is they can get the space exactly how they want it.

There are a couple reasons an owner would prebuild a space:

- So it shows better. It’s one thing to tell a tenant how a space could look, it’s another thing to update it with high end finishes and eliminate the need for anyone to use their imagination (or architect).
- To cater to tenants needing immediate occupancy. If a tenant needs space in two weeks, they are not going to be able to wait for an owner to do a full build-out. This gives a prebuilt space a competitive advantage for tenants that need space asap (who often have a stronger sense of urgency and are more motivated to make a deal)
- To make efficient use of time. While a landlord’s space is vacant and they are waiting for a tenant, if they use that time to renovate the space, they might not actually be “losing” that time, if it reduces the time it takes from lease signing to tenant occupancy.
- Achieve higher rents. Landlords can typically get higher rents on prebuilt spaces since they look better (wouldn’t you pay more for mint, restored car than an old broken car of the same year that the seller promises to fix up?)
- Rent the space faster. Using the same car example, wouldn’t the restored car sell a lot quicker?

Reasons not to prebuild a space:

- Save on out of pocket expense. Even though a landlord might (or in some cases probably will) need to build the space for a tenant later, they are less



motivated to spend the money without anyone willing to pay rent as soon as it's completed.

- What if the incoming tenant is not that picky and doesn't need high end finishes?
- Less flexibility. What if the incoming tenant wants a different layout than you spent money building? If you just built 6 glass offices and the incoming tenant wants a wide open space for their trading desks, you are either turning away a tenant or wasting all the money you spent building those offices. A less extreme example would be if you built 6 offices and the tenant only wanted 4.



Proportionate Share of Real Estate Tax Increases

New York City real estate taxes are assessed every July. Each building is assessed a different tax every year. Sometimes the tax on a building does not go up, but it usually does. Landlords can't predict how much their real estate tax will increase so they pass along the charge to their tenants.

As an example, a tenant occupies 5000 sf in a 250,000 sf building. Their proportionate share of the real estate tax increase would be 2%. If the base tax year is 2008/2009 (July to July) and real estate taxes in the building increase \$10,000 in July 2009, the tenant would pay/reimburse the landlord \$200 (2% of \$10,000). It is not uncommon for a landlord to spread out these payments and charge the tenant in monthly installments instead of one lump sum (especially if it's a high increase). It is important to keep in mind that tenants are responsible for the increases above their base year, not the previous year. Using our past example of the \$200 tenant charge in July 2009, if in July 2010, the real estate tax on the building increases \$20,000, the tenant would now owe \$600 in 2010 (\$200 + \$400 because the real estate tax is \$60,000 more than it was in the base year 2008/2009).

So if there is a high increase in the second year of a five year lease, the tenant will also be enduring the effects of that in every year following. Landlords also sometimes hold tenants responsible for increases in fuel charge, which works the same way, but is typically a much less substantial amount.

Landlords usually will require tenants to accept the current tax year as the base until it is completely over. But if, for example, you are negotiating a lease that begins in June 2009, you should at least try to negotiate a base tax year of 2009/2010 (since the 2008/2009 tax year is almost over). This will not only help you avoid paying your share of the increase at the beginning of the lease, but the result of that increase every year afterwards.



Rent Concession

Otherwise referred to as "free rent", the rent concession is a period of rent abatement given to an incoming tenant. Rent concession are most often awarded to tenants when a space needs considerable work and the landlord is not renovating it, but providing a rent concession to help the tenant offset the construction costs.

However, it is not uncommon for landlords to offer a rent concession on built spaces as an incentive for tenants to rent space from them. Like rent prices, rent concessions given are heavily influenced by the state of real estate market.

On a given space, you can usually get more free rent on a longer lease. Short leases typically do not provide any free rent period unless there is considerable work that needs to be done to the space.



Sublease

A sublease is when a tenant (overtenant) rents their space, or part of their space, to another tenant (undertenant). Typically a sublease is for the entire period of time remaining in the overtenant's lease, but can be shorter.

Extensions can also be negotiated between the undertenant and landlord, especially if there is relatively short amount of time left on the sublease term.

Subleases must always be subject to the terms of the master lease between the overtenant and landlord. These terms cannot be changed, but the undertenant can, and should request a copy of the master lease to review as part of their due diligence.

Subleases are more common than assignments because in an assignment, the landlord absolves the overtenant of any responsibility. In a sublease, the landlord is still entitled to the rent from the overtenant even if the undertenant is not paying.

Here are some differences between leases and subleases:

- Subleases are usually not flexible on term. For example, if there are 26 months left on a lease, that will be the only possible term the overtenant will consider. They will not consider a 24 month term since it's very unlikely (and difficult) to find another undertenant for the last two months. They won't consider a 36 month term since they are unable to sublease the space for a longer term than they have the rights to the space.
- Subleases are almost always leased in as-is condition. Landlords will often do some renovations as part of a deal with a new tenant. Overtenants are usually not interested in the responsibility of construction work and are not as well-equipped to do it. In certain situations, especially if the space is not in move-in condition, undertenants can negotiate a substantial rent concession in exchange for sparing the overtenant from doing any work.
- Subleases are more often furnished than direct leases. This is because the existing tenant is (or was recently) operating out of the space, no longer needs or wants it, and therefore may no longer need or want the furniture that's in it. Although new furniture can be expensive, it is difficult and not very lucrative to sell used furniture so if it can provide an incentive for an



incoming undertenant, the overtenant is usually willing to give the furniture away with the space.

- Subleases can often require higher security deposits than direct leases. One important reason is to protect an overtenant from a subtenant defaulting with a very short term on the lease. For example, if an undertenant defaults with 10 months left on the term, the overtenant is most likely out of luck for the 10 months (whereas, if it was a direct lease, the landlord could lease it for any term length once the tenant defaulted). Another important reason is a holdover clause. Since most leases have a holdover clause that keeps a tenant responsible for 2-3 times the rent if they holdover, an overtenant needs to protect themselves from an undertenant overstaying their welcome and the landlord charging them as a result. This is especially important in a below-market sublease since the overtenant is being charged holdover rents on their higher rent, rather than the undertenant's discounted rent.

and clarification on some common misconceptions about subleases:

- Subleases are cheaper than regular leases. This is true in some cases, but not always the case, especially if the subleases have an above-standard installation and if the market has picked up since the overtenant signed their lease.
- In a sublease, you pay the overtenant the same amount they are paying the landlord. An overtenant has the right to charge any amount more or less than the rate they are paying. They often will not reveal the amount they are paying the landlord and an undertenant is not entitled to know the rent an overtenant pays (but sometimes will know).
- Subleases are usually from companies that are desperate and about to go out of business. If a company is in bleak condition, they will typically dissolve and break the lease rather than sublease. It's also risky for an undertenant to sublease from a shaky overtenant because if they overtenant defaults, the undertenant's office is now in jeopardy and subject to the landlord's discretion. Often, subleases are from companies that have outgrown their spaces (and are doing very well).