

## Why Most Office Subleases Won't Be Sublet

By Jeffrey S. Weil, CCIM, SIOR

**T**he office sublease market in a number of sub-regions across the United States has changed dramatically during just the past six months. There are a number of reasons why some industry experts believe that in many instances current and future sublease space may not be sublet or have its leasehold terminated prior to lease expiration.

Between 1998 and 2001 hundreds of millions of square feet of office space were leased across the U.S. by dotcom, e-commerce, high-tech, VC-funded start-ups, and yes, even by Fortune 1000 established corporations. During these frenzied years of rapid office absorption, companies purchased billions of dollars of new office workstations, private office furniture, file cabinets, new telephone systems, computers, chairs, and other office equipment required to house the workforce moving into this newly-leased office space. The bursting bubble collapsed not just the office leasing market but office furniture and equipment industries as well, causing a glut of almost-new office furnishings of every type, style and price range imaginable. As Corporate America went through phase after phase of significant down-sizing, tens of millions of square feet of office space became available for sublease.

Sublease rental rates were discounted initially 25-50% from the going market rental rates for comparable space, and when the substantial savings in leasing a "plug & play" were factored in many of these bargains were snatched up. Of particular value in a number of submarkets were quality Class A office space, brand-new or almost new state-of-the-art furniture, workstations and equipment, a credit sublandlord that presented no risk of defaulting on the master lease, significantly long-term subleasehold of 5-10 years, and below-market rental rates.

During 2002 and 2003 there was a strong feeling among many landlords that the market was going to return to health sooner rather than later, and thus many landlords did not aggressively market their space at low-enough rental rates to compete with these sublease bargains. To lock in low rates long-term would diminish the value of the building asset, make it more challenging to obtain future financing, and potentially lower the price should a future sale be contemplated. Most landlords were also unwilling to provide a "plug & play" scenario. During mid-to-late 2003 it began to become evident, at least in many U.S. subregions, that perhaps the office market was not poised to recover as quickly as had been hoped. Global off-shoring was sending hun-

dreds of thousands of U.S. jobs to India, China and other low-cost areas. Call centers, back office engineering, insurance processing, accounting, and a host of other office functions vacated millions of square feet of U.S. office space to take advantage of employee costs 30-80% lower than that of the U.S. Technology, once touted as a great labor-saving potential, finally delivered on its promise. Software integrating accounting, human resources, payroll, and other functions efficiently reduced staffing in some departments by as much as 40 percent which created vast amounts of excess office space as a result.

Corporations enjoyed rising stock prices as a direct result from lowering expenses, and regional offices once housed in Class A quarters in some cases were moved to the back of a distribution or manufacturing facility. Per-employee office square-footage diminished further and workstations which may in the past have been 10' x 10' or 10' x 12' went down to 8' x 10' or 8' x 8'. A significant number of workers were "virtual enabled" due to very recent technological advances in high-speed remote internet access, and some companies with telecommuter or mobile work-enabled employees were able to totally eliminate a number of offices and workstations as a result of this empowerment.

**Reason 1.** Many office subleases are down to 1-2 years remaining term, and thus with this short a remaining leasehold, these office facilities may be near-impossible to sublet without Landlord lease extension participation. As it costs \$5-7/sf just to relocate, including moving expense, cabling and wiring, even if the

*Continued on page 6*



*Continued from page 5*

sublease rate is deeply discounted it still may not make financial sense to move in and move out for such a short time-period.

**Reason 2.** Most of the “great office sublease deals” have already been taken. The Class A, terrific location, super views, state-of-art furniture and long remaining terms are becoming more scarce.

**Reason 3.** As terms expire, vacant space not sublet gets added to the landlords vacant space inventory and further increases pressure for the landlord to provide competitive rental rates and terms in direct office leasing.

**Reason 4.** Corporate America continues to downsize, giving up partial or total leaseholds at lease termination.

**Reason 5.** Landlords for the most part now realize the office market may not regain strength for a number of years, and have become more market aggressive to secure new tenancies. This has resulted in lower rental rates, increased tenant improvements, and more lease term flexibility.

**Reason 6.** The amount of medium and larger corporations seeking 20,000 square feet and greater has dramatically diminished during the past few years, while the demand by the 1,000 - 10,000 square foot office user has increased. In a number of instances landlords are beginning to subdivide these larger but unwanted blocks of office space to accommodate these smaller user groups.

**Reason 7.** Corporate America still has a huge amount of “shadow space” estimated at 10-20% of the total occupied office space inventory. This “shadow space” is vacant space within an existing corporate office facility. It can be in either leased or owned property. It may be an entire building or buildings that are not available for lease or sale, but is not occupied. It may be a portion of the floor, or in some cases

one of every seven or eight cubicles empty throughout the entire facility. When Corporate America does begin rehiring, this is the first place new employees will be housed versus leasing new space.

What will increase the odds of sublease space being sublet?

- Longer-term leasehold.
- Sublandlord (Tenant) ability to fund tenant improvements.
- Ability to subdivide premises to meet market size.
- Broker incentives, open houses, bonus fees (our experience is that this is effective 25-50% of the time, but one never knows which space will be in this category).
- Consider paying your sublease listing broker a monthly retainer fee to be offset against commission fees.
- For subleases less than 36 months, significantly higher brokerage commissions in order to be competitive to direct-space fees. Remember, your sublease rental rate may be deeply discounted and your sublease term may be a fraction of the normal 60-month term. Thus, without leveling the commission playing field, fees paid on a sublease may be 25-50% of what the broker can make elsewhere. Commissions are always negotiable, and should reflect the specific market and market conditions.
- Make sure, within reason, that the available sublease space is as presentable as possible. Replace broken or stained ceiling tiles, burned-out lighting, and have miscellaneous equipment stored neatly or put into a back storage area.
- Plug & Play moves the quickest, so if you can, leave all desks, workstations, chairs and file cabinets. Today’s used furniture market still discounts these items to 10-20 cents on the dollar, so leaving these items in place usually provides a greater value to the success of subleasing versus selling to outside vendors or third party buyers, or relocating the furniture and workstations to other offices.

Have your broker set up a meeting with you and the landlord right in the beginning so you know how cooperative the landlord will be if a replacement tenant requires a lease termination or a lease extension to create a 60-month term. There may be a firm requirement by the subtenant for a renewal option with the landlord. What happens if the subtenant tenant requires improvements that trigger ADA or life-safety upgrades that would normally be a landlord cost? Can you market your space at rates below what your landlord is quoting (some leases prohibit this)? If you sublet plug & play space, who may be liable for removing telecom wiring at the end of the sublease/direct lease, the sublandlord, the sublessee or the landlord?

If you subdivide the premises, in order to sublease your space, will the landlord require this space to be restored at the end of your term? How long a process is landlord approval? Are there landlord forms that can be pre-reviewed? How many original contracts must be executed so that the landlord, subtenant, sublessee and brokers have sufficient copies? Find out early!

If your space is not plug & play, be prepared to make it so if this makes economic sense. In advance, line up a space planner, used furniture vendors, and get your pricing estimated so that if time is critical you do not lose a subtenant by unnecessary delay.

For any subleases over 1,000 square feet and with at least nine months remaining term, it is almost always still beneficial to market your sublease space versus letting it sit idle and out of sight of prospective tenants. There is usually little downside and there is always the possibility of salvaging even a few months rent through early lease termination if a replacement tenant is located.

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