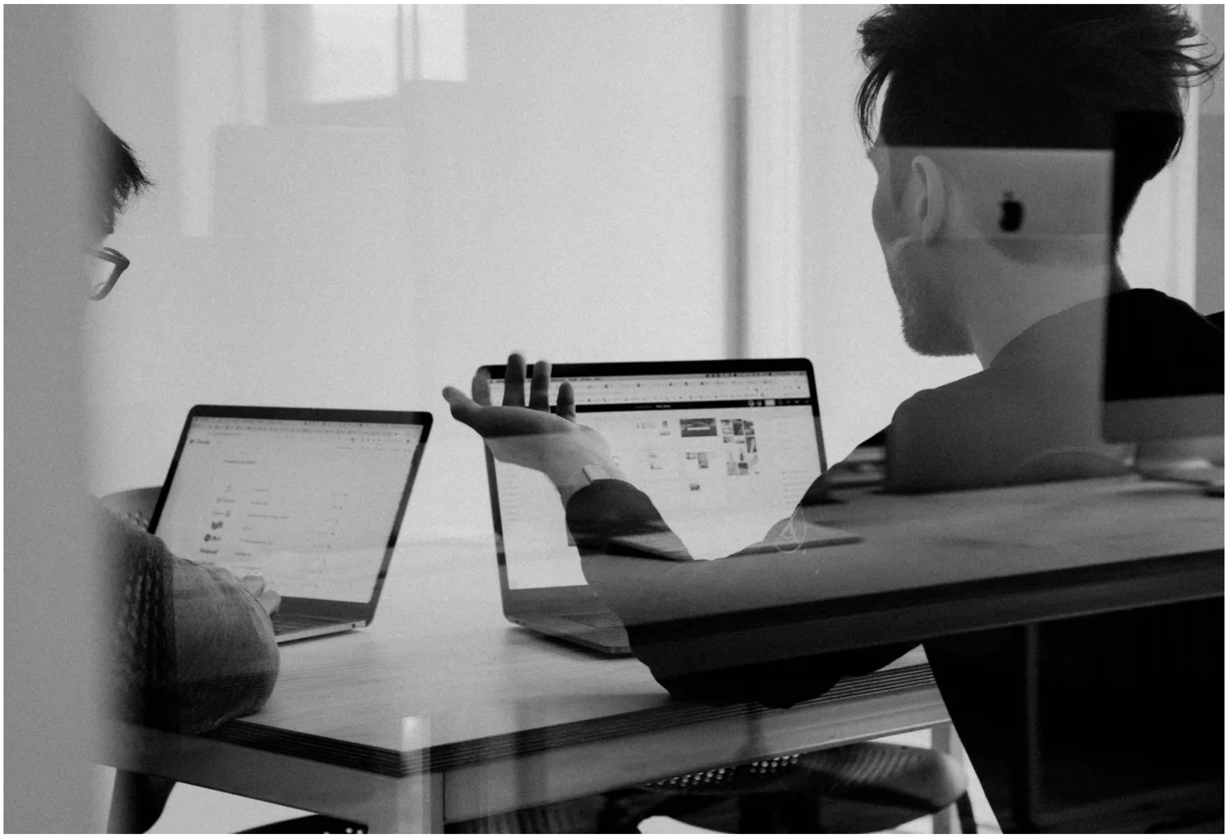
'I'll Show You Mine, You Show Me Yours': More Office Tenants Looking At Owners' Books Before Signing Leases

July 24, 2023 | Miriam Hall, New York City (https://www.bisnow.com/author/miriam-hall-128140) (mailto:miriar

It's traditional in lease negotiations for the owner of an office building to ask a prospective tenant to show proof that they are in good financial standing and can be expected to pay rent every month.

But the public prognostications comparing office real estate to an "apocalypse (https://finance.yahoo.com/news/500-billion-office-real-estate-221017310.html)" and a "Category 5 hurricane (https://www.bisnow.com/national/news/commercial-real-estate/real-estate-is-in-the-throes-of-a-category-5-hurricane-starwood-chairman-says-119909)" haven't escaped the companies in the market for office space, leading to an increasingly common role reversal: tenants asking landlords to open up their books and provide protection in case they go under.



"It's not enough to just say, 'You know, we have bulletproof institutional dollars behind us,'" CBRE New York Tri-State Region CEO Mary Ann Tighe said. "The landlords still want to know about the credit of their tenants, but the tenants now say, 'OK, I'll show you mine. You show me yours.'"

From New York to Atlanta, Miami to Los Angeles, across all types of building classes and lease lengths, more companies are forcing their potential landlords to reveal details about their financial backers and assure them of their ability to meet lease terms and hold onto buildings, industry players told *Bisnow*.

Tenants are taking a close look at the capital stack of buildings and considering the exact implications were a landlord to default on their obligations. The steady stream of office market pain is affecting big-name landlords, which would have been fairly inconceivable just a few years ago.

Distress in U.S. office real estate jumped to $24.8B at the end of the second quarter, up $6.7B from the previous three-month (https://www.bisnow.com/national/news/commercial-real-estate/q2-cre-deal-volume-crashes-63-compared-with-last-year-119886) period, according to the latest MSCI U.S. Distress Tracker. Office is now the most distressed commercial real estate asset type for the first time since 2018, surpassing retail and hotels, which have recovered more quickly from the pandemic.

Brookfield, Blackstone and Related Cos. have all handed back properties (https://www.bisnow.com/new-york/news/office/brookfield-hands-over-brill-building-keys-to-mack-real-estate-119808) to lenders, and defaults have been shooting up across the country. Last week, Starwood Capital Group defaulted on a $212.5M mortgage (https://www.bisnow.com/atlanta/news/capital-markets/starwood-defaults-on-tower-place-100-mortgage-119849) on Tower Place 100, a 614K SF, 29-story building in Atlanta — which sent a shockwave through the local market, said Jodi Selvey, a principal with Colliers in Georgia.

“If they can go belly up, anyone can go belly up,” Selvey said. “It scares you if you are trying to put a tenant in a space. … After the Starwood thing in Atlanta, you will see more questions.”

Among the questions tenants and their representatives are asking are which lender owns the debt on the building and specific terms embedded in the loans, sources said. These conversations are happening on the first space tour, they said, rather than during the final stretch of lease negotiations, as they have in the past.

“It's like asking someone how much money you make on the first date,” Selvey said. “During the implosion in ‘08, ‘09 and 2010, I don’t remember asking these questions.”

Nationally, office leasing rose by 11.6% in the second quarter, the biggest quarterly increase since Q2 2021, according to JLL. The jump likely reflects an increasing return to the office and a solidifying of hybrid arrangements and workplace mandates.

Still, tenants are calling the shots in most markets. In Manhattan, availability hit (https://www.bisnow.com/new-york/news/office/sluggish-q2-for-manhattans-office-market-leaves-record-high-vacancy-levels-119688) a record high in the second quarter, per Colliers, reaching roughly 96.4M SF, a 78.9% increase since March 2020. SL Green, New York City's biggest office landlord, last week reported an office occupancy “low point” of 89.8% across the company’s portfolio.

Tenants are now being extra careful about their tenant improvement allowances, which have been one of landlords' top incentives to land deals in this market. Those allowances are going into escrow accounts in some instances, brokers said, to make sure the promised amount is paid up. In some cases, commissions are being escrowed as well.

"I think the landlords recognize that is part of getting deals done today. ... Being transparent and showing where the building stands in relation to financial health," OPEN Impact Real Estate co-founder Lindsay Ornstein said.

She added that tenants are asking, "Is this landlord going to lose this building, and is someone else sitting in that seat next year?"

Real estate players have long discussed the flight to quality in the office market, as brand-new, well-located properties with significant amenities have dominated the leasing market.

In recent weeks, tenant representation firm Savills has begun using the term "flight to capital" to describe the new phenomenon of tenants factoring in the financial health of properties alongside their amenities.

"You're seeing it right now, especially in Downtown LA, where those landlords that are in a better financial position than others are going to benefit," Savills Head of Office Research Michael Soto told *Bisnow*. "Some landlords are stronger than others, and we all know which ones are in trouble right now."

Sidley Austin's move to 350 South Grand Ave., where the law firm will take 57K SF in the Related Cos. and CIM Group-owned property, was cited as an example of this trend. Sidley Austin is leaving Brookfield's Gas Company Tower, which is now in receivership (https://www.bisnow.com/los-angeles/news/office/brookfield-gas-tower-receivership-118675).

Marisha Clinton, Savills' senior director of Northeast regional research in New York, said private equity firm Clayton Dubilier & Rice leased 144K SF at 550 Madison Ave (https://commercialobserver.com/2023/06/clayton-dubilier-rice-doubling-hq-in-move-to-144k-sf-at-550-madison/). in the second quarter. It is moving from the Seagram Building on Park Avenue, where owner RFR landed a two-year extension (https://www.bisnow.com/new-york/news/capital-markets/rfr-locks-down-extension-on-seagram-building-loan-118917) on a $783M CMBS loan that was maturing this year.

"The firm will be going from an older trophy asset that has a significant amount of debt coming due," Clinton said in an interview earlier this month. "They're pretty much relocating to a recently redeveloped trophy asset that is also in better financial health."

Despite tenants' demands for information in a market that is highly competitive among landlords, opening up their books is not something landlords always want to do, said Shaun Pappas, a real estate attorney with Starr Associates.

"Many landlords are not keen on this type of due diligence and are not turning over such information without push back and questions," he wrote in an email. "Usually there is a happy medium where the tenant and landlord can get comfortable with both of their financial positions and to make sure that the deal makes sense for both sides."

That was the case for Suresh Sani, the CEO at First Pioneer Properties, a New York landlord whose office properties include 33-02 Skillman Ave. in Long Island City, which the firm converted from industrial to office. (https://www.bisnow.com/new-york/news/office/long-island-city-117905)

A prospective tenant at one of the firm's properties asked for financial information, but First Pioneer pushed back and showed due diligence on its loan-to-value ratio instead, Sani said.

However, across the board, tenants want subordination, nondisturbance and attornment baked into leases. An SNDA, as they are known, is an agreement from the landlord that in the event it defaults, the lender won't foreclose on leases and will allow the tenant to continue renting in peace.

Sani said it has been common to have these kinds of arrangements in place for major tenants, but it is increasingly being requested across all tenant types — and not offering it is a deal-breaker.

“Thankfully, we have lenders that understand. … My guess is they are getting so many of these,” he said. “They want the building rented.”

The state of the office market is splashed across headlines around the world. Last month, Bloomberg referred to a “creeping rot inside commercial real estate,” and last week, New York Magazine ran a cover story calling Manhattan “New Glut City (https://www.curbed.com/article/nyc-office-real-estate-rechler-rxr-project-kodak.html),” with office buildings “dangerously empty and crushed with debt.” Starwood Chairman Barry Sternlicht said the market is in a “Category 5 hurricane (https://www.bloomberg.com/news/articles/2023-06-23/commercial-real-estate-reset-is-causing-distress-from-san-francisco-to-hong-kong)."

The coverage is driving the extra focus from tenants because the topic is completely inescapable, said Tighe, CBRE's top leasing broker in New York.

"I'm talking to my folks in capital markets, [asking] what's the situation, then really getting the backstory from the parts of our firm that deal with that, talking to our investment sales operation about what's the dynamic," she said. "I think any thoughtful business person would probably be committing malpractice not to ask the questions."

Contact Miriam Hall at miriam.hall@bisnow.com (mailto:miriam.hall@bisnow.com)

See Also: 'Broken System': Victim Of Landlord-Tenant Officer Shooting Files Lawsuit As Legislators Step Up Pressure (/philadelphia/news/multifamily/landlord-tenant-officer-shooting-victim-files-lawsuit-119960)