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Biz Buzz: Longer Versus Shorter Business Leases

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By Barry Saywitz | Special to the NB Indy

It is crucial for landlords and tenants to understand the pros and cons to both longer and shorter leases. There are many advantages and disadvantages of longer leases for landlords and tenants at this point in the real estate cycle.



For example, in a hot market, the advantage of a longer-term lease is that landlords can take advantage of the fact that rates are up, so the landlord can lock in the lease at the higher end of cycle with annual escalations. If the tenant is renting for the long term, the landlord can secure cash flow with an overall better return, and if refinance rates are still attractive, the landlord can lock in their interest rate for their mortgage as well. Also, if the landlord is planning to sell down the road, a longer-term lease adds value to the property overall - should the market turn in the future, the tenant is still locked in at a higher rate, which secures the cash flow. Regardless of rates, whatever capital landlords put in today, can be amortized over the lease term and the landlord will spend less money in improvements over time with a longer lease. From the

tenant's side, the advantages are similar: if a tenant executes a longer-term lease, they know they have their property and space secured for a longer length of time and they don't have to move in three or five years. And if the tenant is spending their own money on infrastructure and other improvements, they can amortize or depreciate that on their own books over the life of the lease.

The downside of a longer-term lease to the landlord is not much, other than that it ties up the property, so if the landlord wanted to sell or reposition the property, the landlord is making a long-term commitment and would have to live with that, good or bad. A landlord who believes the market will continue to go up may want to do a shorter lease because they believe they may be leaving money on the table. If you believe real estate is a cycle and rates will not go up forever, then it makes good business sense to lock in now at the higher end of the cycle.

On the other hand, if the tenant locks in on a long-term lease and rates go down, the tenant is stuck with a higher rent. Also if the space doesn't work down the line, the tenant may be forced to live with space that is not ideal in size or layout. However, if the tenant knows what it needs into the future and is comfortable in the space, it is better to lock in and secure it.

In regards to shorter leases, there is more flexibility for both sides. On the tenant side, there is flexibility if the tenant grows or doesn't need all the space. If the market should change, the tenant could negotiate sooner than later, if needed. If the market continues to go up, the tenant will just pay more. Tenants who didn't lock in for a longer period of time in the last three to five years will pay the price for not doing so today. There is a competitive advantage to locking in rental rates: if the tenant is a manufacturer or distribution company, and its neighbor is locked in with a low rate, they can be more competitive than the tenant if the tenant has to renegotiate at a higher rate.

Landlord's in a new development, whether office or industrial, will likely not be interested in a short-term lease because many have a budget, investor, or lender that they have to answer to. A developer who is keeping the property long term may not entertain a short-term lease. For developers looking to lease up space because they are selling the product, they would not want a short-term lease because it may affect the value of the property. From a tenant's perspective: there is no good reason a tenant would want to do a short-term lease on new development. Why would tenants want to move in three years if the space is brand new? If a tenant wants a short-term lease, it needs to find existing space that requires minimal improvements in exchange for the shorter term. If the landlord is keeping the building, the landlord will probably

want a long-term lease. If the landlord is selling it or planning on remodeling, then a short-term lease should be contemplated. In this market, it's tough to find a short-term leases and low rents at the same time. In summary, finding the right space and the preferred length of lease term is challenging for both landlords and tenants, so it's best to make sure you think carefully, plan ahead, and negotiate well.

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