SHOULD I STAY OR SHOULD I GO?

NEGOTIATING YOUR LEASE FROM A POSITION OF POWER

CUSHMAN & WAKEFIELD

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INTRODUCTION:

IT'S ALL ABOUT LEVERAGE

During my first week in industrial real estate, an industry veteran explained to me the importance of preparing for a lease expiry. The broker began by listing reasons I should think strategically before making real estate decisions and dropped a number of overused clichés in the process:

- I know I'm going to sound like a broken record here, but it's a challenge to get people to wrap their heads around the fact that at the end of the day, it is always better to be proactive than reactive

- Once you begin the lease extension or renegotiation process, there really are more layers to the onion than people think, and it is up to us as advisors to get people to move the needle, and avoid making knee jerk reactions

- This is a results-oriented business, and far too often in my career I've seen a landlord eat a tenant's lunch, when they fail to successfully plan for a real estate negotiation

“LEVERAGE,”

HE SAID WHILE WAGGING HIS FINGER IN THE AIR.

“INDUSTRIAL REAL ESTATE IS ALL ABOUT HAVING LEVERAGE.”

There I was, an eager 20-something in a recently purchased pinstripe suit and brand new side-part haircut, feverishly scribbling down as much of this advice as I could.

After a while, the broker, who was noticeably more interested in his cell phone than in my presence looked at me and said:

“Look kid, I can talk to you about the importance of real estate strategy until I’m blue in the face, but let me just give you a real-life example you can relate to.

Last year, I was working with an automotive metal stamper who had big ambitions to relocate his business and double the size of his facility. This guy really wanted to put the puck in the net. We began evaluating the market 15 months prior to his lease expiry. Two or three months into our search for a new building, I indicated to him that now was an ideal time to develop a contingency plan for a lease renewal (at his existing building) in the unlikely event that his business expansion was hindered.”

He told me to forget it, there was no way he was staying.

To make a long story short, he lost a manufacturing contract he was banking on winning and ended up staying put!

Regrettably, the terms under which he remained in his building were much, much worse than they would have been had he began the lease renewal process earlier and treated it as a safety net for his business.

The broker then toddled off to the bar and left me to ride my desk with a clearer picture of how important leverage is.

Over the next few years, I came to understand that on most balance sheets, behind the costs of labor and production, facilities are among the top three expenses.

Adversely, a poorly planned facilities strategy can potentially hinder your profitability and your business as a whole.

In commercial office leasing the geography, floorplate, natural light, employee engagement and finishes all have a direct correlation to the brand and image your organization is attempting to portray.

In industrial real estate (distribution, manufacturing, food, etc.,) the customer service, reliability, pricing and execution of an organization's supply chain are the biggest contributing factors to your brand's reputation and overall image.

- Capital is precious; every part of your company competes for the limited amounts available
- If your supply chain and facility investments drain your available capital, then you can't invest in new product development, market expansion or countless other initiatives that could make your company more competitive
- If you starve your supply chain of investment then productivity will fall, operating costs will rise and customer service will deteriorate
- To the contrary, every dollar wasted on unnecessary supply chain infrastructure (facilities, equipment and technology) is a dollar that can't be invested elsewhere, such as product development or building new stores

Most executives, like you, are forced to become experts in real estate every 5 – 10 years when your lease is expiring and you have to choose whether to renew or relocate.

To navigate this process, you'll probably either outsource this expertise to a trusted real estate advisor, or approach a lease expiry with an old school mentality that involves a handshake agreement with a landlord you feel you can trust.

The purpose of this ebook is to identify some details within an industrial lease that are often overlooked and that can come back to haunt you. I'll also provide some tips on how to avoid these pitfalls and i'll introduce you to a series of tenants Cushman & Wakefield (C&W) has crossed paths with that have used these strategies to improve, not only their supply chain, but ultimately their entire business.

CHAPTER 1

OPTIONS FOR WHEN YOUR INDUSTRIAL LEASE IS UP FOR RENEWAL

If you were to poll all commercial real estate agents in your market on when is the right time to begin a real estate assignment, 90% would answer “NOW!”

Either they’re just trying to secure your business, or just as likely, you have started the process too late. Depending on your situation there is often a tremendous benefit to beginning a lease evaluation process sooner rather than later, because like all major capital investment decisions within your supply chain (facilities, technology, IT), the more lead time you have the better.

With that said, a good rule of thumb is to imagine that you have to relocate your operation to another city. How much time would you allow your business to execute this move without putting any undue stress on your organization?

TWO SCENARIOS:

1

You are a 40,000 SF coffee bean distributor bulk stacking in an empty warehouse. Your needs are extremely basic:

- 1 truck level door per 10,000 SF
- 5-10% office space
- T5 energy efficient lighting

You could probably move this operation fairly quickly once you had found a building and squared away the paperwork.

2

You are a 140,000 SF injection moulder that supports the Tier II automotive industry. Your lead time would likely be much longer than that of the coffee distributor since you have complex machining and warehouse equipment that require time and coordination to move successfully.

There is a good chance you will be able to source a ~140,000 SF building available in your market, but what about the physical components needed to perform your operations?

Finding a 140,000 sq. ft. building is one thing, but can it:

- Structurally support the crane columns that would be required for your moulds?
- What about the power? Is 2,000 AMPS enough? What if it is not?
- Are reinforced floors and machine trenches required?
- What about the employee base? Is it unionized?
- How many employee change rooms do you need?
- What about the cafeteria?

Company two must begin its lease renewal process much sooner than Company one.

Exterior influences can further complicate the process:

1. Is the coffee distributor relocating to the hottest and tightest industrial market in the country?
2. Sure, finding an 18’ clear, 40,000 SF building might be possible, but what if the rent is double the current spend for the same amount of space?
3. What if the coin is flipped, and the coffee distributor decides they want to remain in their current space? How much negotiating leverage will they have with their current landlord if they know they are the only option in town?

Suddenly, an easy move has become a lot more complicated and those brokers who said, “NOW” are also saying “I told you so.” Your real estate assignment, much like your supply chain is unique, and as a result the more lead time you give yourself, the better.

BE AWARE OF YOUR LEASE EXPIRY

Sounds simple enough, and yet too many companies unknowningly give away negotiating leverage, as their expiry date approaches

Here's a good example:

A few years back, I worked with a 110,000 SF manufacturer who was the very definition of a captive tenant. Airlines, machine trenches, anti-static rooms and heavy cranes were all critical to this client's operation. Needless to say, the ticket on a facility relocation would have been onerous.

This tenant's lease was expiring in the fourth quarter and we had only begun renewal and extension dialogue with the landlord in the first quarter.

Given the timeline to lease expiry and the sophistication of the landlord, it was no surprise when the landlord issued a five-year extension proposal on the building. It was a bullish rental rate increase issued from a position of strength! Before our next meeting with the tenant, we found out one of the reasons why:

One week before the landlord submitted his proposal, someone from the tenant's team called the landlord to obtain approval to install solar panels on the roof and T5 energy efficient lighting in the warehouse.

Do you see where this is going?

The greatest signal you can give a landlord that you are not planning on going anywhere is to make a significant investment in your building shortly before a lease expiry.

This was a textbook example of a tenant not being aware of their lease expiry and as a result weakening their negotiating power, resulting in multiple years of extra facility costs.

CHAPTER 2

UNDERSTAND YOUR LANDLORD

Within the industrial real estate landscape, there are two types of landlords:

Institutional Landlords (pension funds; REITS; chartered banks; etc.)

Entrepreneurial Landlords
Steve from New Jersey; The Smith Family from Woodbridge)

Just like there are good tenants and bad tenants, there are good landlords and bad landlords. However, these two groups have different motivations and they will typically structure a lease term or lease negotiation accordingly.

Here are some key points to consider:

INSTITUTIONAL LANDLORD:

- Cash rich; deep pockets
- Large leasing team that tends to be sophisticated compensated via commission and performance
- Willing to let a building go vacant if they don't obtain the face rent or capitalization rate they need for their quarterly reports and pro-formas
- Generally incent tenancies by way of free rent, improvement allowances and/or cash inducements in exchange for the preferred face rent on the building
- Tend to dispose of/acquire buildings by way of portfolio trades, rather than stand-alone building transactions

ENTREPRENEURIAL LANDLORD:

- Wide range of ownership types; some may be very influential in individual markets, some may hold very few real estate assets
- Tend to be adverse to long term vacancies within a building
- Rarely face rate or capitalization rate sensitive
- Generally not motivated to provide free rent or cash inducements to secure tenancies, but are often more flexible on the face rent

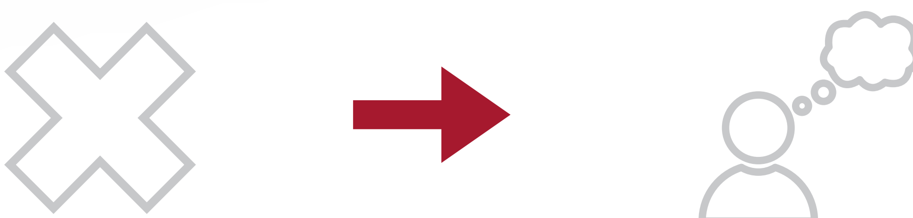
Example:

Not long ago, our team was conducting a performance audit and productivity improvement study for an apparel distributor that had 18 months remaining on their lease term.

From early discussions with this client we got the impression that moving would be difficult and they wanted to remain in their current 150,000 SF building.

Upon review and analysis, we concluded that through a reengineering of the warehouse, they could reduce up to 25% of their area.

Naturally, the tone of the client shifted from:



"We are absolutely not moving!"

"Unless the landlord gives us a below market rental rate, we are absolutely moving! We have 25% more space than we need!"

Through our study, the client received detailed insight into their future operations of their facilities planning. As a result, a fact-based viewpoint had been created to engage their landlord (an entrepreneurial one) as to why they had to relocate.

Negotiating leverage was
created instantly

After a few rounds of back-and-forth between the landlord and tenant, including C&W's re-engineering, the landlord moved their needle and allowed the tenant to remain in the entire 150,000 building for a 7-year lease term.

The real value to the tenant was created by the following:

Throughout the negotiation, the landlord conceded and agreed that the tenant would only have to pay rent on the 75% (112,500 sF) that they actually needed for the first three years of the term. The tenant would have access to 100% of the building (150,000 SF), so the extra 25% (37,500 sF) would be free to the tenant and off the rent roll.

At an average rent of $8.00 psf over the first three years of the lease, the savings looked like this:

Building size the tenant had control of:

150,000 SF

Square footage the tenant was paying rent on for first three years:

112,500 SF

Free square footage for three years:

37,500 SF

Total “Free space:” $8.00 x 37,500 SF =

$300,00/YEAR

$187,500 x 3 years =

$900,000

This is a great example of a client tying their supply chain strategy and warehouse optimization review into the natural lease expiry of their facilities. In addition, the tenant’s awareness of their landlord’s operating philosophy benefitted them greatly, with over $900,000 dollars in savings over a three-year period.

CHAPTER 3

WHY IT'S IMPORTANT TO GET OPERATING DEPARTMENTS INVOLVED

Human beings, by nature, make snap decisions on whether to stay or go. This lizard brain reaction is the very essence of the long accepted psychological response of fight or flight.

When it comes to business, that same stay or go mentality can often apply to your real estate decisions. Generally speaking, when a lease expiry is approaching, the C-suite will begin the process with a pre-conceived idea of whether it is best to stay, or relocate. As anyone who has ever purchased a house knows, the mechanics of a successful real estate deal involve much more than just the building itself.

In residential real estate, purchasing or relocation decisions are often heavily rooted in factors such as geography, surrounding amenities, lot size, parking, neighborhood safety and access to transit.

In industrial facilities, much of the above applies but can also include some of the questions below:

- How much space do you need?
- How many truck level doors do you need? Can the building be underpinned to allow for more doors to be punched out? What would the cost be to complete this?
- How much office space do you need? Is fiber cabling important to your operation? Is the vision of your organization to be open and collaborative, or does the staff work best in private spaces?
- What type of clear height do you require? Are you racking plastic components, and if so, does your insurance require you to maintain an ESFR sprinkler system? What is the adequate sprinkler congrage required?
- What is your power requirement? Can a greater supply be brought in from the street, or do you need a new transformer?
- How many parking spaces do you need? What is your organization's policy on accessibility standards? How important is prominent signage?

While all of these components are important and will certainly impact the success of your real estate project, when the above criteria is evaluated holistically from a supply chain perspective, any bad decisions made for a single facility can become magnified to the detriment of your company's success.

Here at C&W, we have learned that companies rarely make these important investment decisions as part of a comprehensive infrastructure road map.

Many companies split their decisions among departments; finance usually controls IT and operations controls facilities and equipment. Each department makes decisions in a vacuum, sometimes at cross-purposes, and sometimes overcompensating for perceived under-investment on the part of other departments.

That is why it is absolutely essential to involve all departments (to a certain degree) in a facilities decision.

> You wouldn't purchase a new WMS without the influence and input of both the finance and operations department, so why would you not do the same for a multi-year lease commitment?

Here's an example:

Imagine a scenario where your company had made the decision to extend the lease at your current location.

Now imagine after that decision was made, you noticed that a capital improvement was needed to better the operation (let's say a $600,000 improvement cost).

During your lease negotiation, you find that the landlord is enthusiastic to take on this upfront $600,000 capital cost and then amortize it back to you on top of your net rent. On the surface, this may appear to be a good deal for both you and the landlord, depending on your accounting practices, it may not adversely impact your P&L in this given fiscal year.

Sounds great, right?

Logic tells us that landlords are not banks and experience tells us that they will rarely do you any favours – especially without a financial upside.

As a result, you may work the math backwards and uncover that the $600,000 CAP/ex from the landlord is being amortized at 9% over the term of the lease (let's call it a seven year lease term, as this is often the timeframe you should use when mapping out your supply chain strategy).

Now, imagine that after seeing this offer from the landlord, you do some shopping around with other lenders, and discover a Schedule A commercial lender willing to offer you the $600,000 loan for your CAP/ex at an amortization of prime + 1%.

Let's do the comparison:

$600,000 capital investment; 7 year lease term; 100,000 SF user.

LANDLORD'S EXAMPLE:

$600,000 / 100,000 sF = $6.00 psf
$6.00 psf / 7 year lease term @ 9% amortization = $1.15 psf over the course of this lease term

OUTSIDE LENDER EXAMPLE (~4%):

$600,000 / 100,000 sF = $6.00 psf
$6.00 psf / 7 year lease term @ 4% amortization = $0.98 psf over the course of the lease term

This is a difference of $0.17 psf between the landlord's offer to lend and the Schedule a lender.

Therefore: $0.17 x 100,000 = $17,000/year

$17,000 x 7 years = $119,000 over the term of the lease.

But what happens if your finance, operations, transportation and quality departments are all in separate silos during the lease negotiation process? Or even worse, are not brought into the decision-making process at all?

CHAPTER 4

UNDERSTAND YOUR LEASE DOCUMENT:

Yes! Rent is important. Yes, the date of your lease expiry is important. But what about some other expenses related to facilities?

- Snow removal – what does this cost your business on an annual basis?
- Insurance – any idea what your general liability payment is?
- Property taxes the city in which you are located, just decided to reclassify your building as commercial from general employment. Your taxes are going up $0.40 psf/annum – how is this treated in your lease? Do you think your landlord will gracefully pick up this delta?
- If your HVAC is broken, who is paying for it? How is it amortized?
- If your asphalt is cracking and your roof is leaking, who should be paying for this repair? Are you already paying for this through your additional rent (Taxes, Maintenance & Insurance or TMI)?
- What if, for the past five years you have been paying for these repair items when really the landlord should have been picking up this tab, can you recover these payments retroactively?

> And while you may only look at your lease once every five to seven years, this is your opportunity to rewrite/renegotiate your lease so that it serves your company's best interests

If you can't answer all of these questions off the top of your head, don't worry, most business executives can't either, because they only open their lease document once every five-to-seven years. At the exact point when it's time to start thinking about whether to stay or relocate.

When most people think about being a tenant, they think of that scary four letter word: RENT

Rent is important!

With that said, I'd bet that your lease document has one page dedicated to outlining your rental obligation and 50+ other pages covering all of the other items mentioned above.

The industrial roof

We are starting to see landlords trying to take critical capital items, such as the industrial roof, and the expenses associated with maintaining them, then turning them into a profit center to line their own coffers.

As an example:

C&W was evaluating the warehouse optimization for a client who was carefully reviewing a lease extension in their current 170,000 SF facility, versus relocating across the city, into a brand new 150,000 SF distribution center. We had successfully found efficiencies in this operation that in the event of a warehouse reset could reduce the footprint by 20,000 SF.

In this case, it was the roof in the new facility where the landlord was looking to profit from.

Prior to agreeing to a binding document on the new property, the client asked the landlord to send them a copy of their standard lease document.

The additional rent clause read as follows:
The tenant will be responsible for contributing to a roof replacement fund in the amount of $0.35 Psf/annum over the course of the lease term to cover maintenance, repair and replacement of the roof, roof membrane, roof deck and surrounding structure.

Some back of the napkin math revealed the following:

- 150,000 SF lease X $0.35psf/annum = $52,500 x 10 year lease = $525,000

Normally, this would not be a terribly surprising clause because depending on the market you are located in, the treatment of the roof and roof membrane is likely subject to some type of industry standard landlord-tenant arrangement. In most cases the tenant is generally responsible for roof repair and replacement expenses through their additional rent payments.

What made this scenario so surprising is the fact that in the fine print of this same lease document the following one liner was written:

- The roof, roof deck and roof membrane will be certified and subject to a manufacturer's and contractor's warranty, free from any latent material defect, for a period of ten (10) years from the date of installation to completion.

In this case, the tenant was considering relocating to a new building, with a new roof that was to be covered under warranty for 10 years. At the same time, the landlord was looking to charge the tenant for the roof replacement fund, when there was no material exposure to the landlord of having to replace the roof.

An industrial roof in a four-season climate will generally last between 20 and 25 years. Depending on what yours and your landlord's accounting practices are (IFRS or GAAP), the cost of this roof replacement might be straight-line amortized over the useful life of the roof through the additional rent.

Next to the rent being paid on a building, the roof is often the most hotly contested issue within an industrial lease negotiation

FINAL THOUGHTS

Everyone has an opinion on the future of real estate.

On any given week, there is likely an opinion piece in your local newspaper advising you on whether or not you should be a bull or a bear in your local housing market. The same can be said for your local industrial market.

1. START EARLY

If you absolutely have to move, how long would it take you to pull this off (stress free)?

2. CREATE LEVERAGE

You're an industrial user. The physical components of any facility are not easily recreated, and every location can truly be unique to your operation. Landlords already view you as a captive tenant, so do what you can to indicate to them that you are mobile, and that there could be a business case to relocate.

3. KNOW YOUR LANDLORD

Be friendly, but not familiar. Like your supply chain, every landlord is unique, however the one thing they have in common is that they (like all of us) are there to turn a profit.

4. SWEAT THE DETAILS

Your lease is a large document. Make sure you understand what you have and what you are signing up for. Material terms go far beyond net rent.

5. MAKE IT FIT YOUR SUPPLY CHAIN

At C&W, we believe a performance review of your supply chain should naturally and logically go hand-in-hand with the maturity of your lease. We help organizations make better decisions about their supply chain infrastructure (facilities, technology and IT). We design, justify and implement the infrastructure and facilities you need to gain a competitive advantage.

ABOUT THE AUTHOR

Jesse has worked in real estate and facilities consulting services since 2011, and has successfully completed assignments for food, automation, government and consumer packaged goods organizations. Formerly a Vice President of Industrial Services with a international commercial real estate firm and the founder of C&W's industrial real estate advisory practice, Jesse joined Cushman & Wakefield in 2021. Along with Aaron Enriquez, Jesse provides specific expertise for food & beverage facilities across Canada. Jesse is an Ironman Triathlete and holds a degree in Environmental Studies from Lakehead University. He has been recognized by CoStar as one of Toronto's top industrial real estate professionals on multiple occasions.

CUSHMAN & WAKEFIELD

CONTACT US:

JESSE MICAK*
Vice President, Food & Healthcare Advisory
647 500 5748
Jesse.Micak@cushwake.com

AARON ENRIQUEZ*
Senior Associate
905 808 6070
Aaron.Enriquez@cushwake.com

1 Prologis Boulevard, Suite 300
Mississauga, ON L5W 0G2 | CANADA
cushmanwakefield.com

*Sales Representative **Broker