The Punishment of Capital Invested in Office Buildings in 2010

The Office Market Confronts the Same Challenges of the 1990's, and a Few New Ones

Most persons even casually associated with commercial real estate in the 1990's were aware that office space was in a condition of oversupply, and that rates and terms for tenants were more favorable then than they had been for many years. Rental rates in many regions were lower than five years previously, without any adjustment for inflation. Some attention had been paid to how long it would take the inventories of vacant space to be absorbed and at what rates. Of course, the answer depended on the regional market and the health of the economy which supported the local demand for space, but many markets required at least two years without more construction to absorb existing inventories, and some required five years or more. Perhaps a little less attention was paid to how this situation arose, but ease of credit, and the shifting of risk by developers to financial equity partners and lenders was certainly a big part of it. Very little was said about how long the economic consequences would be felt in the office leasing market after absorption of the oversupply, and what those consequences would be.

More significantly, there were lessons learned from the experience of two decades ago that should have been imprinted into the minds of those in the industry, never to be forgotten. But that is clearly not the case. Either they were never learned, or perhaps conveniently discarded when the opportunity to chase potential outsized profits presented themselves again, or a new generation of players who never had been in a war took command of resources. It is never too late for a history lesson, and to take note that those who do not pay attention to history may be condemned to repeat it and learn the agonizing lessons once more. While much is being made of the liquidity crisis occasioned by the meltdown of the capital markets, and rightly so, there is much more to it than just availability of replacement financing. That assumes all commercial office properties are otherwise sound. But clearly, they are not. "Easy money" created an inventory of underlying assets that may not be worthy of debt eligibility, and that makes the problem more deep and complex than just finding a lender to refinance an existing loan that is reaching maturity, and potentially for which capitalization rates have changed a debt/equity ratio that challenges underwriting of the principal balance to lend and the interest rate to charge.

Forget the Marble and Bronze....Show Me The Leases

It is important to recognize that absorption and occupancy rates as a measure of strength in the market are not very meaningful unless tied to the terms of the leases. Reviewing those terms commonly found in leases today, and in the past five to ten years, whether one has a lease from 1990 or 2010, one is struck with the erosion of economic value to the owner. The value of tenant occupancies has diminished significantly, suggesting that even while booming construction was underway in 1990, and little construction in 2005-2010, the last five years reflected serious declines in real returns from operations. Furthermore, certain types of provisions were inserted into leases in both periods, and became commonplace, which are inherently destabilizing for the commercial office lease market, and may operate to drive the equilibrium of office vacancy to higher percentages than previously expected.

Leasing is a fundamentally simple process-the providing of space and appurtenant services for a fee. Leasing involves the use of capital assets by the owner on a long-term basis. The risk of making that commitment of capital by an owner must be balanced by increased rewards when tenancies are shortened to initial terms less than adequate to pay back the owner's investment.

The owner marshals the large amounts of capital necessary to construct and own a building, and leases all or parts of it to tenants unable or unwilling to make a comparable investment for their own account. It may be that the tenant's opportunities for higher yields in its core business are a key factor, or perhaps the tenant desires greater flexibility and liquidity in the commitment of capital. Whatever the reasons, the tenant is prepared to pay a premium over the basic capital cost of the space to the owner. How much of a premium depends on many other market factors, including availability of alternate space. Note that in today's market, and that of the 1980's-'90's, even if a tenant were capable of building its own building it would prefer not to do so, because the benefits and returns to a tenant are generally superior in the short to intermediate term to those that may be achieved by owning a building.

When the initial lease term is less than adequate to pay back the owner's investment, the investment transcends a long-term credit evaluation of the tenant's ability to pay. Thus, where the lease rate may be evaluated as a positive spread over the amortized cost of the building, that spread becomes undetermined at the expiration of the lease term and the landlord's unreturned capital is put at risk at a future date generally well beyond any possibility of forecasting. The setting of the initial lease rate then becomes more complex than the " cost plus reasonable return on capital." Simple logic dictates that for such future risk the owner will charge a higher rate of rent to balance against that risk, especially if future competition from new buildings with more advanced features for tenants will exist, making the owner's building less attractive in that market. The balancing of interests between the owner and the tenant as to which party shall bear the risk of future market rates is influenced by predictions of availability of space in the future. A "flat" lease, one with a standard or fixed lease payment rate, requires assumptions of future market risks by both owner and tenant. If rates in the market increase significantly, the owner's asset returns less than the maximum possible, while the tenant enjoys the space for a rate that in later years is much less than the then market rate. One would first assume that an owner would therefore prefer an adjustable or floating rate lease. But that is not the case, as the prediction that rates would increase over time in the market did not materialize. If rates remain flat or decline, then the owner is the beneficiary of the fixed rate lease.

The owner also may better measure and stabilize his return against relatively fixed costs for debt assuming that operating costs are adjustable in the leases.

With long-term commitments creating a problem for tenants whose growth may require additional space in buildings that may not have it available to lease, tenants have sought to increase their flexibility by shortening lease terms, and including lease extension options, resulting in most contemporary U.S. lease terms for offices being ten or at most 15 years in duration. Strong past and present competition among owners, coupled with the anticipation of its continuation by both owners and tenants, have enabled tenants to shorten initial lease terms, shifting the market risk of releasing even more to the owner. With the exception of a few smaller submarkets, this condition has prevailed for the better part of the last twenty years.

Some very competitive markets have seen a proliferation of five year lease terms for small to medium size tenants. The business assumption by tenants of the ready availability of alternative space at the end of their now shortened lease terms is a critical component of the trend to shorter leases. Until the prospects of future lease space becomes restrictive, and it is not in the tenant's interests to seek longer terms, lease terms will be shorter rather than longer. This first and fundamental risk shift by owners and developers of new office space in competition with each other in the late 1980's was only the beginning in a series of competitive moves made by owners over the ensuing years. With ever increasing competition to find tenants for new and existing projects each new incentive would find itself matched, and then surpassed by a new form of tenant inducement. Each inducement at its heart was a transfer of wealth from owner to tenant. There are scores of provisions in the contemporary office lease that reflect these wealth transfers, and taken together they have turned the basic premises and economic assumptions of lease transactions upside down. A brief look at four of these provisions should illustrate this trend.

The Multi-Tiered or Stepped Rental Rate

The owner desires a certain stated rental rate for a 10 year or 15 year lease. The tenant wants a better incentive to move, in the form of a lower initial rental rate. The owner accedes, but tries to "catch up" by having a higher rate in the later years of the lease, preserving the owner's net effective income stream. The owner may also hope to thereby increase the perceived value of its building by capitalizing the income stream in the later term to obtain future estimated values for its building. But there are big problems with this approach. First, the owner is taking a credit risk that the tenant will be able to enjoy the low cost use of the space in the early years and may be unable to perform in the later years. Certainly the higher rental rates may adversely burden the tenant's business in the later lease years. Almost certainly the rental rate will be above the then "market" rate unless significant inflation, low growth in available space relative to demand or other factors occur to drive up rates. The higher than market rate then becomes a flexibility problem for the tenant and the owner when flexibility is needed most, in the later years of the lease. If the tenant wants to leave the building it is difficult to sublease at other than a substantial loss. (The subtenant is by definition getting used space for a short-term, and is unlikely to accept the inflated rent of the existing lease when the market dictates lower rates generally available elsewhere).

The existing tenant who wishes to sublease is further burdened by the fact that it may still be legally liable to the owner for the balance of rental payments during the sublease term. A short-term subtenant often is not a tenant of the same prestige caliber or even financial strength as the original tenant. A subtenant of any strength is likely to negotiate with the owner for a new ten year lease, seeking the benefit of market-driven inducements to respond to competition from other buildings, especially from new buildings supported by loan-financed competitive tenant inducement packages (free rent, high tenant improvement allowances, lease assumptions). But the owner doesn't want to negotiate a long-term lease extension in a weak market. Indeed the owner may feel that it has nothing to lose by waiting out current poor market conditions if it can. The tenant wants current market rates, and the owner wants its "payback" on the stepped lease.

A similar problem applies to an existing tenant who wants to stay in a building, but needs more space. The tenant may be desirous of taking another floor, and if that floor can per chance be available, a new deal must somehow be made to extend the original lease term to match expiration dates of the existing lease space and the expansion space. The expansion-scenario tenant will want more certainty of pricing, or else it will have two separate leases and lease terms and may be "held hostage" in the negotiation to extend the initial lease term if it takes the expansion space without extending the initial lease term. Even if the tenant has an option to extend its initial lease term it may be based upon a "market rate" clause. That invitation to dispute is too risky for most large tenants, for the definition of "market rate" is very difficult to actually implement. Owners will seek to establish market rate as the rates then applicable for existing space in their building, or all comparable buildings in the local market...but in a building (or market of buildings) filled with "stepped-rate" leases that is a rate well above what may be competitively available from numerous new buildings. Unless care is taken, the owner may actually be in a position where it drives good quality tenants out of its building and into the new buildings, whose competitive advantages are enhanced by new state of the art features and tenant inducements financed by lenders that existing buildings cannot compete with. This will increase vacancy in the existing building, and that vacancy will be slower to be absorbed than vacancy in the newer buildings.

Free Rent

The initial period of the lease term often provides an abatement of all or a part of the rental payments. Within some practical limits it is an inducement that compensates the tenant for moving expenses, new furnishings, fixtures and equipment, and other costs to the tenant associated with changing buildings. But often it goes beyond that oft-stated purpose and constitutes a broader financial incentive to the tenant, an opportunity to increase net operating revenues for some limited period of time, paid for by the owner's lender or equity source. Of course, rent is not free, and once again the owner will measure the yields it receives over time, seeking higher stated rates at "stabilization" of cash flows. This exacerbates the problems of flexibility in leasing for both tenant and owner as the end of the lease term nears.

Tenant Improvements Allowance

Often stated in terms of so many dollars per usable square foot, this allowance is another financing technique provided by the owner to the tenant. Competition among owners has created upward pressure on the allowances, propelling the benefit to the tenant from (1) space ready for finish work at the tenant's expense to (2) space with a "building standard" allowance sufficient to substantially construct all improvements for the business needs of a typical tenant, and then to (3) "above standard" concessions making possible custom designs and material upgrades such as marble flooring, extensive woodworking, built-ins, amenities in kitchens, audio visual centers and elegant conference facilities. Once again, these are owner competition driven incentives to attract tenants by providing "much nicer space" at rates otherwise competitive to other properties. Some discussion may be had that the extra monies invested in the building for tenant allowances will increase its value, but it is a hard point to endorse. Higher tenant improvement allowances don't necessarily add to the value of the cash flows of the building. The more expensive space becomes more heavily designed, and choices of materials that strongly attract some tenants discourages others.

If the market in the future is weak enough, the owner may be faced with tearing out those same expensive improvements if the next tenant of the space does not so highly prize ten or fifteen year old custom finish work, even if it was exquisite. Once again, the cash flows of the building are driven to above market rates in the final years of the lease term, but at a significant cost to the owner in the initial years, and upon releasing the space.

The Lease Assumption

Mandated by the difficulty of attracting new tenants in the increasingly less flexible market, the owner effectively takes over the tenant's old lease, accepting the costs, risks and inconvenience of leasing the space to a third party. The owner must carefully estimate the discount to the existing lease's rental rate that the owner will incur in releasing the property as a cost of this tenant inducement. Unfortunately, it is an imprecise measure and, if the secondary leasing market is weaker than anticipated, the owner risks a much more expensive benefit to the tenant. This lack of predictability makes the lease assumption an almost desperate move for owners, and signals a seriously weakened market. A weak market poses perils for the tenant as well. The tenant needs to consider the possibility that the new landlord may default in making lease payments for the old space, leaving tenant residually liable, as a full release of tenant by the prior landlord can be difficult to obtain.

What Happened?

How did this competition among building owners continue to increase in the face of ever-weakening markets for space? It was a team effort, combining the efforts of developers, lenders and investors, with some interested pressure from brokers and agents, and of course tenant bargaining power.

One factor in the 1980's was the transmutation of the property developer and lender from long-term participant into commission or fee oriented participant with a short-term view, and the availability of equity monies, domestic and from abroad, which acquired interests in existing and new development projects. With the shift of ownership risk to investors, and developer compensation based upon fees and a "piece of the upside", both developers and lenders were motivated to build more properties. There was no shortage of fee driven brokers to hunt for equity and debt for every conceivable project. In the 2000's there was no such surge in development, and lenders applied stricter underwriting standards. Unfortunately, the standards were not the right ones.

Buoyed by absorption of large amounts of space during the economic expansion of 1983 to 1989, equity investors confused that indicator with market strength, when in fact the large amounts of space added to the inventory were degrading the real economic returns to the owner. This problem was exacerbated when several notable purchases of international class office properties by foreign investors at premium prices encouraged development of still more properties. (But note an important fact...for every major international purchase there were probably ten made by domestic insurance companies, pension funds and private syndicates.) In the period of 2003 to 2008 there was not a vast increase in new space that could be considered comparable to the frenzy of two decades before, there was a lot of packaging of debt and placement into CMBS which propelled buying and selling, earning fees and commissions for those in the chain of commerce who did not take any financial accountability for the ultimate success or failure of the underlying property transactions.

Lower capitalization rates on cash flows made feasible many projects for investors and lenders that otherwise would never have been launched. The expectation of low cap rates replaced reliance on cash flow, and investors and lenders accepted internal rate of return projections that depended on the net present value of high future sales prices to generate acceptable investment yields in the 1990's, and continued low costs and availability of debt in the 2000's. The cash flows themselves were distorted by the "stepped" lease and other techniques. Like a ripple from a stone dropped into a pond, the large infusion of Japanese institutional capital rolled through, and then passed, the office markets of New York, Chicago, Washington D.C., San Francisco and Los Angeles in the 1985-1990 time frame. But the factors motivating those purchases passed, and more than a few disappointed their new owners with their current and prospective operating performance, dampening the prospect of more investment from those sources on comparable terms. Prices began to settle back to levels supported by actual cash flows, and absent premium prices most owners preferred to hold and manage through the dip period. With a quick collapse in demand for additional space caused by the onset of economic recession in 1991, the already highly competitive market became a disaster for developers, owners and lenders. In the 2000's, without the addition of large amounts of new space through construction, the lenders instead pursued the new vehicle that emerged from the ashes of the 1991-1995 recession, the securitization of loans, and became fee driven agents passing much of the risk of loss to others.

First to feel the brunt in the 1990's were developers, who without new projects to generate fees could not maintain their staffs and had to layoff many employees or effectively shut down operations altogether. Anticipated large equity positions of developers in properties either did not materialize or were unreachable because of subordination to equity investor and lender priorities. Damage control, rather than profit enhancement, became the prime objective of the developer. Ever greater inducements were offered to tenants to just get buildings leased up so that some kind of cash flow to service debt could be obtained. When possible the inducements were financed by the owner or lender. Not surprisingly, equity and lender participants withdrew from the market for most new office products, and for increased commitment to existing products, so developers lost their outside sources for cash. When the developer had responsibility for cost overruns or cash flow inadequacies of the project, the situation became critical. With some buildings in almost every market moving to make deals at break-even or even below break-even, trying to buy time with inherently insufficient cash flows for the long-term, developers become a class akin to shipwreck survivors in a lifeboat drinking saltwater ... individual stamina would prolong the survival of some over others, but unless rescue came relatively soon a fatal outcome was inevitable. For the 2000's the developer class were not at the forefront. Rather, it was existing or new owners repositioning or trading properties with new debt instruments, though for a few active in developing and building properties, the above was still applicable.

Second to feel the brunt in the 1990's were the equity investors or owners. Existing estimates of leased space are not a measure of financial health, for the business of many tenants suffered in the recession and the credit risk of those tenants for the owner was worse. In the recession of 2007-2010, the condition of the tenants has been more seriously impacted, creating a hollowing out of the creditworthiness of more tenants, and more deeply, than perhaps any time since the Great Depression.

In the early 1990's many tenants reduced their staffs and found themselves with too much space for their needs, perhaps enough to handle six to eighteen months of expansion even after a recovery in the economy began. Most service industry employers, major users of office space, were very cautious with rehiring. That recession had a slaughterhouse effect on the professional and service industries that was unprecedented, with investment and commercial banks, consultants, accountants and law firms laying off professional and support staff in numbers that would have been considered unthinkable in the 1980's. Some of those unfortunate tenants faced "must take" expansion options for space they didn't need at above current market rates. As a result, some tenants began seeking compromises on lease terms, delays in exercising "must take" expansions, and challenging lease provisions with landlords, with negative consequences to net cash flows. In the recession of 2007 the declines in employment were even greater, with one of the darling tenant classes of major high rise office towers, large law firms, laying off thousands of attorneys and staff. And of course the number of major accounting firms was significantly lower than twenty years earlier, following mergers of major names, and the collapse (Arthur Anderson) of others. Great quantities of unused space, underused space, and sublease offerings will take significant time into the hoped for recovery in 2011 to be absorbed. Dynamic changes in the efficiencies of businesses in using space are also causing reductions in the amount of space required to operate, a factor that was evolving as relevant in the 1980's but which have come to be more significant through technologies now common that were not widespread twenty years ago.

With dropping effective rental rates in the 1990's, owners of new buildings had difficulty stabilizing their cash flows at high enough levels to satisfy debt payments, and struggled to get leased to a high enough occupancy promptly enough to avoid the call for additional capital. Often that capital was not just for debt service but for even more tenant inducements to get a rent paying tenant to stop the negative cash flow hemorrhage. "Break even" occupancy rates rose to 85% or higher because the margin on lease deals was increasingly thin. Existing properties had seen many of their prime tenants raided away by tenant inducements in new buildings financed by investor and lender capital that could not be matched by residual operating cash flows of the existing building. Vacancies rose and equity values previously assumed by owners and lenders plummeted with the reduction in cash flows, and the rise in cap rates then demanded by buyers. There was little relief in sight until new buildings were either leased up or stopped offering tenant inducements that could not be matched by existing properties. In the 2000's there is a different challenge. Cash flows are typically sufficient to carry exiting debt and operating costs. But real demand for space in the buildings by the existing tenants is reduced. Given the opportunity to reset, keeping all existing tenants in place, there would be significant declines in current occupancies. When major tenants do default, the prospect of attracting and relocating new tenants is very difficult, and if the loss of a tenant drops the cash flows to a level that is not satisfactory to carry the building operations and debt service, owners have shown increased willingness to throw the keys to the lender on a nonrecourse loan rather than invest more capital to rescue their investment.

Third to feel the brunt in the 1990's were the lenders. Even beautifully designed, well constructed, centrally located, and respectably pre-leased office buildings hit a "wall", with some buildings stalling at 40% occupancies or below after completion in many major markets. That was not an unprecedented occurrence, as the early lease up experience of the Empire State Building or the twin Theme Towers in Century City would attest. When the interest reserves ran out in six to eighteen months, what was to be done? If the owner had financial strength and the market showed prospects of recovery, perhaps the owner contributed additional capital and saw it through. But there were several notables who chose otherwise and withdrew from the market at great loss, including many foreign investors who faced intense problems with their homeland domestic economic positions and elected to liquidate and repatriate monies to their home country. The popular structure of development limited partnerships limited lender recourse, and the passive investment character of the true equity participants increased the difficulty for the owner in obtaining additional equity capital. It was several years before the situation stabilized, and the development vigor never did return over the next twenty years. In the

2000's the lenders have yet to feel the impact seriously. Most of the focus to date has been on the subprime residential mortgage crisis, European sovereign debt instability, and a wary nod to the future that a lot of commercial debt instruments are marching towards maturity and quite possibly the global financial system lacks the ability to replace what is outstanding........even if the assets were to meet then applicable underwriting standards. Approaching a wall at 100mph not knowing if you have brakes is of some concern from one mile away. But it doesn't take long before one runs out of pavement, options and time simultaneously at that velocity.

What Did Owners Do to Help Themselves?

In the short-term the owners in the 1980's-90's attempted, through ever increasingly complex lease provisions, to limit their liability for unpredictable future increases in operating costs. These efforts were moderately successful in earlier years as there was a disparity in the level of technical leasing sophistication as among owners and tenants as to the economic workings of the office building business. However, as the impacts of such provisions began to be understood, tenants began to negotiate away the advantages. Indeed, one might argue that the technique further encouraged the proliferation of the tenant leasing broker, whose skills became more necessary, and more affordable to the smaller space users. The tenant broker's understanding of the market and leasing game brought greater skill to a class of tenants that previously was probably under qualified to protect its interests. The end result was even less advantage to owners, and longer and harder negotiations and bigger legal bills to prepare ever more complex lease agreements. This dynamic change did not go away, but stayed present in the market once introduced.

Why Did It Happen?

At its heart the problem was not and is not real estate, but a complex evolution of business relationships where risk could be ignored rather than resolved. A basic premise, which was fundamentally in error, was accepted as true by a large number of people, who developed a critical dependence upon the perpetuation of that premise. What started perhaps as mistake became a nurtured falsehood, until the entire preposterous falsity collapsed, lacking the skeletal strength of correctness and truth to support itself. How we approach this issue of corporate business social responsibility and personal integrity within business organizations is of great importance, but it is not the focus of this article. Until the firestorm of commercial property failure is controlled, it will not be a top priority of most lenders, developers and investors either. But the problem will cyclically return as it has in the past, in real estate and other businesses until it is addressed.

Look to the form of lease agreement to find the answer. Candidly, may anyone read a beautifully drafted 75 page office building lease, and have the impression that either party is getting a good deal, or even an understandable one? Is it reasonable to expect that those involved in the loan underwriting process really understand them and what they mean economically? Is there a great pressure for them to understand, particularly where the institution they represent will be packaging and passing the loan risk along to other parties with little or no ultimate accountability for the underwriting judgment?

It is fair to say that the basics of even the most complex business transactions can be expressed in a half dozen or so pages, with a few more for customizations and another few for mechanics. Therefore a rejuvenation in the office market should be evidenced by shorter, simpler agreements and fewer complex business terms. Complex agreements exist not because real estate leasing is complex, but because owners and developers were either unable or unwilling to accept the financial risks of ownership, or could not understand the risks, and sought to shift them elsewhere. That shift of risk went to lenders and passive equity partners in many projects via development partnerships and nonrecourse loan agreements in the 1980's, and in CMBS in the 2000's. In leases the effort to shift risk was reflected in the almost incredible creativity and detail applied to allocation of operating expenses and tenant inducements. In the 2000's it was in pools of properties where presumably the assemblage of assets would overcome any unique individual property weakness (overlooking entirely the possibility that when the economic "tide" recedes, as all tides do, that most of not all of the "boats" in the bay would be at increased risk for having their bottoms ripped out).

Where the economic fundamentals aren't enough the developer/owner needs an "edge", and the financial survival of the project soon rests on the "edge" and not on the fundamentals. The "edge" is created by many new concepts and terms, and those take many new pages to document. Unfortunately for the developer/owner, in a highly competitive market an understanding of the " edge" by the tenant market ultimately neutralizes the advantage sought, or even turns the " edge" against the developer and owner. Indeed, tenant strength has contributed to the length and complexity of lease agreements as tenants utilize the tactic against the developer and owner. Those unable to understand or unwilling to accept the risk of ownership will now have greatly lessened ability to participate in the office development and ownership market. Those who do will not have to compete with developers in possession of foolishly entrusted debt and equity monies, and the market should gradually stabilize. But that is not going to be until after the pending challenge is met and surmounted. And at the moment, sitting behind the wheel of that 100mph car....nobody has postulated a possible solution that a significant number of players in the market is willing to accept has viability.

What Happens Next?

Certainly there have been, and will continue to be, failures of office projects. Although one could not rule out failures by large projects, they were relatively few in number in the 1990's given the large equities invested, the strength of their equity participants as a source for additional capital to carry the project through a down cycle, the relatively greater strength of their tenants, and the lenders' desire to avoid foreclosures on such major projects, promoting reasonable restructuring of debt and equity positions. The collapse points of many were not reached. The recession abated soon enough and the recovery was brisk. Absorption picked up, although the large inventories still made many good deals for tenants and marginal ones for owners. But for the recession of 2007 the components are not as positive. The depth of the recession is deeper, the recovery is delayed and expected to be slower, the owner and lender agony is presently expected to be protracted, future liquidity is unknown but anticipated to be lesser, and in some cases the impact will range from severe to fatal.

This is what I said about the future of the market in 1990:

"It should be safe to say that few new projects will be built in the next several years, but then again it should have been safe to say that three years ago. Assuming that gradual absorptions take up the inventories of space, what will the market for leasing and development be like in several years? Firstly, speculative development and construction will be sharply reduced. Finance will be unavailable except for build to suit and substantially pre-leased properties, with cash flows adequate to support debt service and higher returns on equity. With entry into the office building market so restricted, new development will follow demand, rather than lead it, and competition among owners

will decline, but only somewhat. The legacy of the leasing wars will continue through the expiration of the terms of those existing leases. The transfer of wealth from lenders, investors and developers to tenants will continue until those leases expire and are replaced. Such leases will be the order of business until after the current surplus has been absorbed and demand for space becomes sufficiently great for new buildings to be constructed. In the meantime, it's a tenant's market. It took several years of concerted effort to bring the office market to this condition, and it will take several more to work out of this condition. The only really good news for the equity investor is that it invested in office property rather than a luxury hotel.

In the short to intermediate term the tenant needs only to enjoy the benefit of an oversupply of product, and the owners will receive relatively lower returns on their capital investment until that oversupply is corrected. Unlike a bumper crop of apples, or a large inventory of parts, the supply is not readily changed by a short season or a temporary slow-down in production. An asset with a fifty year or more useful life will simply sit empty until demand expands though growth of the regional economy, and the working population that needs such space increases. There will be occasional tenant moves and relocations that benefit certain buildings, and older buildings may effectively drop out of the inventories of space as tenants at all levels "trade up" to better buildings and locations in response to the attractive pricing. (To this point we are reasonably accurate on crystal ball forecasting the future. But below....well a factor was overlooked.)

As this slow digestion occurs, owners will have a choice. They may repeat their strategies of the past two decades, or they may return to basics. Those basics will be:

- *New development on a build-to-suit or heavily pre-leased basis. Developers will need to expend substantial effort to obtain lease commitments from major tenants in older buildings before construction commences. Developers will be compensated on the filling of market need, rather than on the basis of production.*
- *Leases should be longer term, with rates more accurately tied to cost plus a return on investment. Landlords, once finding a tenant, will try to keep them.* (There were pushes for longer lease terms, and with the absence of strong additions to inventory there were some strides in this direction. But overall the condition of the marketplace did not strengthen sufficiently in favor of the landlord, and lease terms remained shorter term due to the strength of the tenant position in the marketplace, although rental rates did rise).
- *Risks should be recognized and accepted by developers and owners who are in a position to understand and take those risks, and others will simply not be in the business. Lease agreements should become simpler and shorter.* (Simply did not happen. Instead there was more conservative underwriting by lenders in terms of acceptable cap rates, coverage ratios, etc., but the genie of engineering risk transfer, once let out of the bottle, just couldn't be put back in.)
- *Business creativity should focus on techniques that bond the landlord and tenant together for their mutual advantage, and not on the cute and clever twists.* (Wishful thinking.)

What really happened was that for the most part the status quo on leasing approaches prevailed, and the owner turned to restructuring its debt positions with newly available and cheaper money to create its net operating margins after debt service. Leases favored higher rental rates before longer terms. Those with access to cheaper cost money got the deals, those who didn't...didn't... The owners "geared up" the debt through the CMBS markets, leverage ratios rose and voila' we were back to the "good old days" of the '80's. Why bash one's head against the wall to change the market, when one can address one factor with a willing counterparty and hopefully lock in attractive returns for the short to intermediate term? When the initial piece was written in 1990, the CMBS market was not robust, and most were hoping, not expecting, for liquidity and terms that would return the lost sources of bank, insurance company and pension fund direct and participation lending on specific assets. Few foresaw a torrent of monies and gigantic pools of mortgages at the levels that evolved, dwarfing the levels of finance from the pre 1990 era. I certainly did not.

And the consequence? We didn't have to learn from our mistakes. We just ran around it like a boulder in the road and hammered the throttle to the floor. Will we learn from our mistake this time around? My immediate concern is more focused on surviving it.

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