Low vacancy rates

How to lease commercial space in a tight market

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Ted Reilly of Cushman & Wakefield Ltd., left, worked to find the right space for Michael Carleton and his staff. Dymaxium Healthcare Innovations moved just east of Toronto's downtown core on Front Street near the St. Lawrence Market. (Michelle Siu for The Globe and Mail)

When Dymaxium Healthcare Innovations was on the verge of its latest business shift to software product sales from custom software creation, chief operating officer Michael Carleton was looking for ways to reduce operating expenses and found part of the solution in the walls around him.

In 2010 Dymaxium was shifting from a large staff of programmers creating custom software to a sales force on the road selling software globally.

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By providing sales people, who are out of the office most of the time, with shared office space, and a growing trend to employees working from home, companies do not need as much conventional office space as they used to.

Dymaxium, which provides health-care economics analysis software to global pharmaceutical companies and health-care management organizations, found itself with office space leased just two years earlier that no longer fit the company's needs, so Mr. Carleton called a commercial real estate agent he had worked with for more than a decade.

"With the business environment changing so rapidly these days, I think most companies need to keep as much flexibility as they can," he said. Small and mid-sized companies need the experience and market knowledge that a commercial real estate agent provides.

"Real estate leasing is the biggest thing you never learn in business school," said Ted Reilly, the Cushman &Wakefield Canada agent who works with Dymaxium.

Tight conditions in commercial property markets are compounding the challenge across the country.

The national central market office vacancy rate fell to 5.0 per cent in the second quarter, down from 5.4 per cent in the previous quarter, making it only the second time vacancies have dipped that low since 1985, according to a recent Cushman & Wakefield analysis.

The drop in vacancies is pushing up rents, particularly in Calgary, Vancouver and Toronto, where the vacancy rate of 4.5 per cent is the highest of the three.

Toronto's commercial vacancy rate hit a cycle-low of 3.1 per cent at the end of 2000, while at the cycle's peak in the third quarter of 2003 it hit 11.9 per cent.

The average rental rate for Class A, B and C properties in downtown Toronto jumped 21 per cent to $22.64 a square foot since the first quarter of 2010. The Class A office space used by large corporate tenants is experiencing the highest rate increases. The price of Toronto's top Class A space in the premium towers, Bay Adelaide Centre and Brookfield Place, is in excess of $80 a square foot, Mr. Reilly said.

"If you're a large tenant, there are new buildings going up that will eventually ease the pressure," Mr. Reilly said. "It's the B- and C-class properties for the small- to mid-sized market where there hasn't been much new space added in the last few years."

In addition, a reverse migration is drawing some companies in the suburbs back to downtown cores to attract and retain top talent, who want to be close to urban amenities and central transit options.

“The real story is that because the market is tight, there are not a lot of great options and you need to start the process earlier than you think so that you can create leverage with the landlord and have time to negotiate the best option for your needs,” Mr. Reilly said.

About 70 per cent of the deals Cushman & Wakefield does are renewals, but even then getting the best deal takes time and planning.

“A landlord does hundreds of deals, if not thousands, a year, so they understand the market,” Mr. Reilly said. “To get the best deal a tenant needs knowledge of the market too. They can’t get it if they’re only doing one a lease every few years. That’s why we do a lot of work for the big law firms, they understand the value agents bring.”

Mr. Carleton of Dymaxium agrees. “I consider their knowledge and expertise an extension of my management team. You want an agent who understands the ebbs and flows of your business.”

“One of the things Ted educated us on was that we didn’t have to be afraid of longer term leases,” he said.

“With a business that has been changing as fast as ours, I didn’t like to sign leases longer than five years,” Mr. Carleton said. “But the business would keep growing and in a couple of years I’d find that we needed more space but I still had a year or two left on the lease. People don’t like to sublet a property if there’s only a year or a year and a half left on the lease.”

So he signed longer leases and as the market tightened, it paid off because the property was easier to sublet or, more often, the landlord happily allowed the lease to be broken.

Last fall Dymaxium moved to its latest location just east of the downtown core on Front Street near the St. Lawrence Market, making sure a Starbucks, which employees consider a necessity, was nearby.

Cost savings from the change in location helped eased Dymaxium’s transition from building customizing software to selling software products. Its bottom line is growing, employees are content in the space and Mr. Carleton will be ready for the next move.

Leasing tips

Start early

Select a commercial real estate agent at least 12 to 18 months before your lease expires.

Choose an agent interested in understanding your business

When interviewing agents pay attention to the questions they ask about your business. Do they show a desire to learn more about your long-term plans or do they just focus on finding a property and closing the deal?

Conduct a lease audit

Provide your agent with a copy of your current lease for review to determine details of terms that might save, or cost, cash.

Determine needs

Is your business changing and how will that affect the amount and type of space you may need in a few years? Your broker should be knowledgeable about the property class, A, B, or C, that your business requires and be able to bring in other design and technical specialists to use the space most efficiently.

Do not fear long leases

If your business plans should unexpectedly change, it will be easier to sublet a location with a longer lease rather than one that will expire in a year or two.

Aim to have at least two property options when negotiations begin

Although you may open negotiations with just one property, when market conditions are tight do not count on getting your first choice.

Focus on the value of the entire lease package, not just the net square-foot lease rate

Leases in major metropolitan centres are typically 50 to 60 pages long and drafted by the landlord. In a tight market, an agent may be able to suggest wording amendments that will reduce your total costs in areas that matter less to the landlord. For instance, many leases include 'restoration provisions' that, in Toronto for Class C space, for instance, currently require a payment of $5 to $7 per square foot of space at the end of the lease. For small to medium-sized companies that can amount to a sizeable cash drain. It might be easier for the landlord to reduce that rather than cutting the lease rate or providing upfront incentives.