## Office Tenants—Retail's Innovative Golden Goose?

Jodi Bain • published in the August 2014 issue

**Retail space** has become an interesting alternative to the old-fashioned office building. Retail developers, owners and property managers have realized a slow creep of traditional office tenants—office oriented service providers—into highly visible retail space. While H&R Block and regional and national dentist office chains may be the most memorable, real estate brokerages, doctors, day spas and other service providers have recognized the economic benefits of retail space locations.

So how do developers and landlords of shopping centers, mall and retail centers with demand from office oriented service tenants evolve their lease terms to accommodate the different expenses associated with office users? What are the considerations? And, what are the issues pertinent to Arizona property owners?

**Historically.** Owners and managers typically find office properties require more often, extensive and costly tenant improvements ("TIs") than retail space. It is also the misery of office properties that office tenants more frequently shift from space to space—seeking better rent rates and offers of TIs—than retail users. Office tenant have customarily received full service or modified gross lease formats. This means, respectively, an inclusive monthly rental rate (for base rent, janitorial, utilities, etc.) or a single rental rate for a significant set of services with clear carve outs. Office leases are not "NNN" format leases that pass through all costs to tenants above a base rental rate.

Meanwhile, retail tenants have historically determined their location selection based on population densities, visibility, traffic patterns, accessibility and the desire for repeat clientele. They are more often tied to their physical location as regional and national chains provided branding with heavy site advertising for key locations. Retail locations are commonly modernized aesthetically—to keep retail tenants—more often than office space. Retail or commercial tenants are accustomed to "NNN" leases that include a base rent plus extensive landlord expenses passed through for tenant reimbursement with the significant cost of TIs amortized into the "NNN" lease over a long-term.

**Great Recession—Ongoing Impacts.** Arizona office properties have been especially hard hit and remain difficult to tenant. Meanwhile, numerous retail chains continue to close their doors across the country. Expect ongoing big-box locations and perimeter (and often highly visible) pad sites to be shuttered over the next few years. Retail closings are due in part to the Great Recession along with the intense growth of e-commerce sales and evolving consumer purchase trends. In fact, major retailers announced significant closings this year—Staples (approx. 225 stores by 2016), JCPenney (approx. 33 stores) and Radio Shack, the national electronics retail chain, announced the closing of 1,100 stores nationwide.

**Shifting Trends.** Over the past decade, the significance of e-commerce and non-physical location branding has significantly changed the retail marketplace for retail chains. And, historically 'ma and pa' in-line retail space users began to reduce their costs by having an online presence—without a physical retail outlet. Service oriented, office format lessees are now available occupants to fill the void created by e-commerce and the Great Recession.

**Shrewd Approach.** Store closings provoke underlying income concerns for financing and investment performance and compliance. The long-term ramifications of retail closing for developers, owners, investors and property managers will be felt for years to come if a replacement user is not found to fill the void. Savvy retail property owners need to evolve their model to remain competitive and successful in their chosen marketplaces. A concern to an owner's bottom line is the control and pass-through of costs to rehabilitate shuttered spaces and other key ongoing lease terms.

**Design and Construction Considerations.** The key is for the owner or landlord to be smart and overhaul the vacant space in a flexible and cost-effective manner—once. Savvy owners should recognize any space will require ongoing floor plan changes—even for long term lessees. Such ongoing changes should be understood during the major overhaul. Underlying construction should be easily convertible to a variety of sizes for a diverse mix of potential users over a depreciable lifespan.

**Keep it simple.** If possible, keep 'demising walls' to a minimum. Big box stores often have high ceilings with span beams with drop ceilings. The existing span beams mixed with updating the drop ceiling may allow for an urban loft impression without extra cost. Work with development service entities to recognize innovative construction components and modular pieces for space partitions. New products allow for energy efficiency, control of noise pollution and often comply with fire rating requirements.

**Retail or Office—Managing and adjusting lease expectations.** A client calls who seeks up to 2000 square feet ("SF") of space with great visibility, in a high traffic area with accessible parking and a secondary entrance for staff. The preference is a reception area, conference room, three offices, file room or area, in-suite bathroom and an employee break area. Key to closing the deal is to keep the rent at no more than $19.00/SF with 2% annual increases and new paint and carpet every five years at Landlord's expense.

**Owner Financing and Lease Term Considerations.** Who is this tenant? Office or retail? Medical, accounting or tax, legal or consulting services? Consumer goods or service based?

Consider for a moment that a common office user transitioning to retail space may be unable to pay out of business revenue for considerable TIs. Nor are they able to afford to fully amortize such costs. **The question remains:** Is it worth it to a landlord to fill in-line or newly vacated big box space with a tenant unable to afford to kick-in for the TIs? In many cases—yes.

Landlord is often focused on income projections without adequate consideration of existing financing restrictions. A landlord must balance their income pro-forma and investor expectations with the underlying property financing obligations. Does the deed of trust require certain occupancy levels? How is the loan-to-value ratio or 'LTV' hit by vacancies? What is the space size when lender approval is required for new tenant or existing lease modification consent? In today's marketplace, these are the types of considerations retail property owners and managers should balance—especially when considering allocation and possible recuperation of TI funds. Knowledgeable and practical advice is more important than ever.

**In Arizona, be savvy & be aware.** Be aware of how to best to plan physical or legal changes to your property and their impacts to property tax matters. Proposition 117 took effect January 1, 2014 for the 2015 property tax year. It changes how Arizona property taxes are calculated on a property's valuation. *There are significant exceptions and pitfalls to this new law.*

The Prop 117 limited property value 5% cap does not apply when there is a change in use, new construction, destruction and demolition, parcel splits or combinations. Remember, Prop 117 does not limit your actual property taxes to a 5% increase. Maintaining control of your property valuation can noticeably reduce overall taxes and a key expense burden.

**The Bottom Line:** Retail owners stand to benefit from office users that seek to position themselves in high traffic, visible retail locations. Cost effective revamping of big box spaces and shuttered pads is possible. Know the constraints of financing and shrewd accounting opportunities. Savvy planning is key.

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