

Exploiting the underground

How to get the most value out of commercial real estate subleases **Interviewed by Steve Trusty**

Your lease will expire in the next 12 to 18 months. You want the best value for your money and maybe staying in the current space is an alternative. Should you expect help from your landlord or your landlord's broker? Will this approach bring out all of the market alternatives or just the ones that suit the best interests of the landlord ... or the landlord's broker ... or the other landlord clients of that broker?

According to Mike Gallagher, vice president of Irving Hughes, there is an underground of available sublease space, much of which is quietly on the market only to those who are really in the know.

"The San Diego commercial real estate market is not much different than the New York night club scene — you have to be connected. There are 4.3 million square feet of sublease space on the market in San Diego today, and even more than that is out there that's not listed and quietly available."

Smart Business talked to Gallagher about the San Diego commercial real estate sublease market and what to consider as options for leasing space.

What causes sublease space to become available?

Prior to the 2000-2002 tech downturn, there was traditionally very little sublease space available and tenants and their brokers didn't focus much on it. Initial waves of sublease space came on the market in 2001 when tech and related service companies began to downsize. Since then, the market has been filled by subleases of large companies downsizing their San Diego operations like Intel, Nokia, Merck, Pfizer and Eriksson.

A vast amount of the sublease space on the market today is the result of merger-and-acquisition activity whereby a San Diego company gets gobbled up, and the result is that the acquiring company cuts the local headcount and looks to dump the real estate. In the last year, the slowdown in residential real estate has caused several hundred thousand square feet of sublease space to come on the market as the result of downsized mortgage companies.



Mike Gallagher
Vice president
Irving Hughes

Why should a company consider a sublease opportunity?

The first is financial. You will save a ton of money relative to leasing space directly from landlords. Companies that need to sublease space will have to discount their space in order to sublease it. In most San Diego office submarkets, the average time the space has been listed for lease ranges from 11 months to 19 months, and it's almost two years in UTC. The sublessor can't wait that long, and cutting the bleeding quickly is the primary concern. Where a landlord is trying to maximize revenue when leasing space, a sublessor is trying to minimize losses.

Another benefit is flexibility. The majority of subleases range from one to three years but sometimes they can be longer term, or the term can be extended with the landlord. Many start-ups or tenants with softer credit find shorter-term subleases attractive. When signing a direct lease for space, landlords want to see the last two years' tax returns and they do heavy credit checking, which can ultimately result in higher deposits or personal guarantees. We generally avoid this risk and cost with subleases.

Another benefit is that many subleases come with furniture, network cabling and

phone systems available, which is generally included at no additional cost, all of which the subtenant owns at the end of the term. There is nothing like moving into a plug-and-play situation and saving hundreds of thousands of dollars on equipment.

Are subleases usually available?

As of this writing, there are 22 high-rises in downtown San Diego, all of which have multiple options available in a variety of sizes. Many subleases are available from law firms, but they are not publicly on the market due to the sensitive nature of how it would appear to employees; downsizing can be very traumatic for any professional firm.

Approximately 20 percent of our downtown clients are going into sublease space and 15 percent of our suburban clients are closing on subleases rather than leasing space directly from landlords. This is where the values are and this overhang of space is going to have to materially move off the market before landlords will be able to increase overall rental rates.

Are there pitfalls in subleases?

The biggest risk is credit. You need to know as much as possible about who you are subleasing from. You want to assure yourself that the sublessor is paying his or her rent to the landlord while you are paying the rent to the sublessor. A subtenant should also make sure that none of the furniture available is leased. Also, a subtenant will want to make sure operating expenses are not passed through, as the sublessor will have a base year that is several years old, and this can create a surprise cost.

Subleases universally come in as-is condition but we are able to negotiate free rent concessions to offset the costs of any tenant improvements or alterations. Again, it is important to work with a representative that is connected and experienced in this unique market of transactions.

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