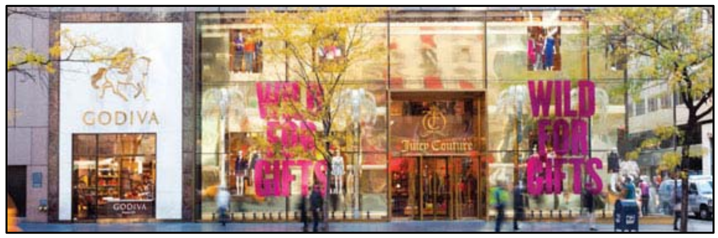
THE REAL DEAL
NEW YORK REAL ESTATE

Friday, May 1, 2015

Fat checks for retail buyouts

Banking on higher-paying tenants, landlords dig deep to get merchants to walk away

BY RICH BOCKMANN



The massive rise in store rents is prompting some Manhattan landlords and developers to reach deep into their wallets to convince retailers to walk away from their leases.

Those players are not willing to wait for retail tenants' leases to expire. Instead, they're paying them big sums to leave, knowing they can lock in new rents at far higher amounts.

While that practice is not new, the amounts being paid are rising fast and are higher than ever, sources told *The Real Deal*.

"It used to be called 'key money,' and now it's called a buyout. It's the same thing; it's just a new word for it," said Faith Hope Consolo, chair of Douglas Elliman's retail group. "The difference is now the numbers are bigger."

The gulf between current (and projected) retail rents and what a tenant may have locked in years earlier are, of course, central when it comes time to negotiate a buyout. And if a tenant signed, say, a 10-year lease even a few years ago, they could be staring down a big check just to pack up and go home.

Indeed, rents have been rising at unprecedented rates — especially on some prime corridors. For example, from 2004 to 2013, the average retail asking rent in Midtown climbed a net of just $4, to $133 per square foot, according to reports from the Real Estate Board of New York. But between the spring of 2013 and fall of last year, average asking rents shot up 49 percent, to $198 per square foot, according to the latest report.

On upper Fifth Avenue between 49th and 59th Streets, average asking rents more than doubled, to $3,420 per square foot, from the spring of 2009 to last fall.

In Times Square, asking rents rose about 150 percent, to an average of $2,317 per foot, during the same period.

And on Broadway in Soho, asking rents nearly doubled, to $890 per square foot, between 2009 and 2014. Retail rents are so high that they're often the determining factor when it comes to purchasing a property.

“It’s upside down. Retail is what’s driving [building] sales,” said retail broker Joanne Podell of Cushman & Wakefield. “When someone buys a building, the first thing they do is call a bunch of retail brokers.”

“I know a couple of buildings in Soho where buyers were asking, ‘What you think this base is worth?’ and I’m saying it’s worth $1,000 a foot, and the tenants are paying $250, $300,” she added. “I’m serious.”

Brokers said the city’s prime shopping districts — Times Square, Fifth Avenue, Soho, and Herald Square, to name a few – are where these buyouts are occurring most.

Developers sometimes buy tenants out too, when they’re preparing sites for construction, though there is certain language often worked into leases that makes the process more straightforward. Many leases include due-on-sale and demolition clauses, which outline terms in advance to deal with the sale or tear-down of a property. These clauses can set a dollar figure, or work out a schedule depending on how much time is left on the lease, said broker Adelaide Polsinelli of Eastern Consolidated.

“Of course, you don’t usually get the highest rent” when these clauses are included, she said. And while it may seem that a tenant without one of these clauses would have an outsized amount of leverage, Polsinelli said developers always have options, such as building around a site or waiting out the end of the lease.

On Fifth Avenue in particular, escalating retail rents are driving transactions. Take, for example, Jeff Sutton and General Growth Properties’ $1.75 billion purchase of the Crown Building at 57th Street, which was due to close around press time. The record-setting deal was driven by the huge potential to increase the retail rent rolls. Retail rents on that property were reportedly well below market rate. REBNY pegged the average asking rents for Upper Fifth at $3,420 a square foot, but Sutton is said to have targeted the retail at $5,500 per square foot.

At 650 Fifth, Sutton and SL Green Realty paid Juicy Couture parent company LCI Holdings $52.4 million about a year ago to walk away from its lease, public records show.

Juicy reportedly had about seven years left on its three-floor, 18,000 square-foot lease. The landlords are reportedly looking to add another 11,000 square feet of retail to the site, which is still seeking a new tenant.

Retail brokers said owners almost always have a new tenant lined up and new rental rates in place when they negotiate a buyout.

The retailers’ performance is also a huge factor in the buyout price. Property owners are more likely to get away with paying less if the retailer is performing poorly.

The mother of recent Manhattan retail buyouts — a deal at 666 Fifth several years ago — was such a market maker that it’s become a case study. In that situation, a partnership of Kushner Companies, the Carlyle Group and Crown Acquisitions paid nearly $75 million in 2009 and 2011 to buy out a trio of tenants: The NBA store, designers Hickey Freeman and Brooks Brothers. “Regardless of the profitability of the tenants, it was going to be an expensive and timely series of lease buyouts,” read a 2013 analysis of the deal by the Center for Urban Real Estate at Columbia University.

Kushner, which bought the building in 2007, brought Carlyle and Crown in as partners on the retail. “At the time of the buy-outs, Kushner underwrote the Fifth Avenue retail at $1,600 PSF, but the subsequent leases were well north of $2,000,” the Columbia report read.

The partners ultimately divided the existing spaces to add additional (and lucrative) Fifth Avenue frontage and then inked four new mega-deals: Uniqlo signed a 15-year lease worth $300 million; Swatch inked a 15-year deal for $80 million, Vornado bought a $707 million retail condo and Inditex, Zara’s parent company, bought a retail condo for $350 million.

Newmark Grubb Knight Frank’s Jason Pruger said not only can landlords increase cash flow from higher rents through buyouts, but can also get more aggressive underwriting for refinancings. “In a lot of the cases, it’s the cost of doing business,” he said, noting that “it has to make sense or they won’t do it.”

“If there’s a big enough spread between what a landlord can get and what it will cost to get [the tenant] out,” Pruger added, “they will do it every single time.”