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Loss factors in New York City commercial market

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Once upon a time, many years ago when twelve inch rulers were inflexible, a hypothetical New York City landlord stood in the vast 10,000 square foot hypothetical lobby of his eleven story hypothetical office building, watching his hypothetical tenants arrive for work in the morning.

The landlord had successfully leased the second through the eleventh floors to ten tenants, each occupying 10,000 square feet. As the landlord stood in his lobby that day, considering the rental revenue his building was generating, it occurred to him that even though each of his ten tenants was paying rent based on 10,000 square feet, no one was paying him rent for his beautiful lobby even though every tenant walked through it at least twice a day.

Nothing if not an opportunist, the landlord decided that when he built his next building, he would tell each incoming tenant that the rentable area on each office floor was 11,000 square feet, even though each floor would actually contain 10,000 square feet. If anyone challenged him on his measurement, he would explain that since each tenant uses his lobby, each tenant must pay for its proportionate share of that common area.

And that is how Loss Factors were made ...

Well, maybe that's not exactly how it happened, but it is true that at one time, there was a rational explanation for why New York City landlords insist tenants pay rent per square foot for space tenants don't really occupy.[1]

Fast forward to today and Loss Factors have become a market driven business term, as relevant to tenants as rent, free rent and tenant improvement allowances.

Whenever a commercial landlord decides to sell an office building in the current climate (an extremely competitive, heavily picked-over sales market where $13.1 billion dollars worth of commercial property was sold in Manhattan in 2005[2]), the first action taken by his sales agent is to increase the full floor Loss Factor to 25%.

Buyers of commercial property, particularly buyers of Manhattan trophy office buildings, generally don't question 25% full floor Loss Factors notwithstanding the fact that Manhattan office buildings come in all shapes and sizes with vastly different floor plate configurations, load bearing column density, width of perimeter HVAC convectors, etc. Imposing a 25% full floor Loss Factor on an inefficient floor plate translates into asking a tenant to pay rent for a lot of inefficient square feet.

So you may be thinking to yourself, okay, a 25% full floor Loss Factor means that tenants actually occupy 75% of the rentable area in a recently sold Manhattan office building, right? Well, no, that's not really right. To understand how to measure and define office space in New York City one must first understand terminology.

"Rentable Area" represents the number of square feet based on which office tenants pay annual rent per square foot. Every landlord advertises vacant space based on Rentable Area but Rentable Area is only an approximation of the size of the premises.

The term "Usable Area", as it's commonly used in the NYC commercial real estate market, is essentially a misnomer. The Real Estate Board of New York (REBNY) guidelines for determining Usable Area were most recently updated in 1987 and recommend that landlords calculate Usable Area by measuring the entire floor to the outer façade of the building (often beyond the window line) and deducting only floor penetrations (e.g. elevator shafts, fire stairs, risers, etc.). According to REBNY guidelines, on a full floor basis, Usable Area includes electrical closets, fan rooms servicing the floor, janitorial rooms, bathrooms, load bearing columns and space occupied by perimeter convectors.

Loss Factors are the difference between Rentable Area and REBNY Usable Area[3] .

Two other synonymous terms commonly used are "Carpetable Area" and "Assignable Area". These terms literally refer to the number of square feet on which a tenant can lay carpet.

On a divided floor landlords apportion common area hallways, bathrooms, electrical closets, slop sinks, fan rooms, etc. to the point where divided floor Loss Factors often rise well above 35% and Carpetable Area can be less than half of the Rentable Area.

So the market has all these terms for quantifying office space, some of which are more than a little misleading. What should tenants be aware of? Certainly, tenants should care a great deal about how much Carpetable Area exists in a certain premises since Carpetable Area correlates directly to how many bodies can fit into a certain space. Rentable Area is crucial too since the number of rentable square feet correlates directly to the annual (and monthly) rent.

Tenants should be aware of Loss Factors and floor plate efficiency. Tenants would be wise to confirm that a Loss Factor in a certain building is consistent with market Loss Factors. (This can be established by having the tenant's architect compare CAD drawings from comparable buildings.) However, in the final analysis, tenants should concentrate mainly on how many people a certain space can accommodate and what the rent is going to be every month, Loss Factors notwithstanding. This is especially true since once it's been established that a landlord is not pushing the Loss Factor envelope farther than his neighbors, challenging his methodology for measuring office space is like pushing a string. One silver lining is that landlords provide tenant improvement allowances based on Rentable Area while contractors tend to submit construction bids based on actual costs of construction, irrespective of Loss Factors. In terms of tenant improvement allowances, one could argue that tenants actually benefit from a high Loss Factor.

In defense of landlords, I recall one situation in the mid 1980's when an owner refused to apply a Loss Factor to his vacant floors. Instead, he asked for a higher rent per square foot arguing that without a Loss Factor, his space was still less expensive than space being offered by competing landlords imposing high Loss Factors. Mathematically, he was correct. But tenants and many brokers didn't appreciate his logic and his space remained vacant until he applied a Loss Factor and lowered his asking rent.

The New York City commercial real estate market, like all financial markets, is susceptible to herd mentalities. As long as most landlords uniformly apply high Loss Factors, tenants' only option is to fight their way up the learning curve and understand NYC Loss Factors for what they are: a market driven phenomenon.

1) Some say the genesis of Loss Factors has more to do with the advent of central air conditioning and the transition from floor by floor air cooled air conditioning units to HVAC mechanical equipment on roofs or designated mechanical floors, causing landlords to apportion mechanical space to tenants' Rentable Areas.

2) According to Real Capital Analytics, the following statistics apply to 2005 sales of Manhattan commercial properties worth a minimum of $5 million: $13.1 billion of total sales, 138 properties, 30.6 million square feet, $426 average price per square foot, 5.24% average cap rate.

3 (Rentable Area less Usable Area) divided by Rentable Area equals the Loss Factor. ■