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Cancellation Strategies in Commercial Real Estate Leasing

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Abstract

In a contractionary corporate environment, lease cancellation strategy becomes an important component of corporate real estate leasing decisions. This paper presents a leasing model in which less well-informed lessors offer leases with alternative lease cancellation options. The model demonstrates that a tenant's choice of cancellation option reveals his private information with respect to the likelihood of option exercise. Tenants who select a lease with a downsizing option are more likely to exercise the option. Given the higher likelihood of option exercise, the model suggests that the downsizing option will be priced higher. We examine a sample of 311 leases, and consistent with the model's prediction, we find that on average leases with a downsizing option have significantly higher contract rent. However, termination and sublet options are not associated with higher rent. The evidence suggests that market uncertainty, private information and adverse selection affect the pricing of alternative cancellation options and the choice of cancellation option.

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