Room for Growth: Office Leasing for Start Ups

Introduction

You’re a fast-growing startup. You’re about to complete your series A or B. While you’ve been 110% focused on your product, customers and investors, one important project has been set on the back-burner; the search for new office space.

You’re not alone. Many companies put this process off until the last possible moment. While it’s not ideal, you can certainly make up for lost time. Securing the right space is more complex than licensing a few extra co-working seats. Following this step-by-step guide will launch you well on your way to securing a competitive deal on that perfect new corporate HQ for your company.

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Assess your needs and set parameters

Perhaps the most difficult aspect of the search for new office space for a young company is predicting headcount. You know how many full time employees you have today. You also know how many you may have next month. But predicting next year, much less the year after is a different story. So ask yourself these questions; What will the scenario look like if I run out of space early, and what will my options be then? What will it look like if I take too much space and don't fill it out? Weigh the upside and downside and try to come up with reasonable assumptions for different scenarios. Have your real estate advisor model out those scenarios so you can fully understand their financial impact.

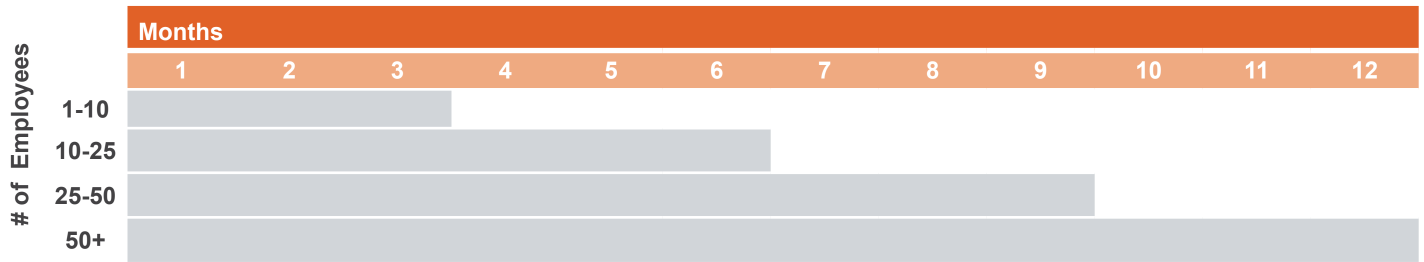
Then determine how you want your employees to work. Traditional office cubicles generally utilize around 200-250 square feet per person, while more contemporary bench seating layouts are closer to 100-150 square feet per employee (both metrics include meeting space, common areas, and reception). Multiply headcount by square footage per employee to arrive at the appropriate size range for your space.

The amount of leverage you have is directly timed to your timing pressure.

Budget enough time

Time can be a funny thing...a lot of time can become a small amount of time, very quickly. Commercial real estate is a notoriously slow and inefficient marketplace. It's not like signing a lease for an apartment where you tour a handful of options, pick one, and sign a standard lease a few days later.

Time can also be your biggest asset. Taking your time can allow you to pass on a less-than-perfect option and it can give you the ability to walk from a negotiation that isn't extracting maximum value. Landlords and sublandlords are also laser focused on your timing pressures and the amount of leverage you have is directly tied to those timing needs. You can never start the process too early (at a minimum you're just getting up the curve and being educated on the market). As a rule of thumb, you should budget time for this process as follows:



The real estate industry is small and word travels fast, so you'll have to assume that parties you're negotiating with will know about other parties you're negotiating with.

Tour the market and engage in parallel negotiations

You'll need to explore every potential option, not only so you can feel that you've covered the market, but also to build leverage for negotiations. The real estate industry is small and word travels fast, so you'll have to assume that parties you're negotiating with will know about other parties you're negotiating with. It's not something you can fake. You will need multiple viable options in order to build leverage and drive savings. Look at all the options, especially ones that may be on the less expensive side. Even if they may not be your first pick, they can still be used as leverage in negotiations with other more costly space options.

At some point within this phase of the process, you'll also want to begin to engage with your current landlord, whether that scenario involves renewing in existing space, a move to other space in a current building, or a relocation within a landlord's portfolio. Whether they make you feel this way or not, at the end of the day, a tenant is a client of the landlord, and landlords hate nothing more than losing a growing client (and facing the associated downtime risk). You'll want to tightly manage both the message to the landlord, and the timing of that message, which is something your real estate advisor will be proficient at handling.

At the conclusion of this phase of the project, the ideal scenario is to be able to develop a short list of 3-4 viable alternatives (one of which may be your current building). Having multiple options gives you the ability to create an auction for your tenancy, and drive maximum value. The other benefit is that you'll have multiple backup deals, in case your top choice doesn't come to fruition.

Once you have your shortlist, it's time to compare the qualitative and quantitative aspects of each option you're considering.

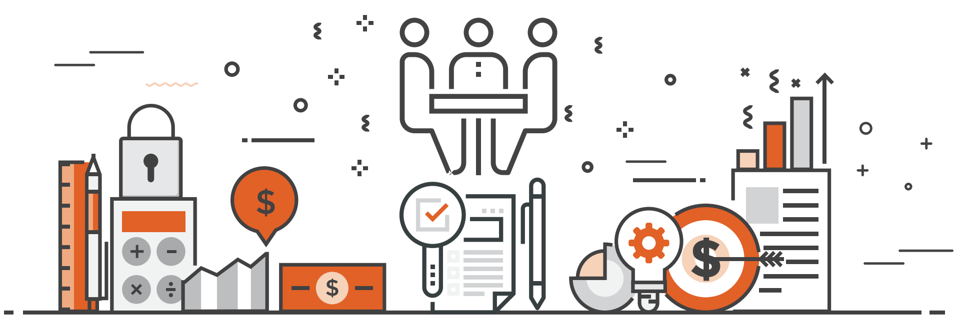
The term sheet is where all of the most important business terms will be negotiated.

On the qualitative side, analyze factors like location (and have your advisor run a commutation analysis based on employee zip codes), building caliber and cachet. Does the building send the right message to potential recruits and investors? Does it offer the right amenities, and access to restaurants and shopping? Is the space itself built out to a high standard, with a layout appropriate to how you do business? Is the space efficient and does it provide for the maximum number of employees within its given envelope? Does it have enough meeting spaces (the #1 complaint for most startups)?

On the quantitative side, examine all of the costs that go into the deal (and have your advisor run detailed financial analyses comparing the various options). Beyond rent per square foot, how are operating expense escalations handled? How are real estate taxes handled? How much upfront capital will be required? Is the space furnished? Is it wired and cabled? All of these items represent potential ongoing costs, and you'll need to do your diligence now, so that you have full visibility going in.

Once you've got your short list, and have a handle on subjective factors, as well as costs, it's time to begin submitting proposals, and to kick off negotiations officially.

Negotiate the term sheet



Tenants often think that the lease is the most important document to be negotiated in this process. While the lease is paramount, the importance of the term sheet can't be overstated. The term sheet is where all of the most important business terms will be negotiated. It will serve as the template for the lease, and will dictate the business deal on which the lease will be based. Exert your leverage here, because once the lease is drafted, your leverage goes way down. Some key terms to pay special attention to include:

Negotiating a right to expand can be key to creating long-term viability within a particular envelope.

Length of lease/term

Young companies understandably tend to prefer short-term leases, and often they can be the best option. But there are some important qualifiers too. If you can sign a lease for 2 or 3 years, and your visibility into headcount projections within that window are fairly solid, then you're in good shape. However, let's say you outgrow the space three quarters of the way through the term. Now, you've got an issue, because the remaining term on your lease is not long enough to be marketable at a full market rate to another subtenant. Subleasing to another tenant will likely be the most viable path to exit an obligation prior to a natural lease expiration. In this scenario, you'll be forced to discount the space dramatically in order to get another subtenant to take it. Worse yet, you could realize a full loss on the remaining obligation.

Now consider a scenario where you sign a lease for 6 years. Chances are you'll outgrow that space within that time window, but whether it happens in 2, 3, or 4 years almost doesn't matter. In any of those cases, you'll be left with enough term to sublease to another tenant, and recover the majority of your obligation.

Short-term deals can be ideal in many cases. Just make sure you consider the downside if you outgrow the space too early, and where that will put you relative to subleasing on the open market. If the potential timing of over-growth puts you up against a diminishing term issue, then you may want to reconsider.

Rights to expand/contract/renew

Flexibility is key in leasing office space. After all, you're making a relatively long-term commitment, and during that timeframe your business may change. Negotiating a right to expand can be key to creating long-term viability within a particular envelope. Seek out opportunities where there's an adjacent piece of space with a lease expiring in a timeframe that lines up with your expansion plans. Or negotiate a Right of First Offer (ROFO) for other space that may come available on your floor, or in the building. These rights can become crucial down the road.

> *Make sure that you have the right to engage your own real estate advisor and that you aren't forced to use the landlord's advisor.*

The right to contract can also be hugely beneficial in protecting against downside. There may be a cost attached to exercising one, but that cost will likely be dwarfed by the sunk cost of carrying excess space, in a downside scenario.

The right to renew can be equally valuable in protecting your space near the end of the lease term. Renewal rights, when exercised, generally trigger a Fair Market Value (FMV) rent reset. However, they are even more valuable in serving as a "marker" on the space, which prevents the landlord from leasing the space out from under you. It also gives you the ability to negotiate a new deal with the landlord, at terms that are more favorable than the FMV reset.

Right to terminate

The right to terminate a lease can help a founder sleep at night, because it gives a company the ability to exit the obligation early. However, exercising this right can come at a significant cost. The right will also generally be exercisable at a specific point in time, as opposed to a rolling right. What are the chances that your need to terminate will come at the exact point in time that your termination right comes into play? Odds are generally fairly low. When you consider that fact, along with the cost, you may realize that while a termination right is a "nice to have", subleasing the space on your own time table may be a far better option.

Right to sublet/assign

Subletting will be key to your exit strategy. Make sure that you have the right to sublet, and make sure that the landlord has to be reasonable in consenting to a proposed sublease. Make sure that you have the right to engage your own real estate advisor and that you aren't forced to use the landlord's advisor (the landlord's advisor will always focus first on the landlord's direct space, and will only bring tenants when the landlord can't fill a tenant's need). Ensure that the profit-sharing arrangement with the landlord is in line with the market (generally a 50/50 split with the landlord). Make sure that consent periods are reasonable (no subtenant will want to wait around for a 60 or 90-day landlord consent period, before they find out whether their deal is consented to or not).

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Operating expense/real estate tax increases

There are a variety of methods for handling these costs. The easiest to understand, albeit most costly to the tenant, is a fixed percentage increase. The landlord may charge you anywhere between 50 basis points all the way up to 3% on your rent, per annum, to cover their costs. A more equitable method is a direct pass-through of landlord's actual operating expense and real estate tax increases, over a base year (generally the year in which you signed your lease). The method utilized depends on a.) what you negotiate, b.) the submarket in which you're negotiating, and c.) the size of your space. But these costs can have a significant impact; just think about what 3% compounding on your rent looks like toward the end of the lease...it takes its toll.

Electricity

Electricity consumption can be charged in a variety of ways; it can be a fixed per square foot dollar amount, it can be based on actual metered consumption, or it can be based on sub-metered consumption. Make no mistake, electricity can be another profit center for the landlord, albeit a relatively minor one. And generally, you won't have too much sway over how it's handled in a particular building. But nonetheless, it's something you will want to be aware of going in.

HVAC

There are also a variety of ways HVAC is handled. In smaller assets, there are often tenant-controlled units dedicated to a particular space. The upside here is that you'll be able to control your own air, and will be able to run it at any time (for those engineers who stay in the office until 11pm). The downside is that you may be required to take on responsibility for maintaining the HVAC system, and may even be responsible for repairs should it break.

In larger assets, typically HVAC will be on a building-wide system and the landlord is responsible for handling it. Here, the building will have set HVAC hours (generally M-F, 8am-6pm) and the landlord will be responsible for maintaining a comfortable temperature within your premises. Maintenance will be entirely on the landlord, but there will be

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a cost associated with running HVAC outside of normal building hours. Something to keep in mind if your employees tend to work odd hours or weekends.

Security deposit/guaranty

Perhaps the second most important term after the rent is the security deposit. With any lease, you will be required to post a security deposit in the form of a letter of credit. The amount is subject to negotiation. In all cases, this will be restricted cash that you will need to set aside with your bank to secure the letter of credit. The main factors in determining the amount will be your company's creditworthiness, and the landlord's upfront expenses on the deal. The landlord will want to see a company's audited financial statements, cash on hand, bank statements, cash burn rate and possibly financial projections. This negotiation is all about getting the landlord as comfortable as possible, to offset the amount of security they may seek. Additionally, there are strategies for reducing the landlord's upfront expenses. For example, the upfront expenses can be spread out over time, and can mitigate the argument for a higher deposit. Your real estate advisor should be adept at structuring deals in this way.

If your company has minimal track record or revenue, a landlord may also seek a personal guaranty, or "Good Guy Guaranty" from the founders. A Good Guy Guaranty is one where personal liability kicks in if the tenant, in the event of default, refuses to turn over vacant possession of the space. While personal liability is always something you want to avoid, these guaranties are generally designed to prevent a tenant from holding space hostage, and refusing to pay rent. Typically, if the space is turned over after default, the individual guarantor won't suffer any harm.

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Finalize the lease

Now that you've defined your parameters, toured the market, negotiated with multiple landlords/sublandlords, and reached a final term sheet, it's time to negotiate the lease. Look for our future guide which will cover the mechanics of lease negotiations. Suffice to say, you will want to engage qualified real estate counsel to help navigate this negotiation. A lease can be a dangerous instrument, with immeasurable pitfalls. Unlike a contract for the sale of a home or commercial property, which basically becomes irrelevant after closing, a lease is a living document. The lease will govern the marriage between landlord and tenant for years to come. Make sure you understand all of your obligations as well as those of your new landlord.

By following this guide and bringing the right advisors on board, you'll be able to navigate your search for new office space with precision, and ultimately extract maximum value for that new corporate HQ you've always dreamed about for your company.

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