



## REAL ESTATE AND LEASE ISSUES FOR ADVISORS

Most small businesses need to lease space. Working from home may be an option, but it can be very difficult to expand beyond a one-person practice in this environment and will eventually necessitate the procurement of a more spacious/professional setting. If you're looking for office space outside the home, you will find almost limitless possibilities, which is part of the problem. So many choices – where to start?

Most financial service businesses tend toward “Class A” space – the best. While this may impress your clients, and create a comfortable working environment for you, keep in mind that your office lease may well be one of the larger checks your business will write every month, and probably will be for several years to come, depending on the terms the lease you sign. Because you need space and because space is expensive, consider your options very carefully. Many office leases are signed for three to five year increments, and your business may look substantially different five years from now. The better you handle real estate lease issues, the more free cash flow you'll have every month to spend on other things.

The place to start is to determine how much space you need, and in what geographical location. Once you know the answer to these questions, you can begin your search in earnest. The best way to begin this process is to narrow down a specific area of the city and survey the opportunities by driving around. Many office buildings have “For Lease” signs prominently posted on or in the property, or provide an information source posted somewhere in the lobby area. If the identity of the landlord isn't obvious, just ask one of the tenants.

Whether you are starting a new business, or just moving to a new location, you should always negotiate for a few months of free rent at the start of the lease. If that doesn't work, negotiate for a lower rent in year one, with stepped-up increases in subsequent years when your business's cash flow is stabilized and more predictable. How flexible the leasing company is will depend on occupancy, the state of the market, and many other factors, so be prepared to negotiate.

Consider carefully any operating costs that the landlord insists on passing on to you, the tenant. Some leases require the tenant to pay for all cleaning, heating/air-conditioning, security personnel, and so on. This is called a triple-net lease. Some leases require the landlord to provide and pay for these basic services, with the tenant paying a proportionate share of any increase in the costs of these services over the base cost in the first year of the lease.

To really understand the process, the costs, and the options available, you will need to look at a number of available properties – a dozen would be a good start. This will give you an idea of quality and costs in the area you've chosen to begin your search. Don't be dismayed. Finding the right place won't be easy, and you'll have to suffer through a lot of disappointments along the way, but when you do find the right office situation, it will be, for many, almost a second home.

Working with a commercial agent who represents the property owner can also be quite challenging. Remember that these professionals, like many financial service professionals, would rather work with larger, more affluent clients. Small business owners seeking to rent 5,000 sq. ft or less of office space aren't always high-priority clients. But stay with it. The good news is that you only have to rent office space every four or five years, on average.

## WORKING WITH A BUYER'S AGENT

As a basic rule, hire a buyer's agent to help you locate and negotiate your lease. The bigger the building, the more experienced your landlord and your landlord's commercial real estate agent will be. Over the course of your career, you will never have as much experience with the intricacies of renting commercial office space, or understand the process as well, as the professionals who do it for a living. Hire one of those professionals to work for you.

In many states, buyer's agents are typically paid for on a commission basis by the landlord. It may not be quite free to you, in that the cost is built into your lease, but it is unlikely that you will be able to save the cost by negotiating on your own anyway. Also consider that, should discussions with the landlord's commercial agent become rancorous, it is nice to have a person outside of your company handling the combative tasks. Through it all, you're free to focus on other pressing business start-up needs.

A buyer's agent doesn't eliminate the need for a good real estate attorney, but it does help you address many of the issues that you need to know about before you sign on the dotted line, and it often makes the negotiations easier.

## HOW MUCH SPACE TO RENT

A good rule of thumb is that you will need approximately one person (including yourself) for every \$100,000 to \$125,000 of gross income your financial services business generates. (Part of this hiring number depends on your level of technology.) For each full-time person in your financial services business, allow for 200 to 250 square feet, which allows for common areas, an average sized reception area, and a comfortable work environment. With some careful space planning, you could reduce this number to 120 to 130 square feet per full-time person. If there is a basic rule here, it is better to have the office space a bit cramped in the early years of a new business. Having more space than you can efficiently utilize is an expensive luxury.

Many business owners gravitate toward creating a very opulent workspace their first time out, when the emphasis should probably be placed on efficiency and proper design/use of the space. Remember that you'll have the opportunity to move and upgrade your facilities several times over a ten to twenty year career. Be patient. Your time will come. The great office with the stunning views can wait until your business is strong and mature.

Many office buildings have a central conference room that can be shared at no cost to the tenants. If this is the case, you can save money on your own rent by not having a large conference room (which sits empty most of the time) in your own office.

Tenant improvements, or "TI," often come with a new office space. TI is a term that refers to repairs, remodeling, and improvements your landlord is willing to make on your behalf without additional direct cost to you. In most cases, TI is built into the long-term lease costs. As such, the longer your lease and the more square feet you rent, the more TI you will have to work with to build out your offices in an efficient and impressive manner.

## EXECUTIVE SUITES

Executive suites can also be an early solution for space needs. In an executive suite arrangement (also called a virtual office or a serviced office), you rent only your own office (and those of your partners), and share a common reception area, receptionist, phone system, copier, scanner, fax machine, etc. with the other tenants. The advantages of executive suite arrangements are that they are very quick turn-key office arrangements, you are not generally forced to commit to a lengthy lease, and it leaves the many details of the office administration and operations to someone else. The downside is that you have little control over your own office environment, and your costs can be substantial.

One of the best strategies to consider is to start off in an executive suite environment with an eye toward finding your own permanent location. By renting space on a monthly or quarterly basis, you'll

have time to settle into your new business and assess your needs, direction, and location. This tactical move will give you the luxury of time to make a permanent or longer-term decision on office space, almost at your leisure. You will have time to find just the right building in just the right area, negotiate the lease, and have it built out to your specifications. The alternative is to try to time your entrance into a new business based on the work habits and punctuality of a remodeling crew in your new office space. It's possible, but there are easier ways to do it.

## SECURITY DEPOSITS

Many commercial landlords will require you to pay a security deposit when you enter into your office lease. The deposit is usually one or two month's rent, but it really depends on the risk the landlord is taking. With a new company that has no track record, the security deposit is hard to avoid. But there are ways to lessen the costs.

Many lessees, or tenants, are corporations or limited liability companies, as opposed to the individual shareholders/members. The landlord is usually open to having a business entity sign as the tenant, provided the shareholders/members of the company agree to be personally liable for the rent payments if the company defaults. You can always attempt to argue that it will either be a personal guarantee or a security deposit, but not both. If given the choice, however, you may actually be wiser to pay a security deposit. Consider the size of your obligation if you lease an office for 4 years at \$5,000 per month.

If the obligation is solely that of your entity, and the business does not survive, individually you may be able to walk away from the remainder of the debt. It's not always that simple, but that is the basic concept. As your business grows larger and more mature, your strength as a tenant will grow as well. But understand an important and basic rule: commercial landlords almost always have it their way.

## ESCALATION CLAUSES

Fixed rent in a commercial lease for more than a year or two is relatively rare. Landlords almost always try to build in "escalator clauses" that increase the rent every year or two, automatically. Many increases in rent are tied to increases in the Consumer Price Index (CPI). If, or when, you're confronted with this problem, there are several ways to mitigate the damages (assuming "no" doesn't work).

The first tactic is to ask that the increase not start until after the second year. In other words, delay the impact. A second tactic is to ask that any increase be capped in amount, such as no more than a 3% increase over the base rent. Third, ask for fixed increases in the amount rather than a formula- or CPI-based approach. For example, if your rent in year one is \$3,000, try to agree that the rent in year two will be \$3,000, followed by increases to \$3,200 in year three and \$3,400 in year four. A set, fixed increase, if reasonable, is much easier to budget for. Again, if you are working with an experienced buyer's agent, you should receive guidance on these issues.

## BUYING VS. RENTING

This subject requires a very careful and thorough cost comparison of the benefits and detriments of renting versus owning. Your accountant or CPA is well situated to help you determine if owning a building (and possibly leasing extra space to other tenants) is a cash flow and tax benefit to you. Owning your own building also brings with it a level of control, prestige (depending on the particulars of the building), and, hopefully, equity or return on your investment.

In most cases, however, buying versus renting is an analysis that is better suited to a mature business model. Owning and maintaining your own building takes time and capital that might otherwise be invested into your business.

## SUBLEASING AND ASSIGNMENTS

An assignment generally refers to transferring an office lease to someone else, as you walk away and have no further responsibility or liability. A sublease, or subletting, means you will lease a portion of your space, or even all of your space, to someone else for a period shorter than the original lease, but both you and the sub-tenant remain contractually obligated to the landlord. Most commercial leases contain a clause that prohibits a tenant from assigning or subleasing the premises or any part thereof without the landlord's prior consent and in the landlord's sole discretion.

As a business owner who, more than likely, hopes to grow and expand the business, you should attempt to modify these restrictions. Your attorney or a good buyer's agent can help immensely in this area. The preferred modification is to require the landlord's consent to an assignment or sublease, but also ensure that the landlord "can't unreasonably withhold or delay such consent." (It is unlikely that you will be able to obtain the unilateral right to assign or sublet without the landlord's involvement in one way or another anyway.)

A start-up tenant (new business owner) should also consider negotiating into the lease enough flexibility in the assignment and subletting clauses to allow for mergers, reorganizations, and share-ownership changes. Again, an experienced buyer's agent or business attorney can help with these issues.

Be very cautious of any clause in the commercial lease that says the landlord can deem a change in ownership of more than 50% of the company's stock "an assignment" that can be prohibited without the landlord's approval. A prohibited assignment can result in the landlord being able to terminate a favorable lease. Many business owners sign their lease and file the 30-plus-page document away until it is time to renew or move on. Overlooking the requirements of such clauses is very easy to do as time goes on, but it can have a negative effect on your future plans.

## OPTION TO EXPAND

As a business owner, there are almost always plans to expand and grow the business. As such, the right to expand into additional or adjoining office space in a building can be very important. Again, work with an experienced buyer's agent or an attorney who has negotiated many commercial leases. Chances are, your landlord will want to help you when it comes time to rent additional square footage if the building you are in has vacancies or will have vacancies.

Negotiate for a Right of First Offer on any space that becomes available in your building. This will require your landlord to present any available space to you first before marketing it to a third party. You can also ask for a Right of First Refusal on a space, though this is often very difficult to acquire. A Right of First Refusal obligates your landlord to bring you any deals he's willing to accept from a third party for space in your building and allow you to match the deal, thereby pre-empting the third party.

When looking for office space, strongly consider starting out in a building owned by or managed by a leasing company that has several commercial properties in the area, so that, if you need to expand, options and choices can be found. Remember, landlords typically want larger business tenants who rent greater amounts of space, rather than the reverse. If you start out in a situation that offers such flexibility, you will have more options when the time comes.

If your current office lease arrangement doesn't offer much in the way of expansion options, you are going to need to carefully plan for the expiration of your current lease and inception of your new lease. Allow for a month or two of overlap between old and new leases to make the move as easy as possible on your staff and your clients.

## MISTAKES TO AVOID

1) Watch for strict limitations on subletting your space. If you lease more space than you need, or you find that, with technology, you just don't need one or two extra offices, it can really help to have the flexibility

to sublease an office to a CPA, for example, or a sole practitioner financial services professional who is not quite ready to join a large firm but wants to work under your roof. In other words, build some flexibility into your lease.

2) Don't rent or lease under your own name if you can help it. If you setup a corporation or LLC (and you should), you want your company to be the lessee, or tenant, on the lease, not you personally. If your business doesn't have any history, try to negotiate a shorter-term lease (two or three years) with an option to extend it later. Binding only your company to the terms of a longer-term lease should always be your goal.

3) Don't assume that you will be signing "a standard commercial lease;" there is no such thing. The longer your landlord has been in business, the more evolved his lease form will be – in his/her favor. With each passing tenant problem or expense, the lease is commonly adjusted over time so that the landlord doesn't experience that problem again. Be aware. Your only choice in some cases is to continue your search for space elsewhere.

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