

Q&A

COMMERCIAL REAL ESTATE Question of the Month

Choosing the Right Lease Term

Q: *What do you recommend as the right lease term for an office lease?*

A: This is highly dependent on your objectives and the nature of your company. So let's start with some of the advantages and disadvantages of short and long term leases.

One of the major advantages of leasing office space, as opposed to purchasing a building, is an easy exit strategy. When the lease is over, you move out without further obligation. This can be a critical advantage of a short-term lease. Do you have a special project that requires human resources for a year or two? A short-term lease is ideal. A start-up company that anticipates major growth and the need for additional space in a few years is another candidate. If you have a short-term lease, when the project is finished, or facilities outgrown, the space can easily be shed without substantial cost.

The disadvantage of a short-term lease is that no one, neither the landlord, nor you, can really afford to make a major investment in the space. Capital improvements to the space are usually amortized over a lease term, so there are very few landlords that will completely build-out space for a short-term lease. Nevertheless, there are often "as is" office installations or short-term sublease opportunities that are available for short-term leases. You will probably have to search more

completely and be less demanding of the final product, to secure them.

The major advantage of a long-term lease, therefore, is the ability for either you or the landlord to invest in a substantial work letter. With the proper credit and/or lease enhancement (additional security, letters of credit, personal guarantees etc.), many landlords will completely build-out custom office space for you. This means you may have little capital investment in the space. You will be,

What is the right negotiating strategy?

in effect, borrowing money from the landlord to invest in your business which you will be paying back in the form of rent over the lease term.

Another advantage to longer term lease is the ability to sublease the space if necessary. A lease term is a depreciating asset. For example, a "fire-sale" price may be necessary to sublease for a short two-year term, while a five-year balance on the lease would let you be more competitive in the marketplace.

Given all of this, what is the right negotiating strategy? I first look at the company's needs, and then to the term necessary to amortize the

investment required for the space. As an example, if you are leasing space for your corporate headquarters, and you don't anticipate explosive growth, then you have a reasonably long term need for space. I would then look to negotiate the shortest lease term possible that will still allow the capital improvements that you need. That may be a five-year term but is often seven years. Then, I am looking for options to renew, and if possible, to cancel. Options are very valuable, and the rule is to negotiate as best you can, but ultimately take any option that you can get, even if it seems unreasonable. Times change and what is unreasonable today may be reasonable ten years from now!

We recently negotiated a below-market lease for office space because the tenant was willing to do his own construction, and was given substantial up-front rent concession for this purpose. The lease term was five years with a five-year option, and a right to cancel the lease with six months' notice! The landlord was willing to do this because he had virtually no investment in the space; and, if the tenant canceled, he would receive back vastly improved office space.

So the name of the game is flexibility. The right lease term for your needs, plus options to renew (and possibly to cancel) gives you a powerful and flexible combination.



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