nyrej

Monthly Q&A: Minimizing risk

July 27, 2010 - Long Island

Q: We own an office building on Long Island that houses our own offices, as well as several tenants. We recently had a tenant close his doors after only a single year of occupancy. How do we avoid this in the future?

A: As a landlord, you will be investing thousands of dollars in securing a new tenant for your vacant space. The expenses will include the tenant workletter, legal representation and brokerage costs at a minimum. How do you minimize the risk of your investment?

While every lease is different, the methods for protecting your investment are similar in most transactions: Securing the upfront expenses, evaluating references, and inspecting the current premises of the proposed tenant.

An entire book could be written on the various forms of securing a lease; that is providing a monetary remedy for the landlord in the event of a default by the tenant. This can range from a typical two or three months security to a full-blown guarantee of lease payments. The important aspect however is that there is a high correlation between the risk of the investment and the security. In every case, this should include a review of financial statements. If you are not capable of reviewing statements to evaluate risk, it should be professionally done. A landlord simply needs to know that his risk is adequately covered.

Requesting references from your prospective tenant is somewhat limiting in that it is unlikely that a tenant will provide you with references that will issue a negative report. However, talking with references will give you a good sense of the tenant's business and how they go about meeting their obligations. You certainly want a bank officer for starters. And, of course, you already have a good indication of problems if the prospective tenant either refuses to provide references or can only come up with a few names. And a list of references is worthless if you don't pick up the phone and call them!

One of the most important, yet overlooked, means of evaluating tenants is a visit to their present operations. I could not even begin to list the questions and answers engendered by my site visits in 33 years of commercial real estate transactions. One visit will illustrate the present operations of the company and how they will fit into your vacant space; the number of employees and parking required; special requirements of the company; the condition of their present space and quality of maintenance (or lack thereof); the overall mood of the company (busy and growing? struggling and contracting?); and the philosophy of the company as reflected by their employees. The list is endless. If nothing else, your visit will raise questions that simply would not have occurred to you otherwise. Insist on a site visit, even if the tenant protests that their present space is not representative of the new lease.

Many landlords, especially those who have endured vacant space for any length of time, may be tempted to minimize or skip entirely some of these means of evaluating tenants. Don't be one of them. If the prospective tenant is bad news, better to find out now rather than six months after you have invested thousands of dollars signing a lease, paying a broker and building out the space.

Do you have a question regarding commercial real estate? Email your question to Commercial Real Estate Q & A at dhunt@huntcorp.com for possible inclusion in a future column.

David Hunt, MCR, CCIM, SIOR is the president of Hunt Corporate Services, Inc., Syosset, N.Y.