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Hunt Corp. Commercial Real Estate Q&A: Picking the right lease term - by David Hunt

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Q: What do 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 terms for a lease.

One 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 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 or 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, 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 a 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 sublease, while a five-year balance on the lease would let you be more competitive in the market place.

Given all of this, what is the right negotiating strategy? I first look to 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 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 we need. That may a five-year term, but is often seven. 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 once 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 to do it. The lease term was five years, with a five-year option. And, a right to cancel the lease on six months notice! The landlord was willing to do this because he had virtually no investment in space, and if the tenant cancelled, 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.

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

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