

# Planning Your Long- and Short-Term Space Choices

*A MANUAL from the Nonprofit Finance Fund and Partnership for Affordable Non-profit Space. Available at: [www.orgSpaces.org](http://www.orgSpaces.org)*

This manual provides an overview of basic facility planning information to assist your organization in taking a step back to: look holistically at your organization; identify your true facility needs; and frame several options available to you. In this process, you may find new opportunities available to you, or discover unforeseen organizational ramifications - both in the short- and long-term.

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## PLANNING MORE FULLY

This section was adapted from workbooks that accompany in-depth workshops conducted by the Nonprofit Finance Fund ((c) 2000), and does not cover in-depth financial assessment, management and/or fundraising/financing.

The larger the project you plan to undertake, the more complex the factors to consider. The following organizations have continuing services or have mobilized to assist non-profit organizations in real estate planning. As you undertake your planning process, we encourage you to contact these organizations about workshops, consultants and financing options:

- Nonprofit Finance Fund
- Northern California Community Loan Fund
- San Francisco Partnership
- CompassPoint Management Center
- ArtHouse and California Lawyers for the Arts

## **Change, Facilities & Program Choices**

Defining long-term program goals is essential before undertaking a major facilities project. Once the facilities choice has been made, programming is "cast in concrete" and changes are very hard to make. Program goals, organizational growth and facilities are linked in the following ways:

**1. Facilities are a means to realizing a programmatic end.**

Having clear program goals will help you determine what facility best supports those goals. If those goals are unclear or programming is in flux, then making a long-term facilities choice could be premature. In such a situation, renting might make more sense than buying or undertaking a major leasehold improvement.

**2. New facilities accelerate an organization's growth.**

This is especially true for smaller non-profits (with budgets of \$400,000-800,000) for whom growth brings the encumbrances of a larger organization: more people, a management infrastructure and many more external stakeholders. Small organizations, used to being able to make rapid program shifts, often fail to realize they lose much of their program flexibility as they get larger.

A successful plan will entail moving forward while retaining a balance among programming, finances, management capacities and facility. This is difficult because facilities change infrequently: they often appear to be once-in-a-lifetime "opportunities"; and they usually involve large dollar amounts and major organizational changes. These major changes and large costs can throw an organization off balance. For example, programming and occupancy costs could increase much faster than revenues. Such imbalances can threaten an organization's ability to survive.

The plans need to be at least as long-term as the facilities commitment, and preferably longer, since facilities are a means to an end. Seizing a facility "opportunity" before making fundamental program choices forces managers to create new programming - and build a new audience - to make the new space work.

## Questions to Ask About Your Program

- ***How much has your organization changed during the last five years?***  
Does significant change during the past few years indicate continued change in the future?
- ***How much do you expect your program to change in the future?***  
The more you expect program to change, the more appropriate staying flexible with your facility becomes. If this is the case, renting may allow greater choice until your program is more fixed.
- ***How much space do you need?***  
To answer this question, you need to know how much space you have. Combine that information with your program plan to determine how much and what kind of space you need. The more you need, the greater the up-front costs, which will tend to tip the scales in favor of renting.
- ***Does your program require specialized space?***  
To the extent the answer is "yes", absolutely unique space is required, then owning your own building will be the best, if not the only, choice. To the extent the answer is "no" or "maybe", then renting becomes a possibility.
- ***How tied are you to a particular neighborhood?***  
Changing location can affect how your work is perceived by your donors and audience.
- ***What stage is the real estate cycle in?***  
The pressure to make a facilities change is most intense when choices are most limited-at the top of the real estate market.

## Assessing Options

Remember that you always have choices. When considering a facilities project, there are some basic decisions to be made:

Stay	Downsize	Share	Buy
Move	Consolidate	Merge	Build
Renovate	Expand	Rent	

The organization's program goals must guide how these options are assessed. The challenge is identifying the options that match what the organization needs, wants, and can afford - now and in the future. The success of the project, and the ability to deliver quality programming over time, requires balancing program, management, finances and facility. To achieve balance, the following issues need to be addressed:

- Designing the space
- Finding a good site
- Making the project's cash flows fit
- Raising the money to complete the project
- Raising the money to operate once the new space is open
- Managing the re-configured staff

Finding a balance means deciding how large a step the organization can take now towards achieving its long-term vision. Many organizations run into trouble when they try to take too large a step or take a step too soon. In order to determine the scope of the project, assess how much of a facility change the organization can sustain without making drastic changes in programming.

Furthermore, consider what to do if:

- Fundraising falls short of expectations
- Costs exceed budget
- Leads/lags develop, resulting in cash flow shortfalls

***Note: Having a second choice or a contingency plan will help reduce risk.***

## Planned Change and Facilities

	ASSESSING	CHOOSING	PAYING	IMPLEMENTING
TOPIC	Evaluate the potential of all facets of the organization	Explore facilities options that balance program needs and organizational readiness	Match the money sources and timing with the project	Carry out your facility plan
KEYS TO SUCCESS	Be realistic and honest about your assumptions	Ability to adapt dreams to meet means	Constant updating of project budget and cash flow	A well-conceived plan and good control over the project
TASKS	<p>Examine:</p> <ol style="list-style-type: none"> <li>1. The clarity of program goals</li> <li>2. The market for program</li> <li>3. Organizational structure</li> <li>4. Functioning of the board</li> <li>5. Financial health</li> <li>6. Financial and managerial growth potential</li> </ol>	<ol style="list-style-type: none"> <li>1. Determine project budget range</li> <li>2. Locate the sources of money</li> <li>3. Plan for organizational change</li> <li>4. Evaluate your options and narrow your choices</li> <li>5. Identify all of the costs involved                             <ol style="list-style-type: none"> <li>a) up-front costs</li> <li>b) implications of on-going costs</li> </ol> </li> <li>6. Make final choice</li> <li>7. Determine organizational budget in the new space</li> <li>8. Look at timing of the cash flow</li> </ol>	<ol style="list-style-type: none"> <li>1. Set capital campaign goal</li> <li>2. Coordinate leadership</li> <li>3. Identify prospects</li> <li>4. Analyze timing of incoming money with outgoing expenses</li> <li>5. Examine borrowing</li> </ol>	<ol style="list-style-type: none"> <li>1. Select a project team</li> <li>2. Finalize design</li> <li>3. Develop phasing approach</li> <li>4. Maintain control of costs and timing</li> </ol>
SOURCES OF HELP	Board, Peers, Program Consultants, Audience history, Financial consultants, Fundraising counsel	Architects, Real estate brokers, Financial consultants, Cost estimators, Fundraising counsel, Lawyers	Board, Fundraising consultants, Financial consultants, Lenders, Lawyers	Board, Architects, Engineers, Construction personnel, Cost estimators, Project manager
ONE LAST QUESTION	Are you clear about your future program goals?	Can you balance your budget in the new space?	Do you have contingency plans for unforeseen costs?	Have you allocated sufficient staff resources to manage the project?

## Analyzing Your Space Needs

This page refers to information to be gathered on a Facility Requirements Checklist. See Facility Requirements Checklist for a sample and a blank form.

### A. Quantify the space requirements

- Start with a quick tour of the current facility to observe:
  - Population and occupancy;
  - Hours and frequency of activities and space used;
  - Noise level;
  - Ambiance;
  - Functional problems.
- Determine:
  - Number of people using each space;
  - Function of each person using a space if applicable;
  - A future growth factor for each space when applicable;
  - Special features required for each space to fulfill its function;
  - Size of each space in net square foot area;
    - Multiply: Width in feet by Length in feet = Square Foot Area;
    - Round up to the nearest full foot when measuring a space;
- Prepare a List of Required Spaces for:
  - Agency's Program Mission:
    - Determining the number and types of program activities;
    - Project program growth and expansion.
  - Program support functions;
  - Program staff
  - Program volunteers
  - Agency's administration;
  - Administrative support staff;
  - Administrative support functions;
  - Visitor requirements;
    - Are many visitors expected? What times of day?
    - Is there a need for security? How strict should it be?
    - Should visitors be carefully controlled within one area?
    - Is there more than one classification of visitor?
      - Program participant;
      - Volunteer;
      - Business visitor.
  - Parking
  - Pedestrian circulation
  - Safety issues
  - Special equipment requirements;
  - Lighting needs;
  - Audio visual requirements;
  - Acoustical requirements;
  - Special environment needs or requirements;
- Mechanical and electrical systems requirements

B. Using the Facilities Requirement Checklist, compare the space requirement needs with the agency's mission statement.

- List in three columns:
  1. Have
  2. Immediate need
  3. Long-term need
  
- Determine whether the current arrangement of spaces and activities:
  - Helps users to meet program mission objectives;
  - Contributes to wasted efforts.
  
- Evaluate current space by identifying:
  - Excess space in one location versus overcrowding in another;
  - Inadequate program activity spaces, storage, filing, work areas;
  - Factors that make present space function now versus factors that will make the new space function better;
  - Multi-purpose functions that can share the same spaces.
  
- Identify agency population by recording:
  - Number of participants now in your program;
  - Number of staff members currently working in your space;
  - Forecast future growth of:
    - Program participants;
    - Staff;
    - Volunteers.
  - Propose additional spaces that will effectively enhance the program mission;
  - Exclude those spaces that are superfluous to the program mission;
  - Eliminate those spaces that prevent the program from fulfilling its mission;
  - Determine which activities cannot be changed versus which can be changed or modified.

**Note: Reject the option to sublet underutilized space.**

## How Much Will It Cost?

This simple question "How much will the 'project' cost?" is the cause of much anguish. Some of the reasons why are:

1. The "project" often goes undefined, or is assumed to mean the construction cost. Everyone answering the question brings his/her own definition of what is included, unless you are very specific.
2. Everyone answering the question has a narrower definition of "cost" and the "project" than the person asking the question. This necessitates probing their responses to understand exactly what they mean.
3. The true cost is usually much different - and higher - than the cost of the facility itself. This is something most managers don't really want to hear.

When a facilities project is one part of organizational growth, the "project" cost arguably means any cost the organization incurs from the moment planning begins to the time "normal" operations resume in the new space - often years later. Costs includes any expenses in excess of normal operations, plus any operating revenues foregone as a result of the expansion.

4. The natural motivation of both sides involved in most "How much will the 'project' cost?" dialogues is to want a low answer. The arts manager, who wants a new facility, wants to hear how little it will cost. The bias of construction people is to underestimate costs, both because they want to get the business and because they are naturally optimistic. Thus there can be an unspoken conspiracy to underestimate costs.
5. The experts don't have the answer. Most of the specialists that managers turn to see only part of the equation. This is especially true with those in the building industry, but it is also true of others - including fundraisers and board members.
6. The answer is difficult to calculate, and can only be arrived at by knitting together the input from many different perspectives. This is the task of the arts manager.

## Comparative Analysis of Costs: Rent vs. Buy

Your search for space may lead you to a few suitable properties that merit closer analysis. Before you decide whether to rent or buy, you may want to weigh their costs and benefits in a systematic fashion to determine which space is best. Most costs and some benefits are quantifiable, and can be analyzed mathematically. Others are not, and should be considered separately, in light of what you learn from your calculations.

What follows is a sample analysis to be used as a model for your own analysis. The sample is preceded by a list of assumptions. Be sure to check your own assumptions carefully before you consider your analysis complete.

CHARACTERISTICS	RENTING	BUYING
Optimum Program Fit	Evolving, Changing	Stable, Fixed
Up Front Costs	Low	High
Operating Costs	Similar	
Project Complexity	Lower	Higher
Project Duration	Shorter	Longer
Financial Controls Required	Minimal	Extensive
Financial Strength Required	Minimal	Substantial
Effect on Cost Structure	Occupancy costs will be more variable	Occupancy costs will be fixed. Repair bills can be large and unexpected.

### RENT OR BUY?

Non-profit agency needs 10,000 square feet of office space.

Rental cost:	\$15 per square foot, or	\$150,000 per year
Purchase price:	\$90 per square foot, or	\$900,000*

\* Seventy percent of the purchase price, or \$630,000 can be financed through a loan at 9 percent for 10 years.

**UPFRONT COSTS**

	<b>RENT</b>	<b>BUY</b>
Legal	\$5,000	\$10,000
Appraisal		\$2,000
Survey		\$1,000
Title Insurance		\$5,000
Environmental Survey		\$8,000
Bank's Legal Expenses		\$15,000
Mortgage Recording Tax		\$10,000
Bank's Transaction Fee		\$9,000
<i>Subtotal, Transaction</i>	<i>\$5,000</i>	<i>\$60,000</i>
Down Payment		\$270,000
Site Improvements*	\$300,000	\$500,000
Security Deposits	\$25,000	
<i>Subtotal, Capital</i>	<i>\$325,000</i>	<i>\$770,000</i>
<b><i>Total Upfront Costs</i></b>	<b><i>\$330,000</i></b>	<b><i>\$830,000</i></b>

**ANNUAL ONGOING COSTS**

	<b>RENT</b>	<b>BUY</b>
Rent	\$150,000	
Debt Repayment**		\$100,000
Cost of Upfront Cash	\$17,000	\$50,000
Ongoing Upkeep***		\$55,000
<b><i>Total Annual Ongoing Costs</i></b>	<b><i>\$167,000</i></b>	<b><i>\$205,000</i></b>

\* Site Improvements: For renters, landlord may pay for these; owners will likely pay between \$50 and \$80/square foot (between \$500,000 and \$800,000 for 10,000 sq. ft.)

\*\* Financing of \$630,000 (70 percent of purchase price) for 10 years at 9 percent interest.

\*\*\* Rule of thumb for moderate upkeep about \$5,50 per foot, or \$55,000 per year.

Source: Thomas B. Harris

## Leasing Basics

Once you have completed your organization's User Requirements Checklist and have considered the issues raised here, you should have a good idea of the type and amount of space you require, the best locations for your clients and staff, and the maximum amount you can spend for rent and improvements.

Leasing space is one of the most flexible ways to house an organization. However, it is important to understand all the costs and provisions of leasing when making your decisions about whether to stay or move and lease or buy. The true cost of a new lease will not be immediately apparent: commercial leases are meant to be negotiated and there are many variables to consider. Following are answers to some frequently asked questions about negotiating a lease; they are relevant even if you are considering renegotiating your current lease.

As with all things, there are no hardened rules in the commercial leasing business. It is possible that your organization may not confront all of the issues presented here, and it may encounter some not presented here.

This is a long document, as there are many issues discussed. Here is a list of the questions addressed (in order) to help you reference your reading:

*Question:*

1. What is the non-profit's role?
2. What are the roles of outside consultants?
3. What will the costs be?
4. Will the monthly costs rise over the term of the lease?
5. What if the space needs renovation?
6. What are the other negotiating points?

*Sources: David N. Lebenstein, Time Equities, Inc. and Arlene Wysong, Sylvan Lawrence Co.*

## 1. WHAT IS THE NONPROFIT'S ROLE?

### ***Get an early start***

In planning your space search, leave yourself plenty of time to explore your options -- at least three months and preferably six to nine months. In markets where vacancy is over 8-10%, deal cycles tend to be longer, and it is recommended that at least six months is budgeted towards the space search.

### ***You direct the process***

You must be involved in the process of finding the right space. The first step is to know what your needs are *now and over the next few years*. As mentioned above, you should have a clear idea of the type and amount of space you require, the best locations for your clients and staff, and the maximum amount you can spend for rent and improvements. Although brokers, lawyers, and architects may be advising you, it is in your best interest to learn and understand as much as possible throughout the process since you will ultimately need to find an arrangement that meets your financial and organizational needs (see [question 2](#), "What are the roles of outside consultants?").

### ***Working as a team***

A small "space search" committee (2 or 3 people) should do groundwork. Ultimately, your board of directors may give the committee authority to negotiate and/or make final decisions if time does not permit full board consultation.

## 2. WHAT ARE THE ROLES OF OUTSIDE CONSULTANTS?

Commercial leases are complex and have a long-range impact on the financial and programmatic well being of your agency. The roles of various professionals whose assistance can be critical to the success of your agency's move are described below.

### **Real estate broker**

#### ***Why use a broker?***

Ultimately, you must reach an agreement with a landlord on a lease's base rent and an escalation package (see question 3, "What will the costs be?" and question 4, "Will the monthly costs rise over the term of the lease?"). While commonly thought of solely as folks who help you find space, brokers spend most of their time negotiating all the terms of a lease. They use their knowledge from other deals and bring their experience to bear in the negotiations. They may act as the agent for the landlord or as the tenant's representative. A broker should be able to tell you about the building's history and the owner's financial background. It is important to understand that rent is only one of the considerations that have an impact on the financial health of your organization. With commercial rentals, the owner's asking price is meant to be negotiated. The broker can identify suitable spaces and can assist you in negotiating a lease that meets your agency's needs.

#### ***Can I find space without a broker?***

In some cases, you might be able to avoid using a broker (word of mouth, newspaper ads, contacts from Board members and friends, pounding the pavement and finding spaces where

owners want to deal directly). But commercial leases can be complex, and generally a top-quality broker who you feel is honest, competent, knowledgeable and sensitive to your needs is an asset which can save you money. Generally, if you require very small amounts of space (below 1,500 - 2,000 square feet), you probably won't be dealing with a broker. Many brokers won't be willing to work on a very small deal because it is a time-consuming process and small deals do not cover their costs.. Free internet sites such as Loopnet.com, Cityfeet.com, Comro.com, Propertyfirst.com, and in some markets, Sublease.com, are all valuable resources for tenants searching in that smaller size range.

***How do I find a good broker?***

The best way to find a broker is to talk with other nonprofits that have had a good experience with a broker. You may have access to a good broker through your Board of Directors. You should interview at least three brokers to find a good fit. Always check out the broker's references and recent clients. The broker should be willing to understand your needs and work within your limitations. There are brokers who specialize in working with tenants and view themselves as the tenant's advocate. Oftentimes, contacting the broker listed on properties found on any of the internet sites listed above can be a good starting point. Pikenet.com is also a good portal site for many commercial brokerage firms.

***Who does the broker represent; who pays the broker?***

Brokers typically receive their commission fee from landlords. The commission is based on a decreasing percentage of each year's rent during the life of the lease, or in some markets, paid on a flat dollar per square foot and year of the lease. (Incidentally, brokers are not on salary, and their commission is usually split with their company.) In some cases, a tenant may want to retain a broker on an exclusive basis by signing an agreement that commits the tenant and broker to work together exclusively for a period of time. In any case, it is rare for a tenant to pay the broker. Feel free to ask brokers you consider working with about their fee arrangements (see "Caution!" below).

When you look for a broker, make sure that you find one who is willing to learn about your needs and constraints. Ultimately, brokers represent "the deal," as they are generally not paid until one is agreed upon. Thus, a good broker will work to come up with an acceptable arrangement for both landlord and tenant, i.e., a "win-win" deal.

However, if you are renegotiating your current lease or responding to a broker's ad for space, you may be dealing with a specific landlord's broker or "agent." In this case, the broker's primary interest is in getting the best price for that landlord.

***Caution!***

To understand fully the brokers' motives, you need to know their various arrangements. The word "exclusive" is used several ways. Some brokers are the "exclusive" representatives of a building or owner; in other words, they're pushing their own space. Although some may have an "exclusive" on certain properties, most know about the same available space through an "open listing."

Further, since you expect your broker to be ethical with you, you should do the same for him/her. For example, don't start dealing with a second broker on the same space. You could be legally liable for two brokers' fees!

**Real estate lawyer*****Is it necessary to use a lawyer?***

In general, someone knowledgeable and with authority from your staff and/or board, together with your broker, should negotiate the business terms of the lease. In addition, your lawyer should carefully review your lease and be sure you understand its consequences before you sign it. He/she will often propose revisions and help you strategize on complex legal and technical issues. The lawyer, however, should generally not be involved in the business issues. It is also possible that your accountant, bookkeeper, office manager, president, board chair, executive director or others can deal with much of this.

A lawyer can also assist in the drafting and review of any agreements with an architect or contractors for the renovation of the space.

**Architect/engineer*****When is it necessary to use an architect or engineer?***

There are several reasons to work with an architect or an engineer early in the process. If you do not know the amount and type of space you require, an architect can help analyze your space needs. During your space search, an architect can research the zoning and building code requirements of each site you identify. There may be restrictions or special permits required for certain uses at each site.

If reconstruction is necessary, you will want an architect or engineer who is independent of the building owner to help determine the feasibility of adapting the space to your agency's needs, estimate the cost of improvements, design the layout and oversee construction. They will also be able to inspect the building systems and conditions and look at whether the building meets technical, regulatory, occupancy and other code requirements. This building conditions survey can also reveal whether there are any problems that would be costly to fix.

Finally, an architect can help you understand and negotiate the workletter (a list of work that the landlord will provide) based on what you need vs. what the landlord is initially willing to provide as part of the lease. (see question 5, "What if the space needs renovation?" for more on renovation.) Normally, the landlord works with his own contractors, but not with an architect. If the landlord is renovating the space, the workletter is the tool for negotiating the work and it allows him/her to price out the work. For this reason, you need to have your own architect to review the workletter before the deal is closed and help negotiate whatever is necessary.

**3. WHAT WILL THE COSTS BE?**

The cost of space will be a combination of your "base rent" and any "escalation provisions" associated with your base rent. These are figured on the basis of footage. However, because square footage is often approximated, landlords are sometimes unwilling to state it in a lease. It is used simply for negotiating a business deal (a lease).

***Square Footage***

Two important terms are usable and rentable square feet. Usable footage is the floor area within the exclusive control of the tenant. Rentable footage is determined by adding usable footage to the tenant's proportionate share of the common areas of the building. Methods of calculating rentable square feet vary from building to building. The difference between the usable and

rentable footage, expressed as a percentage of the rentable footage, is the loss, or load, factor. Try to locate a building with the smallest loss factor possible, since rent is usually based on rentable square footage, and ask the landlord to include a floor plan with your lease. Loss factor is not the only important factor, it is more important that the building suit your needs. You or your architect may wish to measure the actual rentable and usable square footage for verification, so that it matches "1996 BOMA" - the standard measurement method for all commercial buildings. In some instances, however, 1996 BOMA measurements will actually increase the amount of common area counted in the rentable square footage, so always consult your architect. Don't be afraid to bring a roll of measuring tape with you when looking at spaces. The quoted rental generally does not include electricity costs, cleaning services or future increases stemming from escalations (see question 4, "Will the monthly costs rise over the term of the lease?"). In addition, as mentioned earlier, the base rent, additional escalations and the cost of alterations are typically determined through negotiations.

### **Base Rent**

Office space in San Francisco is generally quoted at a price per rentable square foot of space per year. The quoted rental generally does not include electricity costs, cleaning services or future increases stemming from escalations, but variations of this rent structure are common. In Class A, high-rise office buildings, the quoted rent is often inclusive of all operating costs and does not include annual escalations. In more industrial-type buildings in SOMA, Potrero Hill, etc., rental rates are often quoted on a triple-net (NNN) basis, meaning the rental rate does not factor in real estate taxes, insurance, or operating costs. Depending on a number of variables, base rent may or may not begin on possession (see below) and may not include the cost of alterations.

Questions to ask about base rent include:

1. What is the base rent and what services are included in the base rent?
2. What are the rentable and usable square footage areas to be covered under the leased premises? What is the base rent per usable square foot?
3. What maintenance and repairs does the base rent include? Is a complete schedule of cleaning specifications attached to the lease? How often will the windows be washed -- both inside and outside? Are soap and towels provided in the toilet rooms free of charge?

### **Electricity charges**

In addition to rent, the tenant is responsible for the cost of electricity. This is measured in one of three ways: **directly metered**, **submetered**, or **rent inclusion**.

Under **direct metering**, the tenant pays the utility company directly for the electricity.

Under **submetering**, the tenant's electrical usage is measured by a meter, and payment plus a service fee or "markup" is made to the landlord. Different properties are submetered at different rates.

Under **rent inclusion**, electrical consumption is based on a price per square foot which is mutually agreed to in the lease. In addition, both the landlord and the tenant typically retain the right to survey the tenant's electricity usage which can result in a change if the tenant has extraordinary changes in usage.

Questions to ask about electricity charges include:

1. Can the tenant get direct or submetered electricity?
2. Will the electricity be charged on a square foot basis and added to the rent?
3. How is the electricity usage surveyed and what control will the tenant have over the survey?
4. If electricity is included in the base rent, will the tenant be charged additionally for air conditioning?
5. Upon what are the landlord's charges for electricity based?
6. Are the building's tenants in effect paying for all the electricity charges of the building, including power for elevators and public areas?
7. What are the after-hours charges for air-conditioning, if any?

### **Real estate taxes**

As a tenant, you pay your proportionate share of the difference between the current year's real estate taxes minus the base year's real estate taxes. *While you are a nonprofit, you will only be exempt from real estate taxes if the building is owned by a nonprofit organization which has applied for and received exemption for the facility* (currently, for-profit building owners cannot get exemptions for the portions of their properties occupied by nonprofit tenants). The actual tax is determined by multiplying the assessed value of the building by the local tax rate.

Questions which you may wish to address are (also see "Real estate taxes" section in question 4, "Will monthly costs rise over the term of the lease?"):

1. How is the tenant's proportionate share determined?
2. As buildings are currently assessed based on an income and expense statement, what is the occupancy rate of the property?

### **Overtime services**

Some commercial buildings do not provide basic services during the evenings and weekends, such as heat, air-conditioning, porters, and security -- including 24-hour access or even "full service" buildings. Tenants are typically charged a surcharge to keep these buildings open after hours. If your agency is one that requires overtime services, be sure to negotiate this into your lease, including charges, if any, or check the normal hours of operation.

### **Hidden extras**

A landlord is sometimes obligated to provide certain building services such as heat, air conditioning, cleaning, security, elevators, and reasonable hours of access. However, some of these may be hidden extras in the lease:

#### **Air conditioning**

Be sure to find out who controls the heating, ventilation and air conditioning (HVAC) services in the building. If you are not in control, find out if these services are available at all hours. If your floor or office has its own central air-conditioning unit or window units, find out who is responsible for maintenance. You may have to pay for an annual maintenance contract.

Make sure this and other utilities are in good working order before moving in. Find out whether the system is air- or water-cooled. Air-cooled systems are more flexible, particularly if you have lots of evening and weekend activity. While quieter and generally more efficient, you may not be able to control a water-cooled system after hours. It may be

subject to city drought emergency rules, and its use may be restricted. Depending on your needs, you may want to install air conditioning for certain parts of your space if your building does not provide it.

### ***Cleaning and other services***

Find out what services are included, if any, such as cleaning, repairs, security, etc. Expect to pay 12 - 15¢ per square foot extra each month for cleaning services and garbage removal, and possibly for a security alarm system as well. Sometimes you can get the owner to include cleaning services and/or garbage removal in the rent, but this reduces your control over the quality of service. If you are a very small tenant you may elect to handle cleaning on your own.

### ***Insurance***

You will be required to take out property and fire insurance, often a very high amount, and make the landlord a co-insured. Be sure you have enough coverage to protect yourself, but consider negotiating a reduction in the required coverage.

### ***Security Deposits***

Be prepared to provide at least 2 months' rent for security (sometimes as much as a year's rent is held for security), perhaps more if your credit is weak, funding shaky, or the landlord will be doing renovations. This will be held by the landlord until the conclusion of your lease and is his "protection" against your lack of rental payments and/or destruction of his property. The landlord might ask for more money to increase the security deposit as rent increases, although you'd prefer to avoid this if possible.

### ***Hours***

If your staff needs to work evenings or weekends, it will be important to find out if the building is normally open during those hours. If this happens only occasionally, you may have to pay extra to keep it open. If you consistently work odd hours, find out if arrangements can be made for you to have access to the building.

### ***Other Extras***

Look out for hidden clauses in the lease which charge you extra monthly costs for water, sprinkler systems, sewers, etc.

## **4. WILL THE MONTHLY COSTS RISE OVER THE TERM OF THE LEASE?**

The base rent negotiated in the typical commercial lease is only the beginning of determining occupancy costs. The additional costs described in the escalation clauses are designed to protect the owner's fixed income from increases in building expenses such as operating costs and taxes, as well as to declining real return values caused by inflation. At times it is also a profit center for the landlord.

There are generally four major categories of escalation clauses: additional rent, real estate taxes, energy costs and code compliance.

### ***Additional rent***

The escalation clause in a lease is typically referred to as "additional rent." It is this clause which creates the most confusion and has spawned the greatest variety of formulas. Following are the four types.

**Fixed annual percentage**

This cost escalator is a flat rate of increase every year or every few years. For example, prior to signing your lease you could agree to pay a 3% increase every year. An advantage to this type of escalator is that it can provide your organization with more predictable expenses, providing certainty in budgeting and planning. A disadvantage is that it may be difficult to negotiate a favorable rate, as both you and the landlord will be taking a gamble on how much costs will actually increase.

**Direct operating expenses**

In the Pass Through ("Open Book") Method, you pay your proportionate share of the difference between the current year's operating expenses minus the base year's operating expenses. Each year, the landlord presents his tenants with a statement on the costs of running the building.

Questions which need to be addressed are:

1. What is the base year for the operating expenses?
2. What factors are included in the operating costs of the building?
3. Are capital expenses included in operating costs? Brokerage commissions? Legal fees? Tenant work? Will the rent be reduced when labor saving devices are introduced?
4. Does the base amount of the operating costs reflect actual expenses?

**Porters' wage**

Widely used and initiated in the late 1960's, this escalation mechanism is based on an index tied to wage rates for maintenance and operating personnel. It is generally expressed in terms of "penny for penny" (.01 - .01). This escalation is tied to the labor contract negotiated every three years between Local 32B and the Realty Advisory Board of Labor Relations, Inc. Simply put, if the labor contract calls for a \$1 per hour wage hike in a given year, and the escalation calls for .01 - .01, the increase in rent is \$1 per square foot.

Questions which need to be addressed are:

1. How is the base year determined?
2. Are fringe benefits included? Which fringe benefits are included and at what rates?
3. Can we negotiate a rate less than .01 - .01?
4. Is there an additional fuel adjustment provision?

**Consumer Price Index (CPI)**

With this escalator, your yearly increase in escalation charge is determined by the yearly increase in the Consumer Price Index multiplied by the annual rent; this is cumulatively compounded every year.

Questions which need to be addressed are:

1. What type of CPI is used? (U.S. City Average; specific regional or city averages; wholesale price index?)
2. Is base pegged for specific month or average for years? (Average preferable for tenants in majority of cases.)

3. Does formula compensate for portion of CPI increase paid for separately by tenant in tax escalation clause?
4. Will the landlord agree to a fraction of the percent of increase in the CPI?
5. Will the landlord agree to cap the percentage increase in the CPI?

### **Real estate taxes**

The real estate tax amount for which a tenant is responsible may also increase over the term of the lease.

Questions which need to be addressed are:

1. What is the base year for real estate taxes?
2. How is the tenant's proportionate share determined?
3. Is the landlord using a fixed dollar amount as a base?
4. Is there a target assessment?
5. Was the building sold recently or does the landlord have any future plan in that regard?
6. What is the tax history?

### **Energy costs**

Energy cost increases are sometimes passed along to tenants. In negotiating such an escalation clause, consideration must be given to determining whether or not the building is covered for utility increases in other escalation clauses.

### **Code compliance**

Many landlords will try to pass through to tenants the cost of complying with codes such as upgrading of fire and safety systems, maintaining building facade and The Americans with Disabilities Act.

## **5. WHAT IF THE SPACE NEEDS RENOVATION?**

Some landlords will offer rents including a certain amount for renovation; others will amortize the cost of work over the lease-term. In some cases it will be up to the tenant to plan, execute and finance the renovation.

### **"As is" (Construction by the Tenant)**

The lease may offer the space in "as is" condition but may provide for the landlord's approval of all plans for alterations. Freight elevator hourly costs, time usage for delivery and removal of material, and the tenant's right to choose a contractor should be discussed with the landlord.

### **Building standard installation (Construction by the Landlord)**

Landlords will provide or reimburse the cost of a **building standard installation**. The cost of these improvements is spread out over the length of the lease. For example, if a landlord spends \$50,000, he will then charge you that plus an interest factor (to cover his financing costs), thereby increasing your rent. Substantial tenants can generally negotiate for an installation of higher quality than building standard. In any case, the amount and type of tenant work contributed by the landlord should be negotiated and understood. The negotiated agreement for this work is called a **workletter**, which is typically a detailed description of the work from the landlord to the tenant.

The tenant should require the landlord to do all the construction in accordance with precise plans and specifications attached to the lease. It is generally best to hire an architect to prepare and review the plans, in order to safeguard against errors and costly changes. The plans and specifications should be detailed enough to allow you to determine the cost of the work and how it will be calculated. Prior to signing your lease, you should negotiate with your landlord how you will receive credits, when work is complete, for any unused money allocated for the improvements.

## **6. WHAT ARE THE OTHER NEGOTIATING POINTS?**

Each of these are issues you should plan to discuss further with your broker and/or attorney to determine their importance for your situation.

### ***Rent abatement or deferral***

In a slow real estate market, landlords may offer a period of free and/or deferred rent either at the beginning of a lease term or spread over a longer period. Landlords may also waive rent during the construction period.

### ***Options***

You should negotiate options for additional space and lease renewal that match your agency's long range plans.

### **Other indirect financial concerns to consider before negotiations begin include:**

#### ***The term of the lease***

Most commercial leases run for five or ten years with an option to extend. While there may be an opportunity to lock-in a low rent, tenants should be cautious about leasing for too long a term, unless they can be certain about their space needs over time. As a nonprofit, you may need flexibility as your funding may change, or you may grow or shrink unexpectedly.

#### ***Lease liability***

Landlords will want some form of collateral to cover their out-of-pocket expenditures for construction and brokerage commissions. They may seek full-term exposure of the agency's assets and/or personal guarantees of individuals associated with the agency, but agencies must avoid this. A security deposit should stand as the only asset available to the landlord.

#### ***Assignment and subletting***

The right to assign a lease or sublet a space can be crucial to an organization's flexibility for future expansion, contraction or relocation. Recapture rights, notice provisions and the ability to recoup improvements and disposition costs have significant economic impact on a nonprofit's ability to dispose of excess space effectively. If the tenant needs to break the lease, these clauses require the payment of penalties including the unamortized cost of any capital improvements, the brokers fee, any free rent that was negotiated, and a certain additional amount of rent to allow the landlord to recoup any investment into the deal. These clauses must be carefully negotiated to allow you flexibility while balancing the rights of your landlord. It is best to negotiate the most liberal rights possible with respect to assignment and subletting. Landlords will want to be able to approve of the general character and business of the subtenants, but the lease should not provide the landlord with veto power.

**Possession, Occupancy and Rent Commencement**

The date the tenant is legally entitled to the premises is the **possession** date. This date is dependent on the owner obtaining possession of the premises and, if relevant, completing specific work agreed to in the lease. **Occupancy** is when construction work on the tenant's space and common areas is substantially completed (tenant is able to occupy space and business can proceed). **Rent commencement** is negotiated as part of the total financial package. Additional months of free rent can be negotiated based on current market conditions.

**Options**

Options for additional space and perhaps options to cancel portions of the entire space are subjects for negotiation. Renewal options should also be discussed.

**Compliance with the law.**

The agency's legal exposure should be limited to items relating to its own specific installation, and the conduct of its business on the premises. You may want to review the building's Certificate of Occupancy to be sure that the agency's intended use is permitted. Again, as with all things, there are no hard and fast rules in the commercial leasing business. It is possible that your organization may not confront all of the issues presented here, and it may encounter some not presented here. But hopefully this information will prepare you well for the journey of finding and negotiating a lease on an appropriate space for your organization.

*Sources: David N. Lebenstein, Time Equities, Inc. and Arlene Wysong, Sylvan Lawrence Co.*

## Buying Space

When faced with annual rent increases, pass-along charges and other uncertainties associated with leasing, many organizations consider buying the space they need. Ownership provides a financial asset that can be sold at a future date, and a "permanent home" may make an organization more attractive to some funders. Nonprofit owners are often also exempt from real estate tax, which can be a significant savings.

However, buying space is not advisable for every organization. Changes in funding or space needs can place an owner in the position of having either too little or too much space, forcing it to sell or rent out space at an inopportune time. Further, there are significant initial costs involved in selecting a feasible site and negotiating a deal. They include:

- \* down payment and mortgage (if financed)
- \* full purchase price (if not financed)
- \* legal fees
- \* architectural fees
- \* engineering fees

Renovation of the facility is often necessary, adding more upfront costs.

Buyers must obtain funds to cover not only the upfront costs of buying space, but also the ongoing costs of maintaining it. Most organizations require some debt to finance the purchase and renovation of a facility; several options for obtaining loans exist (see "Financing Options"). Thus, debt repayment is a significant ongoing cost that most owners must meet. Maintenance of the facility involves both annual ongoing expenses such as building staff, heat, common area electricity, and service contracts for boilers, air conditioning units, etc. as well as periodic large (i.e. capital) expenses such as replacing boilers, re-roofing, etc. Other ongoing costs include insurance and utilities.

Ultimately, owning space works best for organizations that have a long history of stable programming and funding. Nonetheless, the appropriateness of ownership is not solely determined by economics. The availability and appeal of certain types of space to meet your program's needs are also major factors.

### Types of ownership

There are several types of property ownership including an entire building, a condominium and a cooperative:

- \* **An entire building** affords its owner the greatest degree of control, but carries the greatest degree of financial risk as the owner is responsible for all management, maintenance, repair and replacement work needed.
- \* **A condominium** is a logical alternative for those wishing to purchase space without taking on full responsibility for maintenance and management of a building. In a condominium, the organization purchases a piece of a building, which reduces risk but limits the condominium owner's control over the building itself. Decisions about the building as a whole and common elements are made by the condominium's board of

directors, while decisions about the individual units are made by their owners, subject to condominium guidelines. The owners share the cost of building repairs and maintenance through monthly "maintenance" fees, but pay individually for the cost of repairs and maintenance within their own units.

- \* **A cooperative** is another alternative if a buyer prefers to share building management and maintenance. In a cooperative, the owner holds shares of the cooperative corporation that entitles it to use a specified space via a sublease. Thus, the owner does not own real property and therefore could not qualify for a real estate tax exemption. If the cooperative corporation itself were a nonprofit, tax exemption would be possible if all of the shares were owned by nonprofits, but this is extremely rare. Unlike condos, most coops have underlying mortgages which become part of an owner's financial responsibility under the monthly maintenance charges.

### **Negotiating the Purchase Price**

The key to negotiating a purchase price is knowing "the market," i.e. prices for comparable properties in similar areas. Real estate brokers can be helpful here. (See Leasing Basics [link to page] for more about brokers.)

### **Financing Options**

Bank financing is one source of capital financing; loans from groups such as the Nonprofit Finance Fund is another. A third option is that the seller may offer a mortgage (a "purchase money mortgage") at an interest rate to be negotiated. Sometimes, if the seller is interested in the tax benefit of a charitable donation, he or she may choose to donate a portion of the purchase price to an organization. This is accomplished via a "bargain sale," which reduces the seller's capital gains tax and other transfer taxes. You should understand however, that most real estate owners *do not* need tax deductions, so this approach is of limited value.

### **Deciding What's Best for *Your* Organization**

It is important to consider two main items:

- \* How well the specific available opportunities for both renting and buying space fit the needs of your organization both now and over at least the next five years.
- \* An honest assessment of what your organization can likely afford in both upfront and ongoing costs.

Together, they will guide you to make the best facility choice for your organization.

## Leasing & Real Estate Terms

*Courtesy of the Grubb & Ellis Company*

### SPACE CATEGORIZATION

**Office space** is loosely classified based on the quality of construction, features and the status of location:

- **Class A.** Most prestigious buildings competing for premier office users with rents above average for the area. Buildings have high quality standard finishes, state of the art systems, exceptional accessibility and a definite market presence.
- **Class B.** Buildings competing for a wide range of users with rents in the average range for the area. Building finishes are fair to good for the area and systems are adequate, but the building cannot compete with Class A at the same price.
- **Class C.** Buildings competing for tenants requiring functional space at rents below the area average.

**Industrial.** Industrial space is usually in buildings zoned for industrial uses. They are not available for office use unless a change of use permit is filled and approved by the planning department. In some areas of San Francisco such change of use designations are very difficult to obtain.

**Retail.** Retail space can be leased by office use.

### RENT

**Rent.** Rent is the monetary amount paid by a tenant to lease space.

- **Asking Rent.** The dollar amount asked by landlords for direct available space (not sublease), expressed in dollars per square foot per year in most parts of the country and dollars per square foot per month in areas of California and selected other markets. Buildings will have an average asking rent for available space. Usually a point of departure for negotiations between landlords and tenants.

**Basis.** The rent basis designates what operating expenses are included and excluded in the rent. The most common rent bases are:

- **Full Service:** All costs of operation are paid by the landlord up to a base year or expense stop. In some parts of the U.S., this rent basis is called Full Service Gross.
- **Triple Net:** All costs of operation including, but not limited to, real estate taxes, insurance and common area maintenance are borne by the tenant on a pro rata basis.
- **Modified Gross:** any arrangement whereby the tenant pays one or more of the expenses covered by the landlord in a Full Service lease, but not all of the expenses as in a Triple Net lease. Modified Gross leases cover a range of lease types and terminologies used in various markets around the nation. Some of the more common are Industrial Gross, Single Net and Double Net. The definitions of these bases vary from market to market depending on the expenses they include or exclude.

- **Net of Electric:** A popular form of Modified Gross, this is like a Full Service lease, but the tenant pays for his or her electric charges either to the utility company (according to a meter) or to the landlord on a pro rata basis. In the Northeast, this arrangement is called Full Service Gross Plus Electric. Acronyms: Full Service (FS), Triple Net (NNN).

**Concessions.** In a slow market in order to attract tenants, a landlord will sometimes grant concessions. These most often take the form of free rent but may also include lease buyouts, moving allowances and above-standard tenant improvement allowances. In a hot real estate market concessions are difficult to negotiate.

**Contract Rent.** The lease rates appearing in a signed contract. Typically the contract rate is the first year rate as opposed to the average rate over the term of the lease.

**Effective Rent.** Effective rent equals contract rent less free rent and any cash allowances such as a lease buyout or moving allowance. Escalations written into the lease are included in the calculation of effective rent. Tenant improvement allowances and brokerage commissions are not subtracted from the contract rate in calculating effective rent. (This definition is equivalent to the tenant effective rent. A landlord or lender would likely include all tenant improvement allowances and brokerage commissions in calculating effective rent.)

**Effective Rent Calculation:**

- Effective Rent = (total rent - free rent - cash allowances)/lease term/rentable sf
- Total Rent = rent paid during the term of the lease including escalations
- Cash Allowances include free rent, moving allowances and other cash considerations

**Assumptions:** 5,000 sf lease                      36 months  
 \$25 Contract rate w/\$0.50 annual escalations  
 1 month free rent (first month)

<u>Formulas</u>	<u>Total Rent/Consideration</u>	
Year 1 (11 months)	\$25.00 x 5,000 sf x (11 / 12) =	\$114,583
Year 2 (12 months)	\$25.50 x 5,000 sf =	\$127,500
Year 3 (12 months)	\$26.00 x 5,000 sf =	\$130,000
	Total Consideration	\$372,083

Effective Rent                      \$372,083 / 5,000 sf / 3 years =                      \$24.81 / sf / year

**Escalation.** Leases often include escalations or stepped increases in rent to be paid by the tenant to the landlord at a specified future date (for example, year five of a 10-year lease).

**Expense Stop.** The per square foot annual amount the landlord agrees to pay for operating expenses. Once this amount is exceeded, the tenant pays its pro rata share of the additional costs.

**Free Rent.** To entice tenants in a soft market, landlords may offer free rent, usually a certain number of months at the beginning of the lease when the tenant does not have to pay rent. A number of variations are possible such as giving the tenant free rent in the middle of the lease or prorating the free rent into the tenant's monthly payments. In today's hot market free rent is uncommon.

**Lease Buyout.** In a slow market a landlord may offer to buy out a tenant's existing lease if the tenant will move into the landlord's building. Likewise, in a hot market a landlord may offer to buy out a tenant's existing lease if the tenant will move out of the landlord's building.

**Sublease.** Sublease space is offered on the market by the current tenant for sublease, regardless of whether the space is occupied or vacant. This space often competes with direct lease space (offered directly by the building owner or agent). Sublease space tends to be an important factor in the office and retail markets, less so in the industrial market.

**Tenant Improvement Allowance.** The amount of money which a landlord may agree to give the tenant to fix up the tenant's space. Usually expressed as a dollar amount per square foot. The amount is subject to negotiation between the landlord and tenant. In hot real estate markets, tenants should expect to pay a larger proportion of the cost of tenant improvements. In soft markets the opposite is true.

**Term:** The length of the lease. Leases with a 3 to 10 year term are the most common.

## GENERAL TERMS

**Availability.** The date the space will become available to a potential tenant.

**Inventory.** Inventory is the total building square footage in a particular geographical area that is considered competitive. Also sometimes called the base, base inventory or competitive inventory. The inventory represents those properties on which the market statistics are generated. Not all properties in a market are included in the inventory. Examples would be buildings smaller than the minimum size threshold, functionally obsolete buildings and buildings in which the owner occupies 75% or more of the space (see below). While research departments may include these buildings in their databases in order to track available space in the buildings, they must be excluded from the competitive inventory and the statistical calculations and reports.

**Net Absorption** is the net change in physically occupied space between the current measurement period and the last measurement period. Net absorption can be either positive or negative. Pre-leasing activity is NOT included in net absorption calculations because pre-leasing does not involve any change in occupancy. Net absorption is calculated when the pre-leasing tenant moves into its new space (positive absorption) and vacates its former space (negative absorption). The calculation of net absorption includes transactions that occur in sublease space as well as direct lease space.

**Vacancy.** The vacancy rate is the amount of vacant space divided by the competitive building inventory. Vacant space is physically unoccupied, and it may or may not be available for lease or sublease. This is *physical* vacancy. It is not determined by whether or not a tenant is paying rent on the space.