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# LEASING to dot COMs



by judon fambrough and harold d. hunt

**T**echnology-related firms are an increasingly important tenant segment in many major office markets across the United States, providing landlords with a variety of challenges.

## Assessing Credit Risk

In hot technology markets, assessing the credit risk involved in leasing to start-up firms that are flush with venture capital but have yet to earn profits may be difficult. Landlords may benefit by considering the following.

- **Which stage of development has the prospective tenant achieved, and who is providing their venture capital funds?** Venture capital funding consists of a "seed" stage to finance development of a business plan, a second stage to finance product or technology development and a third stage to support marketing and business development.

Seed funding for technology firms may come from a variety of sources, including wealthy individuals known as *angel investors*. The best venture capital firms often are known locally by reputation only and may not back new firms until at least the second stage.

Top venture capital firms will be familiar with a new firm's "burn rate," the rate at which their cash reserves are being depleted. Determining burn rate can help landlords assess whether a prospective tenant should have sufficient funds throughout the lease term.

- **Does the prospective tenant have an auditor?** Auditors examine a firm's books and write an evaluation of the company's financial position. Landlords should look for a positive opinion from a respected auditing firm.
- **Does the prospective tenant have a board of directors?** If so, who are the members, and do they have successful records?
- **Have investment bank analysts published any information about the prospective tenant?** Although some information

is available free on the Internet, landlords should expect to pay for an in-depth analysis. Many investment banks, such as Bear Stearns or Goldman Sachs, sell their analyses.

- **Can prospective tenants provide letters of credit to secure rent payments for all or a part of the lease term?** If a tenant defaults, the landlord may present the document to the issuing bank, which funds all or a part of the amount indicated in the letter of credit.

Tenants question the need for letters of credit in active office markets for two reasons. First, with demand exceeding supply, landlords can quickly re-lease space, usually for higher rates. Second, under the Texas Property Code, commercial landlords must make a reasonable effort to re-lease the property when a tenant breaches a lease and abandons the property. This duty cannot be waived in the lease.

Landlords are not required to lease to **any** willing tenant; they are allowed to find a suitable one. For example, if the office is designed for a medical tenant, the landlord does not have to lease to a computer firm.

## Negotiating Lease Agreements

Leasing to dot-com startups introduces new dynamics to the negotiation process. Some landlords are demanding equity interests (shares of stock) in the new companies in lieu of rent or security for rent. Others feel that doing so is essentially investing in the stock market and have no interest in taking such a risk.

For landlords who are servicing the mortgage or paying investors an assured return, accepting a warrant (stock option) in lieu of rent may be courting financial disaster, both for the current project and for the future projects with the same lenders or investors.

The use of equity "kickers" was a practice that got savings and loans in trouble in the 1980s. At the least, landlords should be cautious when asking for or accepting stock options.

Leasing agents agree that warrants play an important role in lease negotiations. They are primarily used to "sweeten" an offer when landlords must choose between competing pro-

*Determining 'burn rate' helps landlords assess whether prospective tenants have sufficient funds.*

spective tenants for lease space. Warrants are rarely used for rent or security concessions.

Leasing agents and attorneys alike foresee problems if warrants become more common. The income tax consequences are complex. Landlords should check with their CPAs before accepting warrants. From a legal perspective, it is unclear whether warrants belong to the building or represent personal property and belong to the landlord when the building is sold. Finally, landlords and leasing agents may be tempted not to disclose receipt of warrants to investors and principles.

According to one leasing agent, if companies offer warrants, they are probably not worth the risk. And when the warrants are worth the risk, the companies generally do not offer them. ♣

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