START-UPS AS CLIENTS: NOT AS DIFFERENT AS YOU MIGHT THINK

By John Salustri

Not all start-ups begin life in a garage, especially these days, when small incubator space can be had without a long-term commitment. The good news here is that small start-ups into larger tenants grow. That is, if their prospects for growth warrant a piece of the estimated $131 billion in venture capital that flowed into the space last year.

That's when we start talking about real money. Well, real tenants, at least, but with big plans. And big plans need branded space and room to grow. A 2,000 square foot deal today might not move the needle for a lot of brokers, but those we talked with know that this is also where long-term relationships are forged. (For guidance on keeping those relationships growing, check out Steve Bergsman's article on page 6 of this issue, as he speaks with SIORs on their recommendations for investing in such relationships.)

"In its initial business stage, a start-up typically needs to balance limited revenues with potential high-cost outlays," says Nick McCalmont-Woods, SIOR, CEO and founding partner of London-based McCalmont-Woods Real Estate. "Hence the traditional five-to-10-year lease would be a fetter to business at a most crucial time in the firm's life cycle.

"At a practical level," he continues, "for start-ups that physically need to occupy space in order to conduct their business, the attraction of flexi/shared workspace is clear. Unlike the traditional U.K. lease, there's no requirement to fit-out space at day one, and there's only a nominal two-to-three-month license fee deposit, if any. Also, the huge surge in the supply of desk space has compressed that cost." He says that shared spaces also promote a "highly valued" sense of community, particularly among tech start-ups.

"I've actually been working with start-ups quite a lot," says Adam Collins, a partner in the Genau Group Realty Advisors in Washington, D.C. "Many of them are coming out of shared space like WeWork or MakeOffices, and they're finding that between the one- and two-year mark, they need space of their own. They want more brand identity, more flexible conference room usage, and something more long-term."

Does WeWork Work?

When the start-up is ready to make that leap, it obviously needs the help of a professional. But that out-of-the-gate exposure to shared-space agreements at the very least demands some re-education of the tenant on the part of the broker. And that's only one reason many brokers don't embrace the concept of shared space.

Granted, "WeWork has had a huge impact on the property market," says McCalmont-Woods. "But many start-ups reach out online to WeWork or another flex-space operator before they even consider discussing their workplace needs with a tenant representation adviser."

And therein lie the downstream problems. "The operator will invariably decline to negotiate with a tenant rep," he continues, "which can mean that the start-up ends up worse off since brokers are probably better placed to negotiate more favorable contract terms."

On one hand, the shared space model, "has been able to offer short-term solutions when owners have been focused on long-term leases in a tight market," says Scott Martin, SIOR, an executive vice president at NAI Capital in Pasadena, Calif. "But until coworking came into the picture, I would get a call from a start-up and engage them in discussion. Now that's gone, as the start-ups are fixed on the short-term flexibility of co-working."

But not all brokers share the same skepticism. "I like WeWork," says Collins. "It makes our job a little easier, and for a couple of reasons. I think of them as an incubator for smaller companies of one to 10 employees. Once they know what they like about WeWork and a particular location, it helps define a little more clearly their next leasing decision."

As Daniel Levison told *SIOR Report*[1] recently, "Most brokers don't want to show coworking space because they perceive it as a loss of income. But that's totally inaccurate. The reality is that it can cause a loss of short-term income, but longer term it's actually more profitable." (It should be noted here that, as Levison explained, in addition to his Atlanta-based brokerage activities, he also operates a shared-space service.)

Indeed, Martin tells the tale of an electrical engineering start-up for which he secured a small, 800 square foot lease. That eventually grew to a 24,000 foot deal in a series of expansions.

Been There, Done That

Interestingly, despite the mixed reviews shared space gets from brokers, those who have firsthand knowledge of those operations find it helps increase empathy. "I completely understand the need for start-ups to balance flexibility with cost and brand image," says McCalmont-Woods. "I set up my own business in a serviced office from Abbey Offices—now part of the Regus brand—in Canary Wharf Tower in 2008." He remained for three years, he says, "because I enjoyed the flexibility, the quality of the space and the cache that came from occupying space in what was then the UK's tallest building.

"This shared experience is invaluable in developing a relationship with start-ups that are looking for genuine and authentic guidance on their office-space strategy," he continues. "Hopefully it's not just at the initial business stage, but it starts a relationship that will transition through growth to maturity," which is exactly the point Levison was making.

Martin agrees: "It certainly creates far more empathy with the client. I've had a few dealings with start-up clients this year alone. One was a Med-Chem company in UCLA that was moving into Pasadena, where the owner lived. I could certainly relate to wanting to work closer to home. But I can also relate to the fact that, unfortunately, you have to go where the people are, which in this case was closer to UCLA. You have to sacrifice a little more of your personal and family time during the initial stages of a start-up." He gets it, firsthand, and can commiserate.

Of course, servicing a client means doing what's best for them, and understanding how start-ups work is key to building that trust…even if the advice sends them back to the shared-space provider. "Understanding how start-ups are funded will influence the terms they may seek as well as what's expected of them, from either a landlord or a flexible-workspace operator," says McCalmont-Woods. "For example, I've had to advise some start-ups that their covenant strength was insufficient to acquire office premises under a traditional lease and that they should instead seek to acquire shared space under a license agreement."

Much like credit and background checks in the U.S., "U.K. landlords typically employ a profits test to assess a tenants financial standing," he says, "whereby the occupiers' net profit must exceed the annual rent by a factor of three for the three consecutive years immediately preceding the date of the lease grant. Where this isn't possible, landlords will typically seek a rent deposit, which could range from three to 12 months." Not a

1. http://www.siorreport.com/digitalissues/q3_2019/MobilePagedReplica.action?pm=2&folio=36#pg40

good thing for a cash-strapped start-up. (*See sidebar*)

Different Strokes

It's also important to understand that, like fingerprints, or every other tenant you've ever worked with, all start-ups are different. Martin says he's worked with beginners, such as a chemical manufacturer of time-released capsule shells, that had heavy capital earmarked for lab space.

"Typically, manufacturing start-ups are better funded," he says, "and very conscious of construction specifications—the ceiling heights, power, and ventilation. They also tend to take a little more space than they probably need initially, factoring in growth. So there's a difference between software and manufacturing start-ups."

There are also differences in who is at the helm. "Some company CFOs or CEOs might be in their second or third venture," he says, even though they may still be in their late 20s or early 30s. "They bring to the table a knowledge of the monies they can spend, and a confidence in their decisions." This compares to a "true start-up that comes right out of college. They're a bit more nervous."

But that knowledge can be a double-edged sword as well. "Real estate data over the past five years has become so commoditized through such providers as Loopnet and CoStar that young start-ups think they have the answers," Martin says.

And that little bit of knowledge can foster mistrust of the entire brokerage process. In such cases, Martin's location—a hotbed of start-up activity—helps ease new clients' trepidation. "I try to drop a few names from other start-ups I've worked with in order to build my reputation through my other relationships. That tends to help…most of the time."

Dealing with start-ups is really a tale of two real estate markets. On one hand, brokers are dealing with a new breed of client and need. On the other hand, the old rules still apply. Service, expertise, and understanding still win the day. Despite the new challenges, some things just never change. ▽

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MONEY TO BURN… FOR TALENT

Not all start-ups are shoestring operations, and they come to the brokerage table knowing what they want. "They're not always as cash-strapped as some people might think," says Adam Collins. "I've dealt with start-ups that are just one person and those that have grown to 40 people. It all depends on where they are in their funding cycle. Some do have money and are focused on using that to get good office space to attract talent, especially here in Washington, DC, where the job market is so competitive."

Much like longer-established operations, "A smart start-up really understands what they have to do to win over that prospective hire," he says. "A cheap space without amenities won't win the day. If you can afford to have a nicer area, one that presents well, it goes a long way."

Nick McCalmont-Woods agrees. "There's no doubt that some start-ups are indeed cash strapped, or they just don't like paying fees," he says. "I've been fortunate to have advised some incredibly well-funded start-ups backed by some of the world's largest investment banks, private equity houses and sovereign wealth funds.

"It's not uncommon for businesses such as these to perform like a more mature operation," he continues. "And while office space is still regarded as a cost to the business, they're more inclined to also view it as an asset to attract and retain the best talent and further grow their businesses." ▽