The Art of Subleasing

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By Dana K. Weinberg, CEO

MID-ATLANTIC COMMERCIAL REALTY, LLC

In this soft economy many companies continue to seek ways to reduce costs by eliminating jobs. Fewer employees mean more vacant offices and the dilemma of what do with extra space. Subleasing is a common way to reduce leasing costs today if your company has downsized. Of course subleasing can also be used when your company needs to relocate to accommodate growth, especially government contractors. Businesses with excess space have several options based on market conditions and their lease rights. A business could assign the entire lease, sublease a portion or the entire space to another company or buy out of the lease. This article will focus on subleasing from the perspective of one company subleasing space to another company. Subleasing can be complicated, frustrating and disappointing if you sublease to the wrong company.

Businesses are advised to work with real estate professionals who are knowledgeable of real estate market conditions and able to navigate through the maze of a lease and sublease. Businesses should leverage their time focusing on running their company and let the professionals help you make good decisions.

A sublease is an agreement between a tenant (the "sublandlord") and another business as the subtenant to occupy all or a portion of the tenant's space. The tenant is liable to its landlord for its lease while the subtenant becomes liable to the tenant, its sublandlord. If you plan to sublease your entire space through the end of your lease term, assigning the lease may be preferable by both parties. An assignment does not relieve the tenant from its lease liabilities and obligations unless the landlord agrees to do so. Your company remains responsible for the entire assigned lease even when the new business taking over the lease, the assignee, does not fully perform its lease obligations.

A tenant should negotiate the maximum flexibility in their lease to sublease all or a portion of space with minimal interference from the landlord. We refer to this as "controlling the space". Conversely, the landlord wants to control space in "their" building to stabilize the tenant base which enhances the long-term viability of the lease and the investment value of the building.

When you make the decision to sublease space first and foremost review your lease to determine your company's lease obligations and approvals required. We will review your lease as part of our value-added services. When hired, we will then develop a marketing plan to sublease the space according to your company's business strategy and real estate needs.

Your company cannot sublease to just any company. Your lease will likely not allow you to sublease to an existing or prospective tenant in the building [this is potential competition with your landlord's vacant space], a government agency or a business with an incompatible use. Make it easy for your landlord to approve the sublease. Use the landlord's sublease form to save valuable time and money towards obtaining the landlord's approval. If your landlord does not have a sublease form either ask us or your real estate attorney and one of us can provide you one. Tenants should require the subtenant to provide financial statements for the past two years and leasing references to assess risk and determine the amount of the security deposit. The security deposit analysis should weigh credit risk, the impact on your company's cash flow and market conditions.

Many tenants and subtenants are under the impression once the sublease agreement is signed the subtenant can move in. However, most, if not all leases, do not allow the tenant to sublease space without the landlord's written approval. In some instances, subleases over a certain size may require consent from the landlord's lender. The landlord's approval should be no more than 30 days. The subtenant can only move in after: (i) The landlord approves the subtenant's use and credit; (ii) The landlord has approved the final draft of the negotiated sublease; (iii) The tenant and subtenant have signed the sublease and; (iv) The landlord has signed what is commonly referred to as the "consent to sublease" document.

The landlord may have the right to "recapture" your space and/or terminate your lease once you send notice of your intent to sublease the space. Landlords typically exercise a recapture right in a hot real estate market when your space can be re-leased quickly and at a significantly higher rental rate than your current rental rate. This higher rental rate generates higher property revenues and net operating income which in turn increases the value of the property. This recapture scenario could also work in your favor if you must vacate the space to expand or downsize. Tenants can sometimes have the best of both worlds if they have negotiated a right to rescind the notice to sublease in the event the landlord exercises its recapture right. Now you have a lot more control over your space.

As a future sublandlord your space should be in its most marketable condition to generate the most interest given your financial resources. For example, the rent should be attractive and the space should be in good condition, well lighted and clean. A sublandlord should adjust its expectations depending on market demand and supply dynamics for both direct and sublease space in your submarket. Several factors typically affect the price of sublease space and the time to lease it with some more important than others. Important factors include rental rates on comparable direct and sublet spaces in the building and submarket, size of the space, available or remaining term on your lease, space configuration and features (offices with windows, a conference room and kitchen), building location and elevator identity to name a few. Subleasing efforts may be significantly impacted by the amount of cash available to fund tenant improvements. Offer free rent so the subtenant can fund their own tenant improvements to close the deal. Tenants must be prepared to reduce the rental rate by 10% to 60% below their current rental rate. As a general rule the less time left on the lease the lower the rental rate paid by the subtenant. When market demand is low it is better to make a "deal" today, generate income and mitigate your company's risk than wait for the "perfect" deal. A subleasing strategy will depend on your company's business goals and cash needs. A full floor tenant with 25,000 square feet may have the cash available to demise the space into smaller spaces with each having its own conference room and kitchenette. These smaller spaces may be more attractive to a larger universe of subtenants. Alternatively, it may be more economical to vacate your entire space and wait for one subtenant rather than investing cash into a space you will no longer need. There are creative ways to fund tenant improvements if the landlord is open to negotiating a direct deal with the subtenant after both the sublease and your lease expire. Remember, the landlord wants to know "what's in it for me!" Will the landlord benefit by securing a stronger credit tenant and/or increasing the subtenant's rental rate to market rates? Marketing time can often be reduced by offering "plug and play" space that is fully furnished with a phone system, cabling, internet access, etc. Such "plug and play" space often generates higher rental rates because the subtenant will save time and money. There are other monetary issues to consider when subleasing. One of the most important is to pass through your share of the building's operating costs directly to the subtenant.

What happens if the market rent is higher than the tenant's in-place rent? Most leases give the tenant the right to share net profits from subleasing efforts. The split is typically 50% to the landlord after subtracting subleasing costs (e.g. tenant improvements, lease commissions, free rent, moving costs and legal fees).

Leasing costs are one of the highest costs a business will incur along with payroll and benefits. Payroll and benefits include fixed and variable components whereas leasing costs are fixed and increase annually. Well negotiated sublease language in your original lease will provide you flexibility and options for an uncomplicated exit from your space while a poorly negotiated lease will be imprinted in your mind forever.

We will guide you through the leasing process, help leverage your time, work to reduce costs and position your company to make prudent real estate decisions consistent with business goals and space needs. We will act as your real estate advisor in the traditional brokerage role. Contact us any time to learn more about our value-added services, request references or just ask any leasing questions.