FEATURED ARTICLE

ARE START-UPS WORTH THE INVESTMENT?

BY STEVE BERGSMAN | SPONSORED BY SIOR FOUNDATION

Following completion of a lease renewal, David Klein, SIOR, a senior vice president with Transwestern in San Francisco, was talking with his client—the CEO of San Jose bioCube, which is a San Francisco Bay Area life science incubator (or to put it another way, a WeWork for the life sciences industry.) Like a WeWork facility, life science start-ups enroll, sit-down, and do their science without all the cost, delay, and hassle of building a space. One thing led to another and the CEO asked Klein if he'd be interested in taking a more permanent job as the lone "real estate person" in the position. Klein thought about the proposition and came back with another suggestion: he would invest in San Jose bioCube. He did and is now a co-principal at San Jose bioCube and on the Transwestern team as its broker.

It was a unique opportunity because Bay Area life science spaces are very specialized, with laboratories, research equipment, culture rooms, and special refrigeration needs. For bioCube, these amenities are readily available to its 24 life science company clients. These facilities are expensive to build—in excess of $400 per square foot, fully-equipped. As such, this kind of space is always in critically short supply, with San Jose bioCube spaces 100% leased for the past three years.

Klein had invested in tech start-ups in the past, but now he is directly investing in innovation itself. He had been preaching to tenants that the Bay Area was the place to stake a claim in life science given the large eco-system of academia, major companies, and research institutions, so, as he says, "I put my money where was mouth was." When these young companies are ready to graduate bioCube into their own space, the Transwestern team is there to help and have an early opportunity to invest as well. "It is a synergistic relationship between broker and client", Klein added.

"IT IS A SYNERGISTIC RELATIONSHIP BETWEEN BROKER AND CLIENT..."

It's not surprising, then, how many commercial real estate brokers are involved with start-ups, tech, and otherwise, because the intimacy of dealing with a start-up's management team creates both a knowledge and trusted-advisor track. In addition, many real estate professionals have placed themselves in the position of consultant to start-ups because those first deals for space are going to involve a lot of educational time with the principals for a small amount of space—initially. Klein, for example, represented a company that progressed out of a small bioCube space into 30,000 square feet. It was soon after acquired by Roche and now leases 100,000 square feet. Those are the kinds of home runs that keep brokers interested—just like investing in a start-up itself.

Venture capitalists basically work on the principle that for every 10 investments, five will fizzle out, three will do OK, and two will hit it out of the park. Greg Gunn, SIOR, a senior vice president with Colliers International in Salt Lake City, has personally invested in five start-ups and his scorecard runs the same percentage as the venture players. Of those investments, one is a high-risk play in a biotech company, while another is a 10-year investment. Gunn represented that last company when it took its initial 3,000 square feet and he is currently representing them in a deal for 25,000 square feet.

Gunn notes, "If I'm investing in your company, then I'm your real estate guy for life."

However, that's not the only reason he invests in tech start-ups.

Real estate is a relationship business, and through representation with start-ups, he has developed one-to-one relationships with the C-Suite, either the founder, CEO, or CFO. "If I find out the people are trustworthy and I can learn the culture of the business and understand what they are doing, I will try to find an outside opinion of the company. Based on all that I will make an investment in a start-up," Gunn says.

He reiterates, "the number one thing is to build the relationship with a key executive, second is research about the company, and third [is to] make an assessment of that company's business environment."

More often than not, brokers don't make an actual financial investment in a start-up, but rather invest time and energy if they see potential. On a basic level, the hope is that as the company grows, it will continue to work with the broker. Of course, the big pay-off for everyone—even the broker—comes when the company either goes public or gets acquired, but even in those circumstances there's risk.

"Our firm has helped several start-up companies that have grown to that mid-range size where they've then gotten acquired by large companies," recalls Street Jones, SIOR, a principal with Rich Commercial Realty in Raleigh. "We had been working with this small tech start-up for years, increasing their square footage a little bit at a time. They were eventually in about 7,000 square feet of office space and earlier this year we were working to put them on an entire floor of Class A office building in downtown Raleigh, about 26,000 square feet. We got to the point where we were ready to conclude the lease when we got a call. They were acquired and the conglomerate that bought it had an in-house real estate team—and we were kicked to the curb."

This is not to say that Jones won't work with other start-ups. "You have to understand what the company does and the people behind it," he says. "You have to know who is at the helm. Start-up principals are either totally green or are serial entrepreneurs—there is a huge difference when it comes to working with someone who has done this before versus the recent college grad with little business experience."

Rich Commercial began working with a tech start-up 15 years ago. The first meeting was in a barn where the computer equipment was kept. Jones' group decided to roll the dice and work with the entrepreneurs. Now the company is in 35,000 square feet and was acquired. "Part of that deal was that we would continue to represent them," says Jones. "We are working to potentially relocate them to a new building."

As an individual, Jones has been keeping an eye out for investment potential. "The one I wish I had invested in is a company called FilterEasy, founded by a couple of North Carolina State University students who left college to start the business. It's a subscription service for home air filters. I spoke with one of the founders a few years ago when they were trying to raise capital. Now the company has grown nationwide and has leased a full floor of office space in downtown Raleigh. That is certainly one I wish I had invested in."

Mike Spears, SIOR, a managing principal with Lee & Associates | Houston, has in the past invested in start-ups as an individual, finding both success and failure along the way. "Start-up companies are always a risk as there are so many factors that can impact success," he says. "However, with risk does come great reward when the investment works out."

On the real estate side, a property investment carries similar risk. "When you invest in a building that will be leased by a start-up company, you run a high risk of losing that tenant," says Spears. "Therefore, the landlord is essentially investing in the company when it agrees to do a lease like that."

Whether investing directly in a start-up or acquiring the building a start-up will lease, it is important to conduct a thorough assessment of that risk. "While the financials are obviously going to be weak (or nonexistent in most cases), you can learn a lot by examining the business plan as well as the people that are involved with running the company," says Spears. "Do you believe in the idea? The people? If so, it might very well be worth the risk and, ultimately, can reap big rewards."

In the end, however, real estate can provide a bit of a hedge (versus investing in the actual company) because, in the worst case scenario where the tenant doesn't make it, you are left with a tangible asset that you can sell or lease to another party. So, mitigating the risk can ultimately come down to examining the fundamentals of the real estate, which brokers should be doing in any case.

In Charlotte, N.C., Russell Hughes, SIOR, managing principal of Hughes Realty Advisors, has also worked with a number of start-ups as a consultant. "In realty, any time you work with a start-up you are effectively investing in their future

"YOU HAVE TO UNDERSTAND WHAT THE COMPANY DOES AND THE PEOPLE BEHIND IT."

because they don't know what they don't know," he says. "The goal is to get that company off on the right foot, let it grow, and your compensation ends up being a larger commission down the road."

However, sometimes, there arises a rare opportunity for direct investment. Depending on what side of the transaction the broker is on, it is also possible to trade the commission for equity in the start-up. Hughes says he is currently looking at an opportunity to be an equity partner in a start-up—a commercial brewery in Charlotte—trading his commission for a stake in the company. "These opportunities don't happen all that often," he notes. Most of the time with a start-up you don't want to take that chance, you are just interested in that commission."

For opportunities such as this, Hughes offers three cautions:

1) Don't look at the opportunity as if you are investing free money, i.e., the commission didn't come to me so it never went back out again. It is the same thing as investing hard capital. Always evaluate as if they were asking for your hard money.

2) Look at the long-term viability of the company – your investment earnings are predicated on the company being alive in the future.

3) Are the principals "teachable?" If they are fighting you on your expertise, chances are they are fighting others on their expertise. They are not listening to advice.

"The appealing scenario that every broker tells himself is that this company is the next Netflix, Twitter, or Uber, and I'm going to get in at the beginning," Hughes observes. "The reality is that less than one-tenth of 1% of these companies will even last a year."

While a lot of brokers will invest time and energy working with start-ups, a surprisingly significant number will also invest capital. In regard to real estate, the pay-off is working with a company that will take larger and larger space as it grows. Capital investors hope for a big public offering. The odds are low in both cases, but the rewards are out-sized.

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CONTRIBUTING SIORS

Greg Gunn, SIOR

David Klein, SIOR

Russell Hughes, SIOR

Mike Spears, SIOR

Street Jones, SIOR

Kostas Stoilas, SIOR

IS IT REALLY WORTH IT?

By Steve Bergsman

Kostas Stoilas, SIOR, managing member and founder of Fortress Commercial Real Estate, sits on the board of Tampa Bay Wave, a start-up "accelerator," which offers incubator and accelerator programs, as well as co-working space to tech entrepreneurs. It is a non-profit that coaches, mentors, and advises tech start-ups as they grow their revenue and investment dollars. While Tampa Bay Wave and its participants don't take equity in its tenant companies, Stoilas has watched and advised companies as they get involved in the local ecosystem. He offers a checklist for investors:

BENEFIT TO START-UP FOR GETTING EARLY INVESTMENT:

- Startup needs to get to a scalable point.
- Startup needs key hires and professional services.
- Startup needs sales, marketing and promotions.
- Customer cash is a slow process; investment dollars help speed things up.
- Entrepreneurs are still building and improving their offering.
- Helps keep founders going; get past "friends and family" into angel/seed rounds, then early venture

BENEFIT TO INVESTOR:

- Opportunities for outsized returns.
- Be a part of something exciting.
- Be an angel and help start-up entrepreneurs get going.

THINGS TO CONSIDER, AS INVESTOR:

- Use a portfolio approach by investing in many startups to diversify risk (1 out of 10 will "break out").
- Invest 5% to 10% of your investable capital, and only capital you can comfortably lose.
- Have a steel stomach; it is a risky endeavor.
- Know what type of start-ups you're investing in (i.e. tech, service, product development).
- Don't get emotionally involved.
- Understand the team and the individuals running the start-up.
- Pick industries you understand.