Real Estate Issues for Business: To Lease or Buy

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While the decision to lease or buy business property initially seems straightforward to business owners, managers and entrepreneurs, upon investigating the multiple dimensions of this question, many unanticipated issues can arise. Clearly, there is not an easy answer to the lease or own question for most businesses—no matter what size or industry. By working with employees, qualified professionals, asking the right questions, evaluating financial impacts and devoting necessary time for a serious investigation into leasing and purchase opportunities, real estate investment and business operations risk can be successfully managed.

Generally leasing business property has the following business advantages:

- **Maintains business capital and lines of credit.**
- **Provides for the tax deduction of lease payments.**
- **Provides control of business cash flow.**
- **Offers cost stability for the lease term.**
- **Has a lower initial cost than property ownership.**
- **Affords greater flexibility in amount of space controlled.**
- **Location mobility to meet market needs or relocation to a better facility.**
- **Enables expansion and contraction capabilities.**
- **Is leasing an easier process than a property acquisition?**
- **Removes the risk of loss from physical, functional and economic obsolescence.**
- **Allows owners or managers to focus on core business functions and not property management functions.**

Although commercial and industrial real estate values have fluctuated, the long term property value trend has been upward and many businesses that have owned real estate have realized property appreciation. Our current market has witnesses a resurgence of the office condominium (initially introduced in the early 1980s) and strong demand for single tenant buildings. Both create ownership opportunities for small and medium size businesses.

Owning business property has the following advantages:

- **Eliminates risks associated with rent increases.**
- **Enables the use of financial leverage.**
- **Provides potential benefits from property appreciation.**
- **Allows tax deductions for depreciation.**
- **May hold an opportunity for rental income from unneeded space.**
- **Ability to customize the property to specific company needs.**
- **Provides an image of strength and stability.**

- **Allows greater control**

Owning the right real estate is, however, the critical question that must be addressed by businesses seeking space. How do business owners and managers select the "right" leased or owned property? How should they go about framing questions and gaining an understanding of real estate market conditions, evaluating and comparing properties and evaluating the financial ramifications of leasing or owning? Clearly, these issues vary as a result of business needs and goals. What is right for one company may be totally wrong for another. The answers to the following questions and the order of relevant importance of the questions depend on the nature of the business, financial limitations, and people (management and employees) involved.

<u>Questions for business owners and managers involved in lease versus buy decisions.</u>

<u>1) Understanding the Long Term Cost of a Lease versus the Cost to Purchase.</u>
The cost of a lease versus purchase problem can be evaluated through a discounted cash flow analysis. This approach considers the cost of leasing and purchase by evaluating the flow of payments, tax benefits, facility operating costs, interest rate on the loan, lease rates and other financial commitments for each alternative. The difficulty with this is that <u>assumptions</u> must be made regarding business space requirement for the property, operating costs, residual value of the purchased property, future market rental rates, and the cost of capital. This calculation can be first or last question in our analysis list. The outcome of this analysis depends on several assumptions that must be made. Generally, if a modest amount of property appreciation is included in the analysis, owning the property will have a higher net present value than leasing.

<u>2) Determine Long Term Space Needs, Location Requirements and Facility Amenities.</u>
This is a complex question that varies according to each business. This is the most important question to address because it defines, whether or not the space is leased or purchased, what the business space requirement will be in the long term and the ultimate contribution the new space has on business operations. It is important to obtain employee input into this question and in some cases a space planner should be retained to aid in the discussion of facility needs.

<u>3) Understanding the Real Estate Market.</u>
This is the most challenging aspect of real estate decision-making facing business owners and managers. To be effective in understanding the tradeoffs involved between properties, locations and leased versus owned options. A substantial amount of time must be devoted to following market conditions, potential properties and the operational costs associated with each viable property inspected. This is not easy, is distracting, and takes a great deal of time away from core business duties. Working with an experienced and knowledgeable broker is critical. A good broker will assist in the delineation of space requirements and work within budget

constraints. A good broker will aggressively obtain property information from the owner or lessor's agent and negotiate on your behalf. I have even heard of examples where an agent has obtained permission from the owner to interview the tenants in a property under consideration. The most important component of this is that the business owner and manager must take the time to evaluate and understand the properties and locations available and interface market opportunities with business needs. This takes time---sometimes a lot of time. Space planning and investigation of market investigation should begin at least 12 to 18 months prior to a lease expiration.