



LEASE VERSES OWNING ANALYSIS

By Joseph Larkin, CCIM

Every business that occupies real estate should make an informed decision on owning the real estate that they occupy or to lease a building. The user needs to first evaluate the qualitative aspects of leasing and owning, both the positive and the negative aspects.

The next step is to identify a potential space that is available for lease and a building that will meet the user needs. When a potential user of commercial real estate is evaluating a lease versus own decision, the user is really analyzing the investment value of leasing versus owning a building.

Investment value is a concept that is personal to each individual user. Each investor's investment value differs based on its situation or needs, location, building features, personal finance, or a tax situation can affect investment value. Knowing what components define investment value is crucial when deciding to lease or to buy.

Market value is a concept that refers to the external value of a property. It represents the probable price a seller can obtain at a specific point in time from a typical buyer under normal conditions. Market value differs from investment value. Investment value is used in the decision process to lease or to buy.

LEASING SPACE

Leasing is a means of obtaining the physical and partial economic use of a property for a specified period without obtaining an ownership interest. The lease contract is a legal document in which the owner (lessor) agrees to allow the user (lessee) to use the property for the specified time and under specified conditions. In return, the lessee agrees to make periodic payments to the lessor.

Advantages of leasing:

- **Availability of cash.** Most lease arrangements have fewer restrictions than loan agreements, providing flexible financing. There is little initial cash outlay in leasing. In addition, leasing is well suited to piecemeal financing. A firm that is acquiring assets over time may find it more convenient to lease than to negotiate term loans or sell securities each time the firm makes a new capital outlay.
- **Flexibility.** Leasing can provide more flexibility for many owners who may need cash to invest in their main business (inventories, salaries, equipment, etc.). It may be more prudent and profitable to use their financing capabilities to run the main business than to invest in real estate to house the business. Avoidance of a down payment frees up that money for other uses. Opportunity costs will be an important consideration for the investor.
- **Ability to depreciate land.** You can't depreciate land if you own it! Since the lease payments will reflect both the lessor's investment in the building and in the land, the lessee in effect is able to depreciate the land by deducting the full amount of the lease payment for tax purposes.

- Tax relief. Leasing also can provide some tax relief because the lessee can deduct the full amount of the lease payment for tax purposes, thus participating in the tax advantages of ownership in a limited way. If a lease is triple-net, the lessee will pay its portion of property taxes and can deduct them as an operating expense for tax purposes.
- Source of financing. Leasing is often the only available source of financing for the small or marginally profitable firms since the title to leased property remains with the lessor, reducing the lessor's risk in the event of the firm's failure. If the lessee does fail, the lessor can recover the leased property. Also, leasing is said to provide 100 percent financing because most borrowing requires a down payment. Here is no down payment with leasing.

Other Advantages to Leasing:

- Low risk of obsolescence. It may be possible for the lessee to avoid some of the risks of obsolescence associated with ownership. The lessor will charge a lease rate based on its required rate of return on the investment property. The net investment is equal to the cost of the asset minus the present value (PV) of the expected salvage value. If the actual salvage value is less than originally expected, the lessor bears the loss. The real question is what will be the demand for the property in the future and how much will it be worth?
- Stability of costs. Leasing tends to smooth out the expenses for the lessee. Because lease payments are a continual monthly outlay, earnings tend to appear stable when assets are leased rather than owned. This can be very important to businesses that must strictly monitor cash flows or have seasonal cash flows. The ability to accurately anticipate costs is very important to many businesses.
- Spatial flexibility/mobility. Leasing can provide more flexibility if a business expands or contracts. It also provides more mobility if a business needs or wants to relocate.
- Cash flow. Most businesses run on cash flow and are valued based on cash flow. It would be unfortunate if a business purchased a property and then lost money in the sale of the business due to reduced sales caused by reduced inventory, equipment training, etc.
- Technology. Leasing can allow a commercial user to respond to technological changes more quickly. Some businesses need to be on the cutting edge of technology and moving may be the most efficient way to accomplish that goal.
- Location. Leasing can allow the user to be at a premier location that would not be affordable otherwise.
- Focus. Leasing allows concentration on the primary business without the distraction of managing real estate.

Disadvantages of Leasing

- Cost. For a firm with a strong earnings record, good access to credit and the ability to take advantage of the tax benefits of ownership, leasing is often a more expensive alternative. Individuals and smaller firms, however, may find that leasing and borrowing terms are approximately equal-
- Loss of the asset's salvage value. In real estate, this loss can be substantial. A lessee also may have difficulty getting approval to make property improvements on leased real estate. If the improvements substantially alter the property or reduce the potential range of its uses, the lessor may be reluctant to permit them. The lessee may consider these important. They may range from technological changes necessary to the business, physical changes to accommodate staff, or cosmetic changes to impress customers.

- Contractual penalties. If a leased property becomes obsolete or if the capital project financed by the lease becomes uneconomical, the lessee is legally obligated to keep paying the lease and may not cancel it without paying a penalty.
- Taxation. Leasing provides only limited tax relief.
- Appreciation. Leasing does not provide participation in property appreciation.

Other Disadvantages:

- Control. Leasing does not allow control of other tenants. New neighboring tenants may not conform to the type of image the lessee seeks. New tenants may create demands on the physical plant that the lessee was not anticipating.
- Operational control. The lessee has no control over business amenities. The lessor may cancel the lease on an inexpensive sandwich shop that was attractive to the lessee's employees. Communal amenities like conference rooms may be closed and leased for profit. New building personnel may not provide the same level of service as the lessee originally enjoyed.
- Changes. The lessee may have to accept changes to the space that the lessor wants but the lessee opposes. For example, the lessor may decide to install all new lighting to lower costs, but the lessee may not feel this is necessary and may not want the disruption to business.

OWNING THE PROPERTY

Owning is a means of obtaining the full economic use of a property for an unspecified period by obtaining an ownership interest. If an owner is also a user, physical use of the property would be obtained as well. While there may be a mortgage contract to borrow funds to purchase the property, owners are generally free to use the property as they wish, even though they are obligated to the mortgagor.

Advantages of Owning:

- Tax savings. The owner of a property is entitled to the tax savings resulting from cost-recovery rules, mortgage interest and the cost of tenant improvements during the holding period and when the property is sold.
- Appreciation. The owner of an asset, a building in particular, is entitled to all of the appreciation in value.
- Income. Income from tenants can be used to pay the mortgage on the property or may be used to fund the owner's principal business or be used for other investments.
- Control. The user or investor who owns a building has, within the limits of the law, freedom to operate the building as it sees fit. Being able to control the appearance of a site and take advantage of the prestige of its location may be important to certain businesses. Other owners, perhaps nearing the end of their holding period, may wish to keep expenses low. Ownership also allows control of costs.

Disadvantages of Owning:

- Initial capital outlay. Cash down payments to acquire the property may divert cash that could be used to finance the company's operations or other investments.

- Financing. Often a company's ability to obtain a loan will not only depend on its financial but also will depend on the financial marketplace.
- Liability. A mortgage loan or a deed of trust can affect the balance sheet (by increasing long-term debt) and the related debt restrictions sometimes required by a lender
- Legal compliance. Compliance with changes in laws or zoning may be unforeseen, costly, and unavoidable.
- Risks. There are risks to ownership, such as potential damage, obsolescence, and the inability to sell at preferred prices at the right time.
- Inflexibility. Space may be inflexible and cannot be enlarged or reduced depending on business fluctuations or other forces.

All the advantages and disadvantages of the specific situation should be evaluated carefully to determine the most beneficial acquisition method to use. Once they have been considered, the cost associated with each option then should be analyzed.