REAL ESTATE LEASE VERSES BUY

When it comes to real estate for small business owners, the prevailing philosophy is that owning the real estate is always better than leasing, therefore, the lease-verses-buy analysis is seldom considered. If a business is trying to decide whether to lease or buy, a short financial exercise can help make a decision that will maximize the profit potential of the venture.

To analyze the lease-verses-buy decision, it is beneficial to look at the cash flows in three phases: 1) Costs incurred to take possession of the property, 2) Expenses required to keep possession of the property, and 3) Income or expenses realized upon vacating the property.

Costs of taking possession include a security deposit, tenant improvements, or a down payment on a loan. If substantial tenant improvements are required and you have the cash in hand to complete the tenant improvements, you might consider purchasing. You can use your capital as a down payment, and finance the improvements along with the real estate through a single loan. To assist entrepreneurs, the Small Business Administration grants very competitive loans that require as little as 10% down. This program gives a good incentive for business owners to purchase property with fewer costs up front relative to other commercial loans.

While considering expenses associated with taking possession, it is important to consider opportunity costs. If the return from your business is greater than the return you expect on a real estate investment, you might consider leasing and using the extra capital to expand your business in other locations. Leasing to leverage capital has been successfully implemented by publicly traded growth companies such as Walgreens and Starbucks.

Once in control of a property, business owners will incur costs to maintain possession. The largest real-estate expense required to keep possession of a property is a bank loan or lease payment. In the lease-verses-buy analysis it is necessary to consider how these payments may adjust over time. Lease payments usually have an escalation clause and bank loans may have a periodic rate review that can impact payments. If you anticipate being in the same location for 20 or more years and have purchased, you may pay off your loan and have a period of time where there are very few real estate expenses incurred. Because of the principal reduction that is realized in a purchase scenario, leasing usually provides a lower payment to maintain possession of the property unless a substantial down payment is made when the property is purchased.

The cost of vacating the property is also important to consider. Upon vacating the property there may be income received or expenses incurred. These can include a security deposit returned or proceeds or losses from the sale of the property. Those who purchase expect the proceeds from the sale will more than offset the principal reduction payments, the down payment, and provide a return on their cash invested. If that projected return meets your required return for a real estate investment then purchasing is the right choice, assuming the interest component of the loan payment is comparable to what a lease payment would be. If the return is less than what you would expect from a real estate investment, then you are better off to lease and deploy your capital into a better opportunity.

The lease-verses-buy analysis is an extremely valuable tool that can be used to reduce costs and maximize the overall return for your business Consult with your commercial real estate broker or investment advisor for details for how to further implement the lease verses buy analysis for your business.

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