Leasing versus Buying Business Location

Should you lease business property for your factory, warehouse, store or office, or should you buy it? The assistance of a financial advisor is strongly recommended, as the decision is important and fairly complex.

References:

Buy or Lease? Commercial Property Decisions

Buy or rent office space? Here's how to decide

Although costs for the space from which you want to operate your business are significant, the buy or lease decision is more than a financial decision. Three factors should be evaluated: **Market, Financial,** and **Other Considerations.**

Market Analysis

Real estate market research considers those factors that affect the supply and demand for a particular type of space within the specific market area. Conducting this research is a vital step in deciding to buy or to lease because the property must be a good real estate investment if it is purchased. Market information is crucial to negotiating a competitive lease if the property is not purchased. Because the accuracy of the information is so important to the conclusions reached in the Financial Analysis, the data must be carefully developed through Market Analysis.

Financial Analysis

In making the buy or lease decision, the Financial Analysis is used to identify the financial advantage of one alternative over the other. The principal focus of the analysis is to choose the alternative that will provide the needed space at the least net cost. To determine this, the after-tax cost and benefits of owning the property is compared to the after-tax cost of leasing the space. All other things being equal, the course of action with the least net cost is chosen. Because lease payments, operating expenses, depreciation and interest are deductible expenses, the analysis is usually made on an after-tax basis.

When considering a multi-tenant building and leasing space, the consequences of becoming a landlord are added to the analysis. By investing sufficient equity to purchase or construct a multi-tenant building, the owner acquires an income stream from the building's other tenants.

Assume you can either purchase a building / space or lease it for five years. If it is purchased the following need to be considered:

- Cost plus closing costs.
- Balance to be financed.

- Interest rate and period of the loan.
- Building's depreciable value, and annual upkeep.

Because annual operating expenses, depreciation and interest are tax-deductible, the actual **cash outflow associated with purchasing the building is:**

Operating expenses plus mortgage payments, minus the tax shield provided by the deductible expenses.

To make an appropriate comparison with a five-year lease, it is necessary to assume the property will be sold at the end of the fifth year and to estimate the after-tax cash flow from resale. The property's estimated resale price and estimated after-tax cash flow from resale also need to be considered.

If the building is leased for five years, the annual lease payments need to be considered, including any yearly increases. Annual lease payments are normally due in advance. However, in some cases monthly arrangements can be made. The tenant will pay all operating expenses. For this comparison, the annual operating expenses would be estimated to be the same as if purchasing the building or space. Because the lease payments and the operating expenses are tax deductible, the **after-tax cost of leasing is:**

Lease payment(s) plus operating expenses, minus the tax shield provided by the deductible expenses.

This process will indicate if there is a financial advantage to buying or lease the property. However, this advantage is dependent upon the assumptions made about the resale of the property at the end of the fifth year. Without the resale benefits, the total cost of leasing the property may be less than buying the property. Therefore, the assumption of a percent annual increase in the property's value is critical. This indicates the dependence of the financial analysis on the market analysis. The use of a resale assumption does not imply that the property must be sold; rather, it is used to estimate the net equity in the property so that buying can be compared with leasing over the life of the lease.

Other Considerations

The decision of whether to buy or lease real estate is much more than a financial decision. The following points should be considered:

1. Business enterprises need space to conduct their business activities but, in most cases, real estate is not their principal business. If the firm leases needed space, it can adjust the amount of leased space as market requirements change. If the firm owns real estate, adapting quickly to changes in the market may be more difficult because of the time required to plan and construct a property or to buy a property when more space is needed or to sell the property when less space is needed.

2. If a multi-tenant building is to be used, the business also becomes a landlord. Aside from the other consequences of owning real estate, how will being a landlord fit in with your other business activities?

3. An existing building can be inspected to determine its quality and its suitability for the business enterprise before it is leased or purchased. In certain markets, an existing building's market value may be less than its replacement cost; if the space is suitable for the business, it can be obtained at an attractive price. How does buying an existing property differ from constructing the property? A newly constructed property should have no functional (or other) obsolescence and should be designed especially for the

user's needs; however, when completed, the new building may be unsatisfactory and may have cost more than planned or both.

4. Balance sheet issues may be important to a company making the buy or lease decision. For example, future borrowing restrictions resulting from real estate debt may be a concern; if so, leasing to keep real estate off the balance sheet may be an attractive option. The buy or lease decision melds the Market and Financial analyses with other business considerations. This might result in a decision to lease, even though purchasing the property appears to be financially advantageous.

Factors Favoring Leasing

Leasing eliminates the immediate need for sizable amounts of cash up front.

- There can be no down payment, other than one or two months of prepaid rent.
- Lease charges are spread over a comparatively long period of time; individual payments can be lower than service on debt.

Restrictions placed on business' finances are usually fewer than what banks require.

Lease payments are deductible operating expenses for tax purposes.

When leased, property ownership remains with the lessor; consequently, the risk of a decrease in property value ***lies with the lessor, not you.***

Lessors are frequently willing to take more credit risk than a bank might be willing to take (i.e. lease financing might be available where traditional bank loans are not).

Operating leases are not shown as liabilities on the balance sheet.

Factors Unfavorable to Leasing

Leasing is frequently more expensive, in the long run, than buying.

- If you buy, you can deduct for tax purposes both depreciation and interest on the money borrowed to purchase the property.
- Interest rates "implicit in the lease" are usually higher than those charged by banks.
- If you don't closely track dates specified in some leases, there is a risk of incurring significant additional charges. For example, failure to exercise a purchase option by the date specified can result in costly additional monthly payments.
- Annual lease payment may be due in advance.
- Leased property cannot be used as collateral.

Kinds of Leases

Accounting standards classify leases as either "operating" or "capital" leases.

Capital leases result in an asset and a liability being shown on the lessee's balance sheet, similar to how an asset purchased with a loan would be shown. The accounting and tax rules contain separate specific criteria to determine whether the lease is to be capitalized. Among others, these include leases where ownership is transferred to the lessee at the end of the lease or a purchase option is included. Accounting / tax advisors can assist you in applying these rules. All leases which are not "capital" leases are "operating" leases.

Lease payments under operating leases are deducted in the year paid. Leases, that are "capital" for tax purposes, require that the assets be amortized and a portion of the payments used to reduce principal.

Other Lease Terminology

Net Leases:

- Lessee responsible for maintenance, taxes, and insurance.

Gross Leases:

- Lessor responsible for maintenance, taxes, and insurance.

Making the Lease versus Buy Decision

The worksheet below can be used to catalog information to helpful in making the Lease versus Buy decision.

Using a Net Present Value Analysis approach is a good way to compare alternatives on a financial basis. This method can be made using computer spreadsheet software or a financial calculator. The same analysis technique may be used if you are considering purchasing property with internally generated or accumulated cash reserves of the business.

As noted above, a lease which contains an option permitting the lessee to buy the property may be considered as a “capital” lease so that none of the payment is deductible as rent.

Buy or Lease Analysis

A. Buy

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Equity investment	$28,000					
Operating expense		$3,500	$3,605	$ 3,713	$ 3,825	$ 3,939
Depreciation		2,043	2,128	2,128	2,128	2,128
Interest		7,125	6,993	6,849	6,691	6,519
Total expense			$12,726	$12,690	$12,644	$12,586
Tax rate			0.31	0.31	0.31	0.31
Tax shield		$ 3,927	$ 3,945	$ 3,934	$ 3,920	$ 3,902
Operating expense		3,500	3,605	3,713	3,825	3,939
Interest		7,125	6,993	6,849	6,691	6,519
Principal		1,386	1,518	1,662	1,820	1,992
Tax shield		(3,927)	(3,945)	(3,934)	(3,920)	(3,902)
Annual after-tax cost of buying		$8,084	$8,171	$8,290	$8,416	$8,548
After-tax cash flow resale						$33,454

B. Lease

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Lease payment	$10,000	$10,300	$10,609	$10,927	$11,255	
Operating expense		3,500	3,605	3,713	3,825	$3,939
Total expense	$10,000	$13,800	$14,214	$14,640	$15,080	$3,939
Tax rate	0.31	0.31	0.31	0.31	0.31	0.31
Tax shield	$ 3,100	$ 4,278	$ 4,406	$ 4,538	$ 4,675	$1,221
Lease payment	10,000	10,300	10,609	10,927	11,255	
Operating expense		3,500	3,605	3,713	3,825	3,939

Less tax shield	(3,100)	(4,278)	(4,406)	(4,538)	(4,675)	(1,221)
Annual after-tax cost of leasing	$6,900	$9,522	$9,808	$10,102	$10,405	$2,718

C. Summary of the Analysis

	Buying	Leasing
Initial outlay	$28,000	$ -0-
Present value of annual cost	31,387	40,046
Total cost	$59,387	$40,046
Present value of after-tax cash flow from resale	(20,772)	-0-
Net cost	$38,614	$40,046

LEASING - BUSINESS LOCATION

Before you sign a lease ***for your business facilities***, be sure your business has a solid business plan in place, which is also necessary if buying. Consult an attorney for approved wording of the lease agreement.

When considering a lease, determine:

1. Are you required to carry insurance on your part of the building?
2. Does the landlord have liability insurance?
3. Do you have the right to sublet?
4. Are there provisions for expansion?
5. What restrictions are there on the use of the property?
6. Is there plenty of parking space? (Check the parking lot on a busy day.)
7. Is the rent high or low in relation to the area and facilities provided?
8. What provisions are there for renewal or canceling of lease?
9. How much must be spent on renovating, carpet, shelving, counters, decorating? Will the landlord pay for some of this through a build out or refurbishing allowance?
10. Will building codes permit your plans for renovation?
11. Do zoning laws permit your type of business?
12. Will a building permit be required when a structure is changed?
13. Who furnishes heat, light, water and repairs inside and out?
14. Are there mutual waivers of subrogation (see Note below for sample wording)?

It’s advisable to have an attorney and perhaps your insurance agent review the lease prior to signing it. Check City, County and State offices to learn whether there are plans to build a new highway or relocation of existing ones that might affect traffic flow for the area.

Note: Following is sample wording for waiver of subrogation:

Landlord and Tenant each hereby waive any and all rights of recovery, claim, action or cause of action against the other for any loss or damage that may occur to the premises or any improvements thereto, or any personal property of Landlord or Tenant, arising from any cause that :

- Would be insured against under the terms of any property insurance required to be carried hereunder; or
- Is insured against under the terms of any property insurance actually carried, regardless of whether the same is required hereunder.

The foregoing waiver shall apply regardless of the cause or origin of such claim, and shall not apply if it would have the effect, but only to the extent of such effect, of invalidating any insurance coverage of Landlord or Tenant.

Sources: Entrepreneur Media, Inc. ©1993, Revised 9/2007, and
Tierra Grande, the Real Estate Center Journal, Spring 1995, Instructor's Notebook

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