



Area Development

SITES AND FACILITY PLANNING

FACILITY PLANNING

TO LEASE OR TO OWN: THAT IS THE QUESTION

The decision to lease or to purchase commercial real estate is facilitated by following a relatively simple process, as outlined herein.

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As the commercial real estate markets around the country slowly struggle to recover from the current economy, businesses will begin to view real estate in a different light. Commercial real estate will again become a commodity, providing corporations with increased equity and forcing companies to evaluate whether to lease or own their facilities in the future.

This determination will be based on a variety of decision-making factors, including whether the entity is a publicly held or private corporation, a partnership or a sole proprietorship. Some corporations may not want to tie up capital in real estate because they feel their funds would be better spent increasing inventory or expanding internal operations. Others may find that if they plan to be in a particular market for an extended period of time and require extensive improvements to the property, owning rather than leasing makes more economic sense.

LEASING PROS AND CONS

A variety of factors are involved in the decision to lease or own a particular property. Should a company be interested in leasing its manufacturing or distribution facility, some benefits may include the following:

- Entering into a lease for the property often involves minimum cost.
- Typically, a tenant improvement allowance can be negotiated to offset a majority of the improvements.
- Depending on the tightness of the market,

some amount of free rent can be negotiated to offset relocation costs.

- The leasing scenario provides the company with flexibility in the long term. Should needs change over time, the tenant has the ability to either sublease the facility, terminate the lease with a buy-out provision, or

One decision-making factor is whether the entity is a publicly held or private corporation, partnership or sole proprietorship.

relocate at the termination of the lease to a facility that better fits its needs. Although there is some exposure in vacating the property prior to the expiration of the lease, these costs can often be mitigated.

Most companies are unable to foresee the future needs of their businesses and therefore prefer to lease rather than purchase the property, thereby gaining flexibility. However, in many instances a company will find that it has been in the same facility for 10 or 15 years and could have purchased the building several times with the money that was paid in rent over the life of the lease.

Purchasing property often is difficult for companies once they have been in the building for a long period of time. The facility is now much older and probably requires significant maintenance and upgrades. As the new owner of the property, the company would now be responsible for those upgrades. Additionally, if a company has installed extensive improvements specific to its use, it becomes difficult to relocate because of the cost of moving equipment and machinery, as well as the cost of downtime during the relocation process can be expensive. This scenario provides very little renegotiation leverage at the termination of the lease if the landlord is aware of the costs involved. Therefore, the company may wind up paying a premium to remain in the building.

Another negative aspect of leasing property for manufacturing and distribution is that typically these leases are on a triple-net basis, placing the burden of maintenance, taxes, and insurance on the tenant without affording the benefits of owning the property. Roof maintenance, air conditioning, landscaping, etc. fall within the tenant's realm of responsibilities. These costs can be significant, and the landlord then reaps the benefits of the tenant's improvements to the building. Should the tenant own the property, these improvements can be depreciated over time and potentially incorporated into a refinancing package.

In many financial analyses, little difference exists between signing a long-term

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lease and owning the property. However, should the tenant be forced into a long-term obligation at higher than market rental rates, the tenant is then locked into these future obligations. This may put the tenant in a negative position as compared to competitors who have less overhead expense.

THE PURCHASING OPTION

There are several advantages to purchasing a facility, depending on the size and structure of a company. For example, creative financing from the seller who is willing to carry back a portion of the down payment would reduce the company's initial cost to acquire the property. Additional funding sources such as the Small Business Administration (SBA) assist smaller, privately held companies to acquire properties with as little as 10 percent down. This type of financing also incorporates the cost of any initial improvements to the property into the overall financing package. Typically, purchasing property requires 30–40 percent as a down payment plus additional costs to make necessary improvements to customize the building. This can make purchasing the property prohibitive.

There are also tax benefits to owning the property, such as the ability to depreciate equipment and improvements over a longer period of time. When the company is a partnership, closely held corporation, or family-owned, the shareholders or owners have the ability to purchase the property and lease it back to the corporation. This provides additional tax benefits for the owner. If an individual owns the building and the company is sold, the real estate can be retained for investment purposes. In the case of large corporations, if a subsidiary or operating unit functionally does not fit in the building, the company can re-lease it to another company.

As with leasing, there are drawbacks to owning commercial property, including the lack of flexibility should the company outgrow the facility or should the facility become functionally obsolete. The exit strategy in this case is to relocate and incur the expense while either re-leasing or selling the owned facility. Depending on the market conditions at the time, the property may be worth less than what was paid for it. The property may also require significant improvements in order to re-lease it to a third party. In this case, the company will incur additional expense to dispose of the property and lease a new facility.

Another disadvantage to owning property is that many companies feel that their money is better spent in their operating budget rather than tied up in real estate. For those corporations that can receive a better return from using the funds elsewhere,

buying commercial real estate may not be the right answer. Commercial real estate markets across the country are rebounding, and now is an opportune time to invest in real estate if this fits within your business plans and financial parameters.

For small businesses, closely held corporations, sole proprietors, and family-owned businesses there are significant advantages to owning the property, both from a financing standpoint as well as to build equity on the balance sheet so as to increase the value of the corporation. Large corporations with multiple facilities often have a different valuation process because many corporations today are constantly changing their business plans and consolidating to adapt to workplace and marketplace changes. Since SBA funds are not available to large corporations, motivation to buy should be based on the availability of funds and the opportunity cost of that money, plus the future value of the property.

Regardless of the structure of the company, all factors must be examined in making the decision of whether to own or lease. Most important, the company's business plan — and not the real estate — should dictate the decision. □

The Saywitz Company is a national commercial real estate brokerage and consulting firm specializing in assisting corporations in the leasing and purchasing of commercial real estate and can be reached at 949-930-7500 or www.saywitz.com.