LEASE VS. OWN: NO SUCH THING AS A "ONE-SIZE-FITS-ALL" SOLUTION

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Corporate executives and leaders are often concerned about whether their company should lease or own its real estate asset(s). However, determining whether a company should be a tenant or an owner of its premises is not an easy task and it requires a complete cost analysis and evaluation. In the recent past, due to favourable accounting treatment as well as declining capitalization rates, operating leases were particularly favoured financing vehicles for corporate real estate needs. Economic conditions however have dramatically shifted following the 2008 financial melt-down, which impacted the attractiveness of leasing premises.

**Economic Environment**

Analysing the economic conditions is critical to any lease vs. own analysis. Such review should take several economic indicators into consideration such as interest rates, capitalization rates, property values and capital market rates of return, all of which are by nature fluctuating. The face of the real estate industry has changed following the fall of 2008. In the United States, commercial property values experienced a steep decline, in majority due to reduced rental revenues and increasing vacancy rates. Concurrently, the capital markets were also undergoing a drastic correction, requiring significantly higher rates of return on real estate investments, causing an increase in capitalization rates. The real estate market in Canada was not severely impacted by the later combination, but similar effects were noted. Just 24 months later, the opposite was observed with sharp decreases in cap rates that mirrored long term bond yields.

The lease vs. own question is in essence a financial decision, but decision-makers should not overlook aspects such as expense deductibility, opportunity cost, risk, flexibility, quality and investment strategy.

**Tax Deductibility**

The lease vs. own debate should not limit itself to the core expenditures relating to the occupancy of the premises, but rather decision-makers should pay special attention to after tax implications. Indeed, one of the benefits of property ownership is to leverage tax advantages, which are out of reach for tenants. In Canada, tenants may only write-off their lease payments as opposed to commercial property owners who may write-off: loan interest costs and depreciation thus yielding more tax advantages.
Cost of Ownership vs. Leasing

From a pure operating perspective, ownership may seem more expensive than leasing. First, ownership requires a significant initial input of capital to acquire the property (initial down payment, interest rate on mortgage, legal fees, etc.). Plus, in most instances, even more capital is required to retrofit the property for the business operations of the company. Hence many corporations are not interested in acquiring real estate assets.

Once the acquisition is completed however, the real estate owner will benefit from regular payments that are either equivalent to or less than leasing or may even create some inflows in situations where the owner uses only a portion of the property and rents the excess space. But what truly distinguishes between lease and own cash flows, is the potential cash inflow resulting from the sale of the asset. In underperforming markets, acquiring prime real estate at the right price may be a wise investment.

Opportunity Cost

Unfortunately corporations may not have their cake and eat it too; they must make a decision between lease and buy. When a company acquires a real estate asset which they occupy and operate from, it is foregoing the potential collection of fair market rent for this same space from a third-party. The cost of ownership is not limited to mortgage obligations and operating expenses, but also includes the opportunity of cost of this same rent the user didn’t collect.

Opportunity cost should be addressed, however, this cost only has importance if one analyses the cost of owning a property as a User against owning a property as a Landlord. In most lease vs. buy scenarios the opportunity cost becomes irrelevant because, for most companies, the decision is made between becoming a user or a tenant and not the investment decision to acquire real estate as a Landlord. Furthermore, the analysis must take into consideration the corporations weighted average cost of capital (W.A.C.C.). Does the yield on equity in the real estate outperform alternate demands on equity?
Flexibility and Quality

Before making any decision on lease vs. buy, real estate executives should develop a long-term real estate strategy and ask themselves whether their company is anticipating any expansion or contraction of their physical plant in the next five years. This strategy should address any expected growth in personnel, floor plan optimization and production capacity. Acquiring a larger building than what the corporation requires can provide additional benefits. Not only would the company maximise its tax benefits, but the excess space could generate revenue once leased and would provide growth potential and flexibility.

While a corporation should acquire assets based on quality and flexibility, the focus of all acquisitions should be put on building design. Indeed, as embedded in an investment strategy, acquisitions should be made for assets that could accommodate future growth as well as maximising the resale value. Corporate executives and leaders should be looking for the right property, suitable for their operations, offering growth potential while still abiding by long-term sound real estate principles.

CBRE Financial Consulting Group - Sample Lease vs. Own Report
"Location Location Location"

Some business owners and real estate managers are open to purchase assets, however, some business activities, such as retail, are location-driven and unfortunately the right property is often not available to buy. A real estate broker becomes especially instrumental to guiding the client in the marketplace. With access to unparalleled market information, a CBRE broker can assist corporations in making an advised decision by providing a complete review of all available properties on the market, whether for lease or sale. The same market data then becomes the basis of the negotiation with the potential Seller and/or Landlord.

Financing and Risk

Some corporations are reluctant to acquire real estate and would prefer to keep the capital available for business growth. Although the purchase of real estate assets will indeed freeze a large sum of money, real estate decision-makers should know that there are various ways of structuring an acquisition with financing which would limit the risk for the organization.

No lease vs. own analysis would be complete without a risk assessment. Indeed, the debate should not be between “own or lease” but rather “long or short”. A company which makes the decision to leverage the advantages of purchasing real estate assets should quantify the risk associated with the acquisition and understand the market where the asset is located.

The reason for acquiring real estate should not be based on the potential appreciation from the sale of the property. Unfortunately, this cash inflow is not guaranteed, and highly depends on building design, quality, flexibility, real estate market conditions and timing. If a company is experiencing important changes in size, operations, etc. ownership may be a risky venture. If however, the business is stable and has a well defined long-term strategy, purchasing a real estate asset may be an interesting scenario.
The last couple of years taught us that market conditions may shift drastically, therefore corporate executives and leaders should implement strategies for creating flexibility in their existing leases. CBRE offers a variety of services to assist clients in developing long-term real estate strategies. Indeed, corporations should negotiate leases offering exit solutions should major changes affect operations or should the perfect acquisition opportunity arise in the market. With the help of CBRE’s Tenant Representation Specialists, companies can reinforce their strategic position by negotiating early termination clauses, options to purchase, and first right of refusal on a potential sale of the property.

When it comes to the lease vs. buy decision, there no such thing as a one size fits all solution. Each situation must be addressed individually and CBRE can be of assistance in determining what would be the best business solution for a corporation. Our specialized Financial Consulting Group (“FCG”) provides quantitative analysis to assist clients in understanding the financial impact of leasing versus owning. Our professionals understand the issues critical to this analysis and can identify whether ownership or leasing will best meet a client’s stated objective. By using a methodology which takes into account such factors as expansion requirements, lease buyout costs, financing options, and accounting and tax considerations, we empower our clients to make not only an informed decision, but the right decision.

CBRE professionals will involve the appropriate specialists to assist in the process. Such may include Research and Consulting (market data), Debt and Equity Finance (sourcing debt), Capital Markets (market analysis and negotiating expertise), Consulting (workplace strategy) and Management Services (operations).
REAL ESTATE ADVISORY SERVICES

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