Hunt Corp. Commercial Real Estate Q&A: The ultimate tool in evaluating leases - by David Hunt

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Q: We are in the process of deciding where to lease new office space and have several alternatives. What is the best way to financially evaluate two or more leases?

A: The very first step in comparing two or more lease alternatives is to understand the financial impact of each. Of course, there will be subjective considerations in any final decision, but if you do not have an understanding of the financial ramifications, you will not be able to make those subjective decisions clearly. As an example, what exactly will be the financial impact of leasing in a prestigious class A building with all the amenities, as opposed to a class B building?

The absolute best way to evaluate two or more leases, or a buy-lease decision, is a present value calculation of future cash flows. And I will flatly say that no commercial lease should ever be signed without a present-value analysis.

What is a present-value analysis? Simply put, all the costs of occupancy are calculated or estimated for each year of occupancy, and then each of the future costs is converted to today's dollars ("present value") using a discount rate. As you probably know, a dollar is worth less in the future than a dollar today. That is because we can invest today's dollar for a return in the future. This is the basis for a discount rate, which is usually the rate you can obtain in an alternative investment. In the case of large corporate users, the discount rate is likely to be their weighted average cost of capital (WACC.)

We use several modeling programs which are really glorified spreadsheets. Certain assumptions are made in agreement with our client. For example, almost all tenants are responsible for their proportionate share of real estate tax increases. What is that increase likely to be? We could project 3%, or be more conservative and project 5%. The beauty of modeling programs like these is that we can run the programs for both assumptions and see exactly what the impact will be.

Any kind of a definable cost can be entered into the spreadsheet. In a spreadsheet that compares a lease renewal with a relocation, you would want to include moving costs only in the relocation scenario. If a lease requires a security deposit in year one, with its return in year ten, you should show the cash outflow in the first year, and the cash inflow in the tenth year.

There are several compelling reasons to prepare these present value analyses of future cash flows. First, it is an excellent means of completely evaluating the lease and projecting increases. Second, and most obvious, is the comparison of two or more alternatives – the lower “present value” cost is the better financial choice, all other things being equal. Another often overlooked reason for this exercise is to forecast your cash flows. Exactly how much cash will be required in each scenario, and when?

Finally, when comparing two different alternatives, the difference (or delta) between the two alternatives represents the cost of the subjective, non-financial decisions. In other words, is the class A office building really worth an additional $175,000 over the term of the lease? It may or may not be, but the discounted cash flow analysis gives you the total cost of those subjective attributes, and allows you to make the decision accordingly.

Insist that your real estate representative or broker provide you with a present value analysis of each alternative under consideration. You really cannot have a true picture of your actual costs without it.

Do you have a question regarding commercial real estate? Email your question to commercial real estate Q & A, at email@huntcorp.com for possible inclusion in a future column.

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