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Hunt Corp. Commercial Real Estate Q&A: Buy or lease? - by David Hunt

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Q: Everyone seems to think that we should buy, not lease, our next building. What is the best way to make this decision??

A: While every case is different, there are certain underlying factors that drive the best decision in most buy-lease scenarios. These factors are the availability of capital, the alternative use of capital, and the anticipated growth of the firm.

To properly compare these factors and their results, a cash flow analysis should be prepared. This cash flow analysis will show the inflows and the outflows during the desired holding period. Each of these cash flows is then discounted back to its present value ($1.00 today is worth more than $1.00 spent ten years from now.) In this way, any number of lease and buy scenarios can be compared to one another in a very objective manner. As an example, a company may compare a ten-year lease with a purchase. The lease in a cash flow analysis will usually reflect a steady series of outflows that increase with each passing year. A purchase on the other hand, will show a down payment in the first year, fixed series of outflows each year, representing a constant mortgage payment, and a sale of the property in the tenth year. In each case, certain assumptions must be made, such as a discount rate and market appreciation.

One of the most important factors in evaluating leasing and buying is the availability of capital. The down payment and other significant costs in closing are the reason that relatively young companies rarely are able to purchase real estate. All firms need to evaluate their capital requirements, not only now but in the foreseeable future, to ascertain that the real estate does not take a disproportionate bite out of their cash reserves.

Closely related is a firm’s evaluation of their alternative use of capital. This completely depends on the business of the firm and the capital requirements of their product or service. As an example, if a manufacturing firm can generate a 30% return on every dollar invested in the manufacturing of widgets, it would hardly make sense to invest the same dollar in bricks and mortar. There are many Fortune 500 firms who have an established policy of leasing space only, for just this reason.

Finally, the anticipated growth of the firm is very important in evaluating a buy-lease scenario. The reason is that the majority of the expenses in a purchase are upfront. If an insufficient time is available to amortize these expenses, e.g., a relocation of the company three years later, the unamortized expense will make the purchase scenario much more expensive. We have conducted cash flow analyses for our clients over many years, and typically find that the break-even point in a lease-buy scenario is somewhere within five to seven years. So, our general advice is to avoid purchasing a building if a move within the next five years is contemplated.

This also means that purchasing real estate is typically more appropriate for established, stable firms. Fast growing firms, especially those who have trouble forecasting even three years in advance, should concentrate on leasing. Whether you lease or buy, the cash flow analysis is appropriate in every situation, as it can be used to compare multiple lease or multiple buy scenarios, as well as a comparison of the two.

In summary, there is no one solution that applies to every firm in answering the buy-lease question. But with the proper evaluation of these factors in a cash-flow analysis, a clear answer will usually emerge.

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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