A number of factors must be considered when a company is determining whether to lease or purchase operating space. Often there is no right or wrong answer. Each option has its advantages and disadvantages. In this scenario, XYZ is a growing 4-year-old company specializing in communications management technology. Revenue and profits have slowly but steadily increased with employment projected to triple from 50 to 150 in the next three years. Having outgrown its original renovated facility, we asked:

Should XYZ lease or purchase its new office/technology development space?

Strategic Plan Needed Before Purchase

By David Funke

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When reading the case information for XYZ company, there were several critical pieces of data that will have a significant impact on the decision to purchase a building. These critical points are:

"Growing, 4-year-old company" — This company is still getting established. Although all seems to be going well, there is reason to question what the future holds.

"Profits have slowly but steadily increased" — Normally a new company with slow but steady increases in profits is starved for capital to fund expansion.

"Employment projected to triple" — This is a sign of a company expecting explosive growth. Companies projecting this kind of growth are rarely accurate in growth projections. The future is relatively uncertain.

It is common for entrepreneurs and small business owners to be enamored with the idea of owning real estate. There are normally a variety of reasons driving the desire to own versus lease the company facilities, including the following:

- Prestige of ownership — For many business owners, the feeling of owning a company facility is not unlike the feeling of owning one's home. There is often a sense of pride that comes from building equity in real estate instead of paying rent to a landlord
- Control of the space — It is comforting to know that no landlord has the ability, at the end of a lease term, to force the company to vacate the premises
- Property appreciation — Most people make the assumption that real estate is always going to appreciate. Business owners often like to think of the company's real estate as their personal 401(k) plan, with plans to cash in on the accumulated equity when it is time for them to retire
- Cost savings — In a typical year, the occupancy cost associated with owning real estate is generally less than leasing

The assigned task here is to make the case for the business owner to make the decision to purchase a building. This is a very difficult assignment.

If the company owns its real estate it probably will, in fact, enjoy pride of ownership, maximum control of the space, benefit from appreciation and pay less in occupancy cost in any given year. The great fear is the potential cost to the business if ownership proves to be the wrong choice.

In the real world, if a client as described in this case was insistent on buying a building, the logical questions to ask would be:

- What if you outgrow the building?
- What if you need access to the capital you are committing to the real estate investment?
- What if you need to sell the building quickly and there are no buyers?
- How much time do you have to devote to property management related issues instead of running your rapidly growing business?

If, after addressing all of these questions, the client was still committed to owning the building, a possible strategy for the purchase could be as follows:

- Purchase a building that is well-designed for expansion. Make sure the facility, with expansion, will accommodate the growth needs of the company for the foreseeable future **or**
- Purchase a building that lends itself to multi-tenant occupancy. Buy a building with more square footage than is initially needed. Lease the excess space to other tenants on short-term leases. The expiration dates of the leases for the other tenants should be staged to allow flexibility for growth of your company

Whether purchasing a building with expansion capabilities or excess existing square footage, it is

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Flexibility is Key to Growing Business' Success

The decision to lease or purchase a facility in which to operate a business is a critical decision, one with long-reaching implications.

Real estate ownership has several advantages such as potential appreciation, equity buildup, income from tenants as well as the image considerations and perception of stability. On the other hand, real estate is not a liquid investment and a dynamic young company can quickly outgrow a facility, just as the company in question has done with its existing facility.

Business growth is cyclical and market conditions change. Young companies with aggressive growth plans need a real estate solution that will meet their immediate needs and will also accommodate the fluctuation of today's business environments.

The first and most important step in solving the lease vs. own decision is to evaluate what the next three to five years hold in regards to capital requirements and facility needs. The tenant's growth strategy will fluctuate and, in turn, so will its real estate requirement. Given the example of the fast-growing communications technology company, leasing from a real estate company with a successful track record of partnering with expanding businesses could be the best option.

Consider the 'big picture'

There is much more to the lease vs. own decision than a simple spreadsheet calculating present value. Most seasoned commercial real estate professionals will confirm that assumptions such as operating space requirements, cost and availability of capital, future lease rates and sales price projections can easily skew the analysis. Careful consideration of the "big picture" is needed.

There are many advantages to owning real estate. Growing companies, however, need to diligently consider when the time is right to purchase a facility. Once the company has matured, the lease vs. own decision may change. Central to the decision is partnering with a real estate company that can help the business whenever its needs change.

Young, rapidly growing companies should consider the benefits of leasing:

Flexibility

This point cannot be stressed enough. No one likes to talk about the possibility of downsizing; however, the prudent business decision should include this scenario. Leasing allows a company the flexibility to accommodate boom time and slow periods.

Consider leasing from a developer/landlord that creates master-planned business parks. As the company grows or consolidates, the need for available adjacent space is paramount. The real estate company is concerned about creating a long-term relationship with the tenant. By leasing, the opportunity exists for same business park relocation, expansion into adjacent space or consolidation into space across town if the need arises for strategic relocation.

Another consideration is the length of the lease. For young companies that require little or no renovation to a facility, lease terms can be structured with more flexibility. The company's long-term real estate decision can be postponed until the future is clearer, allowing the business leaders to focus on other core business decisions.

Speed to market

In today's fast-paced, competitive, just-in-time environment, companies need real estate solutions quickly to ensure business success. Speculative development, real estate facilities built with the flexibility to accommodate many different uses, fills the need for young, growing companies. The facilities are often in "move-in condition," allowing immediate occupancy. This product availability saves valuable time and attention for company leaders.

Managing capital resources

When purchasing a facility, companies are required to invest a significant amount of equity (down payment) into the building at the time of purchase. Further, the cost of renovation is often an out-of-pocket expense and the mortgage can restrict borrowing capacity. By working with a well-capitalized real estate company, the landlord has already made the down payment, and while a modest security deposit is generally required, renovation costs can be rolled into the lease price.

This enables a company to invest its capital into growing its business, which generally yields a higher rate of return than other investments. As the business grows over time, the real estate partner can similarly help the business expand using the same process.

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By Jay Archer

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Strategic Plan

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absolutely critical for a rapidly growing company to purchase the property with an exit strategy in mind.

What happens if the company grows much more quickly than anyone anticipated? If the property needs to be sold quickly so the company may move to a new facility, the property must be marketable to another user.

Many companies choose to own their real estate, but most do not. If management of this company is capable of clearly projecting the future growth needs of the company and the property would be easily marketed to other users, it may be a very good decision to own, but only after a serious discussion about the strategic plan and the anticipated long-term real estate needs of the company.

Flexibility is Key

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Another capital management benefit is the tenant's ability to deduct 100% of the rent expense against its profit. This deduction is often worth more than the depreciation and interest deduction of owning real estate. Further, young, growing companies need to consider the opportunity cost of focusing on brick and mortar instead of growing their business.

Maturity matters

In short, the subject company's short tenure and aggressive growth plans create a compelling case for leasing a facility. As the company matures and solidifies its business model and long-term growth strategy and becomes better capitalized, owning real estate may indeed make sense. For the time being, the company should partner with a proven real estate provider that has the experience and expertise to manage its real estate needs today and in the future.