Lease or Buy?

Factors to Consider When Buying Commercial Real Estate

By Stephen A. Cross, CCIM

Once your business has established itself as a viable going-concern (at least three years of profitable existence), and providing you can *clearly* anticipate your space requirements over the next three to five years, you should consider owning the property that houses your business.

With that said, there are several critical decisions and factors that warrant careful consideration before proceeding with a purchase of commercial property:

Decision #1: *Have you saved enough cash for a down payment?* Most conventional lenders will finance 90% of the purchase price for commercial real estate to be used in your business. They want you to have an equity position in the property and, in some instances, may require as much as 20% down.

Financial institutions will also require an appraisal of the property … generally from one of their approved appraisers. This appraisal will confirm that the purchase price is reasonable when compared to recent sales of comparable properties. All purchase contracts should contain a contingency provision that makes a satisfactory appraisal a material element of the purchase.

Decision #2: *What is the likelihood that your business may need the down payment amount as future working capital?* Many business owners and corporate decision-makers choose to lease space because they reason the money tied up in an illiquid investment (such as real property) can be better utilized to grow their businesses.

Decision #3: *What type of image do you wish your business to project?* Most of America's businesses do not require prime locations and typically need less than 10,000-square-feet of operating space. Thanks to the availability of business condos, small– to medium- sized office users, medical practitioners, and businesses requiring warehouse and/or showroom space can now readily locate affordable properties to lease or buy.

Decision #4: *Should you buy a building to suit your current needs or invest in a multi-tenant property?* If your business is in a growth mode and likely to expand, you can benefit from property ownership by acquiring a building larger than initially required and leasing the unneeded portion to others. Lease excess space for either short terms or stager expiration dates to provide flexibility. Rental payments your tenant(s) make may contribute significantly to your mortgage payment.

(Seldom Discussed) Factors that Affect Price

The adage that *"price is determined by supply and demand"* oversimplifies the dynamics in today's commercial marketplace. This is because "owner/users" of property are competing with investors for the same *limited number* of properties. To further stack the deck against well-meaning but under-informed buyers, property owners hire real estate agents (aka "brokers") to maximize the value of their property.

Listing agents help increase value by quoting "market" rates or "comparable" sales without fully disclosing factors that, if known, could serve to lower the asking price.

For example, the selling price of existing buildings has been greatly affected by investors making "1031 exchanges." Section 1031 of the IRS code provides for the deferment of taxes on the appreciated value of a property when exchanged for a like-kind, more expensive property. To avoid current taxation, and because of time limitations in completing the exchange transaction, many property buyers have been willing to pay top dollar for the airpark's limited supply of commercial property, thus inflating the "comps."

Another tactic used by property owners to increase value is to write leases with significant up-front rental concessions (free rent, tenant improvement allowance, and the like) in order to attract tenants willing to pay top dollar rental rates. Unlike selling prices, which are part of the public record, rental concessions are proprietary and are seldom disclosed. All too often, unsuspecting buyers pay inflated prices based on the capitalized value of an inflated rental schedule, which then become "comps" used by future buyers and appraisers to help determine and/or confirm value.

In order to make fully-informed decisions, savvy buyers and investors obtain objective information about the market from unbiased, experienced commercial real estate advisors and refrain from representing themselves in *any* commercial real estate transaction. Reputable advisors avoid undisclosed conflicts of interest by never listing properties and are typically compensated on either a fee-for-services or contingency basis, sharing commissions with the listing agent(s) that result from the transaction.

Because there is a limited amount of land within the greater Scottsdale Airpark, in my opinion, it makes good economic sense to invest in a building as soon as practical and economically feasible. In the long run, commercial real estate should be viewed as a significant source of retirement revenue for you and your family or, if you lease space, for your landlord's family. Ⓢ

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