



Lease vs. Buy in REIA

By Frank Gallinelli

In our previous article, we discussed the concepts that underlie a lease vs. buy decision in regard to commercial real estate. RealData's Real Estate Investment Analysis, Version 12.0 contains a module that can help us quantify such a decision. In this article we'll take a brief look at how to use and interpret that part of our software.

The first and most important step is to use REIA to complete a standard analysis of the property - its purchase price, financing, income, operating expenses and potential resale. To do this, we'll use the General, Lease-by-Lease Summary, Annual Property Operating Data, and Cashflow/Resale Analysis worksheets as we would with any income property.

There is one special consideration in regard to the lease information: We must use the first lease block in the Lease-by-Lease worksheet (rows 10 through 34) to describe the space we would occupy, using a rent that we could realistically expect to collect for the space if we were not using it for ourselves. It's important to understand that we're not interested in what rent we might charge ourselves or our business, but rather what rent we should be charging in an arms-length transaction. This is the amount that the unit should generate and it is the amount that we will lose if we move in.

Once we feel confident that we have created a good property analysis we should move on to the Lease vs. Buy module. Entering data into this part of the program will usually take very little time since most of the data used in this worksheet is derived from entries and calculations made in the earlier worksheets.

There are a few items from earlier sheets that we can override here if we wish. For example, we can choose a Present Value discount rate different from the one we used in the property analysis. We want to keep an "apples-to-apples" comparison, and so we assume, whether we purchase and occupy the building or just rent space as tenants, that we will do so for the same period of time. For that reason, we project that if we own the building, we will sell it at the end of the same year that our lease would expire if we just rented. The Lease vs. Buy module will default to the sale year that we entered in the Cashflow Analysis sheet, but as a convenience we can change the year here, without having to bounce back to the earlier sheet.

In reality we may choose to stick with the building longer if we buy rather than lease, but the resale analysis allows us to define the extent of growth in the building's equity as of the lease-end date. That equity growth, if any, would be one of the benefits of ownership, and we should take it into account to make a sensible lease versus buy comparison.

In regard to rent income, the typical situation is one where the income we enter in the first section of the Lease-by-Lease summary is indeed the rent we would lose if we took over the space for our own use and it is also what it would cost us to rent the same or a comparable space. To bump a rent-paying tenant and take over his or her space is not a free pass - so, if you haven't done so already, now would be a good time to review our previous article on the subject of "opportunity cost."

There may be special circumstances where we believe the rent value of owner-occupied space might be different from what we entered in the Lease Summary. If so, the Lease vs. Buy module provides us with a place to override that previously-entered data.

Likewise, we can override our own cost to lease space if we feel it might differ from the Lease-by-Lease Summary. As an example, in our Lease Summary we may have made the assumption that it would be necessary to offer some type of one-shot concession or abatement to secure a tenant. That's fine if we expect to occupy the same space ourselves, because we would lose no more income than we would have received. But if we might be spending to lease a comparable space in another property, then perhaps we would not receive such an abatement. Our total cost to lease there might be higher by the amount of the abatement.

It's that easy; there are no further inputs.

So, what will the program tell us? Essentially, in each scenario - lease space, or buy a building and use a comparable space with it - the program looks at the various cash outflows and inflows and discounts them back to a Present Value amount.

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In the "lease" situation, we are typically looking at periodic lease payments - in other words, a series of outflows. In the "buy" option, we are looking at an initial cash outflow used to purchase the property, followed by periodic cash flows (either positive or negative) as we own, occupy and operate the building and finally a cash inflow when we sell the property.

<i>Cash flows as a tenant leasing 1,400 sf</i>		
	<i>Before Taxes</i>	<i>After Taxes</i>
2001	(18,065)	(11,562)
2002	(20,260)	(12,967)
2003	(22,484)	(14,390)
2004	(22,537)	(14,423)
2005	(22,590)	(14,457)
2006	(22,644)	(14,492)
2007	(25,499)	(16,319)
2008	(28,356)	(18,148)
2009	(28,413)	(18,184)

<i>Cash flows as an owner occupying 1,400 sf</i>		
	<i>Before Taxes</i>	<i>After Taxes and Reserves</i>
Initial Investment	(552,641)	(552,641)
2001	24,268	12,559
2002	41,320	26,621
2003	41,790	26,312
2004	52,669	32,602
2005	56,468	34,293
2006	50,937	26,457
2007	61,084	35,605
2008	72,353	41,826
2009	1,216,303	1,079,987

(80,652) = Present Value of Cost to Lease
(assuming lease runs to end of year 2009;
estimated cash flows are monthly, after-tax and are discounted at
11.5% per year.)

(21,828) = Present Value of Cost to Buy and Occupy
(assuming sale at end of year 2009;
estimated cash flows are monthly, after-tax and are discounted at
11.5% per year.)

Positive amounts are net gains; negative amounts are net losses.

Preferred choice is to buy and occupy.



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What we find in this example is fairly straightforward. Leasing is money out the door. When we discount back all lease payments at 11.5%, the Present Value of those payments is a negative \$80,652. Hence, in discounted dollars, this is the after-tax amount that it costs to lease the space. By contrast, the only negative amount (i.e., the only cash outflow) that occurs in the purchase scenario is the initial investment. Subsequent cash flows from the property are all positive, presumably because other rental units generate enough revenue to offset the loss of the owner-occupied space. A final and substantial positive cash flow occurs at the end when the property is sold. Discounting all of these amounts back at the same 11.5% rate gives a Present Value of a negative \$21,428, clearly less than the cost of leasing. Hence our model reports that the preferred choice is to own and occupy.

It's worth noting that in any kind of pro forma analysis our result is only as good as our assumptions. Prudence would suggest that we take "best case," "worst case" and "most likely" scenarios. If the outcome is ambiguous, then perhaps there are factors less measurable that should influence our choice. Used carefully, however, a powerful tool like the Lease vs. Buy Analysis can be an enormous help in our decision-making process.