



Lease vs. Buy and Opportunity Cost

By Frank Gallinelli

From time to time user's of RealData's Real Estate Investment Analysis software call us, seemingly perplexed by the program's "Lease vs. Buy" module. It's not that the software is difficult to use - quite the contrary, in fact -- but rather it seems that they have difficulty getting a handle on the lease vs. buy concept itself. In this brief article, we'll discuss the notion of lease vs. buy decision-making. Then in Part II, especially for the benefit of our REIA users, we'll offer some guidance on the use of this module of our program.

Let's start with one of our patented penetrating glimpses into the transparently obvious: As a prospective user of commercial space, you can purchase a building and occupy space therein, or you can lease the same or comparable space from a third party. When you set out to choose between buying and leasing in these circumstances, you are faced with mutually exclusive alternatives. In other words, you can't do both. If you're looking for space for your own use, you have to pick one option or the other. Buy a building and use it, or lease space from someone else.

The notion of leasing from someone else is pretty straightforward. You pay the money and that's what it costs (after accounting the time value of money, of course, as we'll discuss shortly).

To buy a commercial property and then to use all or part of it is not as simple. Let's consider a non-real-estate analogy. You are graduating from college and can choose to start a career immediately or go to graduate school. Grad school will cost you \$15,000 per year for two years for tuition. You can ignore room and board - you've got to live somewhere and eat, no matter what you choose. So the grad school choice will cost you \$30,000, right? Wrong.

You must take into account something called "opportunity cost." Opportunity cost is a benefit or advantage forgone as the result of accepting an alternative. It's the quantification of a tradeoff. It's what you give up for what you get.

Every choice has a price. In this case you've chosen to delay the start of a career by two years and the opportunity cost is the salary that you didn't earn for those two years plus any other career-related opportunities you missed by being out of the game.

When you program your "grad school vs. early career" decision model, it may look like this: Will your degree be worth more than the tuition plus the opportunity cost? In simplest terms, will your lifetime earnings be sufficiently greater with a graduate degree to justify two years of tuition, lost salary and cold pizza?

A lease vs. buy decision model for commercial real estate must also necessarily deal with the issue of opportunity cost. In short, if you occupy some part of a property you purchase, you must forego collecting the fair market rent from a third party who might otherwise use that space. It's very much like the grad school scenario. Using the property doesn't cost just the mortgage payments and the taxes and insurance, (i.e., the obvious costs, such as tuition). It will also set you back the opportunity cost, the rent you could have earned but didn't.

Keep in mind that you can't say to yourself, "I'll charge myself a lower rent and then the space will be a bargain." First, and most obvious, paying yourself with your own money doesn't really enhance your revenue stream. More to the point, the space is worth what it's worth. If you don't receive the full value in real money, that loss is your opportunity cost.

Both the leasing and the purchase options involve periodic cash flows. If you lease, you make payments on a regular schedule. If you buy, you probably begin with an initial amount of cash down; then make regular mortgage and tax payments as well as other outlays for operating expenses; and finally have a cash inflow from the ultimate resale. A proper analysis would compare the present values of these two series of cash flows to see which one would be more costly. In order to make a meaningful comparison, you would want to assume that you would own for the same period of time as you would lease.

Why do you want to discount each of these series of cash flows to a present value rather than simply taking them at face value? Consider each cash flow stream:



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1) Leasing: Although the stream of payments is likely to be fairly regular, the lease rate may escalate over time. How quickly and how much it escalates can have a material effect of the real cost of the lease.

2) Buying: The stream of payments here will almost certainly not be as level as with a lease. The initial outlay to acquire the property (down payment, mortgage points, legal and title, etc.) is likely to be much more than the initial cost to lease. Subsequent cash outflows may be smaller than with a lease, or they may even be cash inflows if you are using only a portion of the property and receiving rent from other tenants. Finally, there should be a significant cash inflow at the end of the holding period when you sell the property.

Clearly, the amount and timing of cash flows in these two situations is likely to be much different. To compare these two series of cash flows in a meaningful way, we can't simply add each series up - we have to take into account the time value of money by performing a present value calculation.

How can we do that? Tune in for Part II of our discussion when we look at the Lease vs. Buy module in our Real Estate Investment Analysis software.