Lease Versus Own

Advantages and Disadvantages

Excerpts from CCIM – User Decision Analysis-2012

Leasing

Leasing is a means of obtaining the physical and partial economic use of a property for a specified period without obtaining an ownership interest. The lease contract is a legal document in which the owner (lessor) agrees to allow the tenant (lessee) to use the property for the specified time and under specified conditions. In return, the lessee agrees to make periodic payments to the lessor.
As with other business decisions, leasing affords a user certain advantages and disadvantages.

Advantages of Leasing

Availability of Cash. Most lease arrangements have fewer restrictions than loan agreements, providing flexible financing. Leasing is well suited to piecemeal financing. A firm that is acquiring assets over time may find it more convenient to lease than to negotiate loan terms or to sell securities each time the firm makes a new capital outlay.

Financial Flexibility. Leasing can provide more flexibility for owners who may need cash to invest in their business (inventories, salaries, or equipment). It may be more prudent and profitable to use their financing capabilities to run the business than to invest in real estate to house the business. Avoiding a down payment frees that money for other uses. Opportunity costs and capital
costs are important investor (and user) considerations.

Additional Tax Deductions. Since lease payments are fully tax deductible and reflect rent paid for both the land and improvements, the lessee can deduct the cost of rent paid for the land. In an ownership position, cost recovery is not allowed on the land portion of the investment. If the lease is a net lease and the lessee pays operating expenses in addition to rent, the operating expenses are deductible as well.

Source of Financing. Leasing is often the only available source of financing for a small or marginally profitable firm since the title to leased property remains with the lessor, reducing the lessor's risk in the event of the firm's failure. If the lessee does fail, the lessor can recover the leased property. Also, leasing is said to provide 100 percent financing, while most borrowing requires a down payment. Because lease payments typically are made in advance of each period, this 100 percent financing is diminished by the amount of the first required lease payment.

Low Risk of Obsolescence. It may be possible for the lessee to avoid some of the risks of obsolescence associated with ownership. The lessor charges a lease rate based on its required rate of return on the investment property, provided it is less than or equal to market lease rates. The net investment is equal to the cost of the asset minus the present value (PV) of the expected salvage value at the end of the lease. If the actual salvage value is less than originally expected, the lessor bears the loss.

Stability of Costs. Leasing tends to stabilize the lessee's expenses. Because lease payments are a continual periodic outlay, earnings tend to appear more stable when assets are leased rather than owned. This can be very important to businesses that strictly monitor cash flows or have

seasonal cash flows. The ability to anticipate costs accurately is very important to many businesses.

Spatial Flexibility / Mobility. Leasing can provide more flexibility if a business expands or contracts. It also provides more mobility if a business needs or wants to relocate.

Technology. Leasing allows a commercial user to respond to technological changes more quickly. Some businesses must be on the cutting edge of technology, and moving may be the most efficient way to accomplish that goal.

Location. Leasing allows the user to be at a premier location that otherwise would be unaffordable.

Focus. Leasing allows the user to concentrate on his primary business without the distraction of managing real estate.

Disadvantages of Leasing

Cost. For a firm with a strong earnings record, good access to financing, and the ability to take advantage of the tax benefits of ownership, leasing is often a more expensive alternative. Individuals and small firms may find that leasing and borrowing terms are approximately equal.

Loss of the Asset's Salvage Value. In real estate, this loss can be substantial. A lessee may have difficulty obtaining approval for property improvements on leased real estate if the improvements substantially alter the property or reduce its potential range of uses. Although the

lessee considers the improvements important—such as technological changes necessary to the business, physical
changes to accommodate staff, or cosmetic changes to impress customers—the lessor may be reluctant to allow them.

Contractual Penalties. If a leased property becomes obsolete or if the capital project financed by the lease becomes uneconomical, the lessee is legally obligated to keep paying the lease and may not cancel it without paying a penalty.

Appreciation. Leasing does not provide participation in property appreciation.

Control. Leasing does not allow control of other tenants. New neighboring tenants may not conform to the type of image the lessee seeks, or they may create demands on the physical plant that the lessee was not anticipating.

Operational Control. The lessee has no control over business amenities. The lessor may cancel the lease on an inexpensive sandwich shop that was attractive to the lessee's employees. Communal amenities such as conference rooms may be closed and leased for profit. New building personnel may not provide the same level of service as the lessee originally enjoyed.

Changes. The lessee may have to accept changes to the space that the lessor wants, but the lessee opposes. For example, the lessor may decide to install new lighting to lower costs, but the lessee may find this unnecessary and a disruption to his business.

Owning is a means of obtaining the full economic use of a property for an unspecified period in the form of an ownership interest. If an owner is also a user, physical use of the property is obtained as well. Owners generally are free to use the property as they wish, even though they may be obligated to a mortgagee. Just as leasing can have distinct advantages and disadvantages, so can owning. Consider the following elements when making the decision to own.

Advantages of Owning

Tax Savings. The owner of a property is entitled to the tax savings resulting
from cost recovery rules and mortgage interest expense deduction during the holding period and when the property is sold.

Appreciation. The owner of an asset, a building in particular, is entitled to all of the appreciation in value.

Income. If a portion of the property is rented, income from the lessees can be used to pay the mortgage on the property, fund the owner's principal business, or be used for other investments.

Control. The user or investor who owns a building has, within the limits of the law, freedom to operate the building as the user sees fit. Controlling the appearance of a site and taking advantage of the prestige of its location may be important to certain businesses. Other owners, perhaps nearing the end of their holding period, may wish to keep expenses low. Ownership also allows some control of costs.

Disadvantages of Owning

Initial Capital Outlay. Down payments to acquire the property may divert cash that could be used to finance the company's operations or other investments.

Financing. Often a company's ability to obtain a loan not only depends on its financial condition, but also on the financial marketplace.

Financial Liability. A mortgage loan or a deed of trust can affect the balance sheet (by increasing long-term debt) and the related debt restrictions sometimes required by a lender.

Legal Compliance. Compliance with changes in laws or zoning may be unforeseen, costly, and unavoidable.

Risks. Risks to ownership include potential damage, obsolescence, and the inability to sell at preferred prices at the right time.

Health and Safety Liability. The owner is liable for the safety and well-being of tenants, employees, and the public within and outside of the building.

Inflexibility. Space may be inflexible and cannot be enlarged or reduced depending on business fluctuations or other forces.

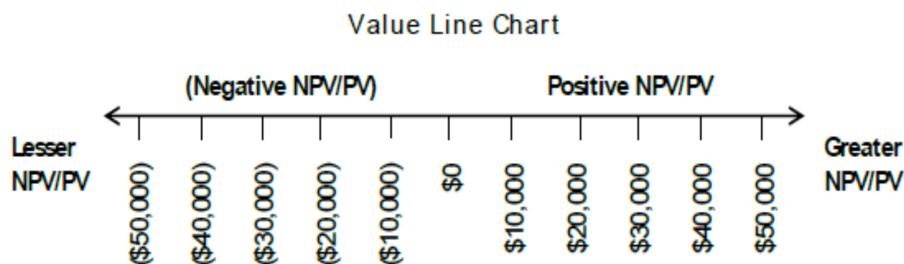
Comparison Techniques

The two methods of comparing leasing and owning costs are the NPV method and the internal rate of return (IRR) method. The NPV method compares the NPVs of the cash flows for each of the alternatives. The IRR method calculates the IRR on the difference between the owning and leasing cash flows. Since the tax situations of owning and leasing are dissimilar, use cash flow after tax (CFAT) in both methods. CFAT refers to

the amount of money left after accounting for all operating expenses, including property taxes, financing costs, and income tax obligations. Regardless of which method is used, the holding period for the leasing and owning alternatives must be the same.

Net Present Value Method

This method reduces each alternative to its periodic cash flows after tax. Applying the user's appropriate after-tax discount rate, an NPV is calculated for each alternative. Corporate users typically use their after-tax weighted average cost of capital as the discount rate, while non-corporate users typically use their after-tax opportunity cost. Once the PVs or NPVs are calculated for each alternative, compare the values. The greater value is always the better economic choice.
The following value line chart shows that values increase as you move from left to right.



For example, if an NPV analysis indicates that one alternative result in an NPV
of ($40,000) and another alternative results in an NPV of ($30,000), the correct choice would be the alternative that results in an NPV of ($30,000). As shown in the previous chart, ($30,000) is farther to the right than ($40,000) and therefore is the greater value. The value of ($30,000)

is greater than ($40,000), even though in raw numbers, 40,000 would be greater. As a practical matter, in this example the fact that both NPVs are negative means that the user is giving up something for either choice. The lesser amount given up is the better choice. In other words, giving up $30,000 is better than giving up $40,000. Also look at the comparison in terms of the cost associated with each alternative. A cost of $30,000 is a better choice than a cost of $40,000.

Consider another example of an NPV analysis in which one alternative result in an NPV of $10,000 and another alternative result in an NPV of $20,000. The NPV of $20,000 is the better choice. The chart shows that $20,000 is farther to the right than $10,000 and therefore is the greater value. The fact that both alternatives result in a positive NPV indicates that a positive economic benefit is associated with either choice. The greater economic benefit of $20,000 is the better choice.

Consider a last example of an NPV analysis in which one alternative result in an
NPV of ($20,000) and another alternative result in an NPV of $10,000. The NPV of $10,000 is the better choice. As shown in the chart, $10,000 is farther to the right than ($20,000) and therefore is the greater value. Even though in terms of raw numbers, 20,000 would be greater than 10,000, $10,000 is a greater value than ($20,000). This example indicates that one alternative results
in the user giving up $20,000, but in the other alternative, the user receives a positive economic benefit of $10,000. Receiving a positive economic benefit of $10,000 is a better choice than giving up $20,000. If applied correctly, NPV/PV can be a useful tool for users when making economic decisions. The correct application is to choose the greater value, or the one that is farther to the right on the value line. In the case of negative values, the greater value is also the lesser cost. In other words, choose the value on the right, and you will always be right.

Internal Rate of Return of the Differential Cash
Flows Method

The IRR method subtracts the lease alternative's periodic cash flows after tax from the own alternative's periodic cash flows after tax and calculates an IRR of this differential. This IRR is after tax and is compared to the user's appropriate after-tax discount rate. This method allows the user to identify the discount rate/opportunity cost at which the costs to own or lease are equal. When the decision maker's opportunity cost is higher than this equilibrium rate, it will be cheaper to lease.

The IRR of the differential cash flows also indicates the after-tax yield on the capital invested in the ownership alternative if the user chooses to own. This yield can be compared to the yield on alternative investment opportunities that may be available, such as investing in the core business.

The following steps are used in the IRR of the differential cash flows method:

1. Determine the after-tax cash flows for both the lease and the own alternative.

2. Subtract the lease alternative's periodic cash flows from those of the own alternative to determine a differential cash flow for each period. Calculate the IRR on the differential cash flows for the holding period.

3. Compare the resulting IRR with the decision maker's opportunity costs.
❧ If the IRR is greater than the appropriate discount rate, the best decision is to buy.

❧ If the IRR is less than the appropriate discount rate, the best decision is to lease.
❧ If the IRR equals the appropriate discount rate, revert to non-cost factors to make the decision.

Like any real estate decision, there are multiple variables that at any stage of the process can change the direction and evaluation method(s) used to formulate the appropriate plan of action. Different companies/investors have different tolerance levels for risks, time, financial leverage, ROI, etc. That being said, the information shared within this article is an overview of some industry standards and common practices that can enable the "user" to make an educated decision.