



bespoke  
commercial real estate

## BUYING VS. LEASING Commercial Real Estate

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A common question among small business owners is whether to buy or lease commercial property. The most important thing they want to know about are the costs.

To help, we ran an analysis on a real commercial property for sale and created a detailed example of the costs and benefits of buying vs. leasing commercial real estate.





# Summary Of Buying vs. Leasing Commercial Real Estate

We conducted a detailed analysis on a real commercial real estate property for sale. We found that buying commercial real estate is a better option than leasing if you plan to stay in the same location for 7 or more years. If you plan to stay in a single location for less than 7 years, then leasing might be a better option.

This is because we found that over a 15-year occupancy period, leasing commercial real estate costs as much as 86.6% more in our example than buying commercial real estate. However, when the expected occupancy period drops from 15 years to 7 years, the cost of leasing is actually less than buying commercial real estate. This makes 7 years the “breakeven” point for buying vs. leasing.

Our analysis takes into account the following:

- Up-front costs
- Monthly recurring costs
- Opportunity costs
- Tax savings
- Asset price appreciation
- Increases in business equity
- Money earned in the sale of property

However, when deciding to buy or lease commercial real estate, there are other factors you have to consider, including:

- Will you outgrow your space?
- Do you want to deal with the hassle of maintaining a property?
- Can you afford to tie up liquid capital in commercial real estate?
- Do you want the flexibility of a lease or the stability of a mortgage?
- Local trends in the commercial real estate market.

With this in mind, let’s take a look at the general benefits and drawbacks of buying vs. leasing commercial real estate. This should give you a better understanding of the right option for your business.

# Benefits Of Buying Commercial Real Estate

Commercial real estate is a long-term asset that stores its value fairly well. For this reason and more, many business owners are interested in investing in an owner-occupied commercial real estate space. The benefits of owning your own commercial real estate property are as follows:



## 1. Equity Upside

The beauty of buying commercial real estate is that your monthly loan payments help you build equity. This is because a portion of those monthly payments goes towards paying down your principal loan amount. When you eventually sell or refinance your property, you can extract the difference between the remaining loan amount and the current fair market value as equity for your business.

This is in contrast to leasing commercial real estate since lease payments go to the landlord and no principal is paid down. Buying commercial real estate gives you more upside when compared to leasing commercial real estate.

## 2. Asset Appreciation

When you own commercial real estate you can also take advantage of asset appreciation.

This appreciation represents the increase in the value of your property over time.

For example, the U.S. Commercial Property Price Index has increased by as much as 26.2% over the last 10 years. When you eventually sell your commercial property, you earn capital gains equal to the difference between the purchase price and the current fair market value.

## 3. Rental Potential

Businesses that buy commercial real estate typically occupy more than 51% of the commercial space. The remaining space can be rented out to tenants. These tenants can include retailers, restaurants, companies that need office space, and more. This means that there is a lot of rental income potential when buying commercial real estate.

However, keep in mind that if you rent out part of your space to tenants, you'll typically have to act as a landlord and deal with the various requirements. If this is too much of a headache, you can also hire a property management company, but this will eat into your profit potential from renting.





## 4. Tax Benefits

Those who buy commercial real estate can deduct the following when calculating tax payments:

- Interest expense
- Depreciation expense
- Non-mortgage related expenses

These expenses can be multiplied by an average corporate tax rate of 35% to find the dollar tax savings. However, since the full amount of the monthly loan payments can't be deducted (only the interest expense), the tax benefits when buying commercial real estate are typically lower than leasing commercial real estate.

Most mortgage-related expenses, such as closing costs and origination fees, typically can't be deducted for tax purposes.

## 5. Control Your Property

When you buy commercial real estate you control your property. When leasing, landlords have certain rights built into the lease. For example, many landlords negotiate rental increases, giving them the legal right to raise the rent on a tenant's lease at least once a year.

This means that when you lease a commercial space you might be at the whim of your landlord. If average rental increases are around 3% a year, and if you have a 36-month lease, your rent can increase as much as 9.3% over the life of the lease, if not more. This can create instability for a lessee.

However, situations like these won't arise when you own your own property. Instead, you'll have peace of mind that you have a fixed monthly payment for as long as you stay in the space. This means that your monthly payment will not be tied to the commercial rental market.



# Drawbacks Of Buying Commercial Real Estate

While there are many benefits of buying commercial real estate, there are also natural drawbacks. Many of these drawbacks stem from the fact that commercial real estate is a hard asset and is therefore an illiquid investment.

## 1. Upfront Capital Requirements

When you buy commercial real estate you'll typically have to invest as much as 6x more in upfront costs when compared to leasing commercial real estate. This is due to the fact that most people who purchase commercial real estate finance the purchase with a loan that requires up to at least 10-20% as a down payment (but this number can easily climb to 40%).

Other upfront costs include:

- Due diligence fees
- Closing costs

This is the largest drawback to purchasing commercial real estate since many businesses don't have the capital requirements necessary to cover the costs.

## 2. Increased Liability

Owning a commercial property also comes with increases in liability. First, you'll be responsible for the health and safety of the people inside it. You'll also have to deal with the repairs and maintenance of the property itself.

If you decide to rent out a portion of your property to other tenants, you'll also have to assume the liability of property manager, which forces you to take out additional insurance policies and comply with more stringent legal requirements.

Some business owners find this to be too much of a headache. Instead, they'd rather lease a commercial real estate building and focus on their core business.

## 3. Downside Risks

Just like with any investment, there is the risk that the asset can actually decline in value. When this is the case businesses actually lose money on their investment.

For example, if you purchase a property for \$250,000 and the value of the property declines over a 5-year period to \$225,000, you'll lose \$25,000 if you decide to sell. In recession environments, it might be cheaper to lease rather than buy due to the risk of owning an asset that might decline in value.

## 4. Lack of Flexibility

Since commercial real estate is an illiquid investment, there's less flexibility when compared to a commercial real estate lease. For example, lease terms can be as short as 3 years while mortgages can last for 15 – 30 years. This means that when you buy commercial real estate it'll be harder to move to a new location or expand your current space.

This also means that your capital is tied up for a long period of time, creating potential opportunity costs. For example, the down payment needed to buy the property could be allocated elsewhere in the business, possibly generating a higher return.



# Benefits Of Leasing Commercial Real Estate

While it may seem prudent to invest in a real estate asset, there are many benefits of leasing commercial real estate. Most of these benefits come from greater flexibility when compared to buying commercial real estate.

## 1. More Liquidity

When you lease commercial real estate, you're required to commit comparatively less in terms of upfront expenses. For example, the types of upfront costs you should expect to cover include:

- Security deposit
- Attorney fees
- Pre-lease inspection
- Possible broker's fee

Overall, the amount of the upfront costs can be as much as a 6th of the costs associated with buying commercial real estate. This provides your business with more liquidity since less of your capital is tied up in a long-term asset.

## 2. Tax Benefits

Like buying commercial real estate, there are many tax benefits associated with leasing commercial real estate. Specifically, the types of costs that you can deduct when calculating your taxes include:

- Lease payments
- Property insurance
- Property taxes
- Utilities and maintenance

Unlike buying commercial real estate, it's possible to deduct the entire amount of your lease payment. This gives you more tax savings, on average, when you lease commercial real estate.

## 3. Greater Flexibility

Since lease terms are typically between 3 – 10 years, there is more flexibility when leasing commercial real estate. This means that you can move locations or expand the size of your commercial space much easier than if you bought a commercial real estate property.

Further, there are often more properties available for lease when compared to properties available for sale. This gives you more options and greater flexibility regarding the types of properties you can occupy. What's more, many of these lease options might be too expensive to purchase, but affordable to lease for a few years.





# Drawbacks Of Leasing Commercial Real Estate

Of course, the benefits of leasing commercial real estate naturally have their own drawbacks. The majority of these drawbacks come from a lack of control over your commercial property.

## 1. No Investment Potential

Since you don't own your commercial space, you won't be able to take advantage of long-term investment potential. This means that you can't earn a return in the form of price appreciation in the event of a sale or refinance. What's more, you won't be able to build equity in the property, further reducing your income potential.

Finally, since you can't act as a landlord, there's no rental income potential. All of these factors greatly reduce the potential return and increases the comparative costs of leasing vs. buying commercial real estate.

## 2. Higher Monthly Payments

Depending on the lease agreement, you can end up paying a higher monthly payment when compared to a monthly loan payment. For example, a triple net lease agreement, which is standard for retailers, holds tenants responsible for such costs as:

- Monthly property taxes
- Monthly retail insurance
- Monthly utilities and maintenance costs

This, coupled with the lease payment, will often cause the monthly lease to be more expensive, on average, than a monthly loan payment.

## 3. No Property Control

Since you don't own your commercial property with a lease, you'll often be at the whim of your landlord. For example, lease agreements usually outline annual escalations, which is the annual amount your landlord can raise rent prices. Other lease agreements stipulate scenarios when the landlord can terminate your lease, such as in the case of an anchor tenant leaving.

What's more, once your lease ends, your landlord is able to increase rent above and beyond the escalations outlined in your previous agreement. The result is a lack of control over your property and what you'll

# How to Buy or Lease Commercial Real Estate

When purchasing or leasing commercial real estate, you'll typically want to engage a broker or agent to help you search and negotiate.

If you're thinking about purchasing commercial real estate, you'll also want to consider your various loan options. The loan you choose will dictate the overall cost of purchasing commercial real estate.

Regardless of whether you want to lease or buy commercial real estate, in addition to your cost / benefit analysis, you'll always want to consider the following:

- Availability of property in the area
- Current size of your company
- Future expansion plans, if any
- Average monthly cash flow
- Amount of working capital in your bank

All of these factors will help you decide if buying or leasing commercial real estate is the right option for your unique needs.

## Bottom Line: Buying vs. Leasing Commercial Real Estate

When deciding whether to buy or lease commercial real estate, the number one concern is typically the difference in costs. After running an analysis, we found that any business that stays in a place for longer than 7 years should consider buying commercial real estate.

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