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Buying vs Leasing Commercial Real Estate

By Elena Lewis

Abstract

If your business is successful and your current lease is about to expire, you may want to consider buying commercial space or industrial space rather than continue leasing space for your small business. Both leasing a business and buying a commercial space have their ups and downs. A thorough review of both will help you make the best decision for your business.

Getting Started

I. Commercial Real Estate Definition and Types

What Is Commercial Real Estate (CRE)?

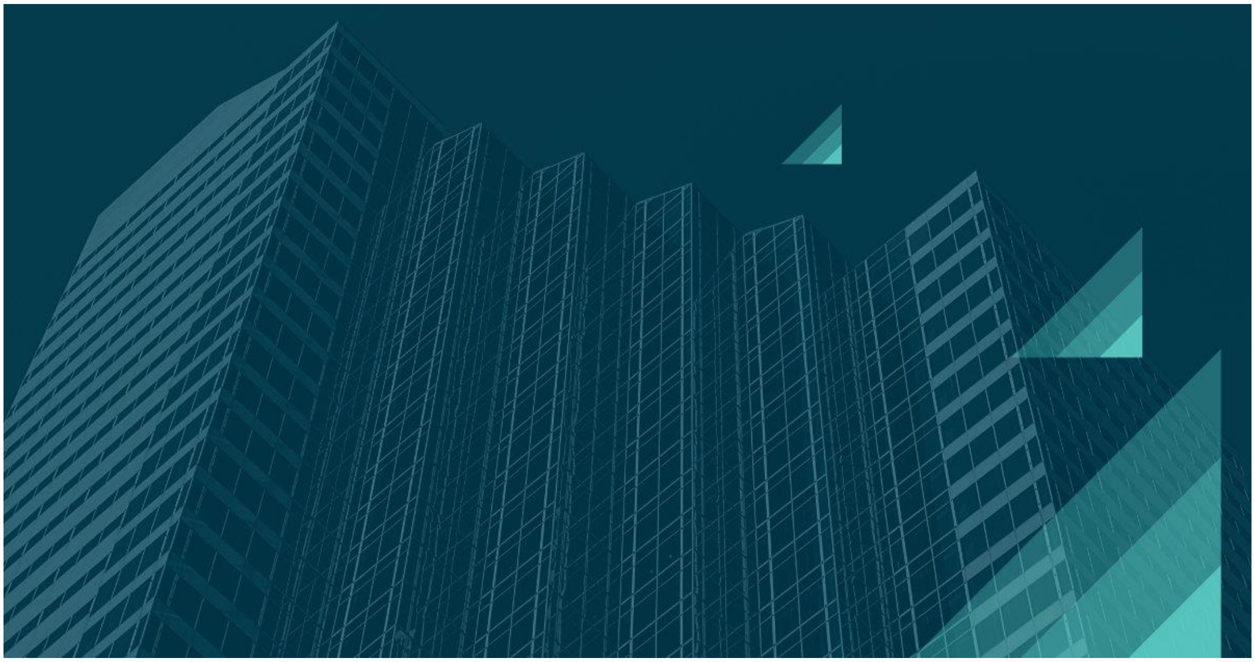
Commercial real estate (CRE) is property used exclusively for business-related purposes or to provide a work space rather than a living space, which would instead constitute residential real estate. Most often, commercial real estate is leased to tenants to conduct income-generating activities. This broad category of real estate can include everything from a single storefront to a huge shopping center.

Commercial real estate comes in a variety of forms. It can be anything from an office building to a residential duplex, or even a restaurant or warehouse. Individuals, companies, and corporate interests can make money from commercial real estate by leasing it out, or holding it and reselling it.

Commercial real estate includes several categories, such as retailers of all kinds: office space, hotels and resorts, strip malls, restaurants, and healthcare facilities.

The Basics of Commercial Real Estate

Commercial real estate and residential real estate comprise the two primary categories of real estate property. Residential properties include structures reserved for human habitation and not for commercial or industrial use. As its name implies, commercial real estate is used in commerce, and multiunit rental properties that serve as residences for tenants are classified as commercial activity for the landlord.



Commercial real estate is typically categorized into four classes, depending on function:

- Office space
- Industrial use
- Multifamily rental
- Retail

Individual categories may also be further classified. There are, for instance, a number of different types of retail real estate:

- Hotels and resorts
- Strip malls
- Restaurants
- Healthcare facilities

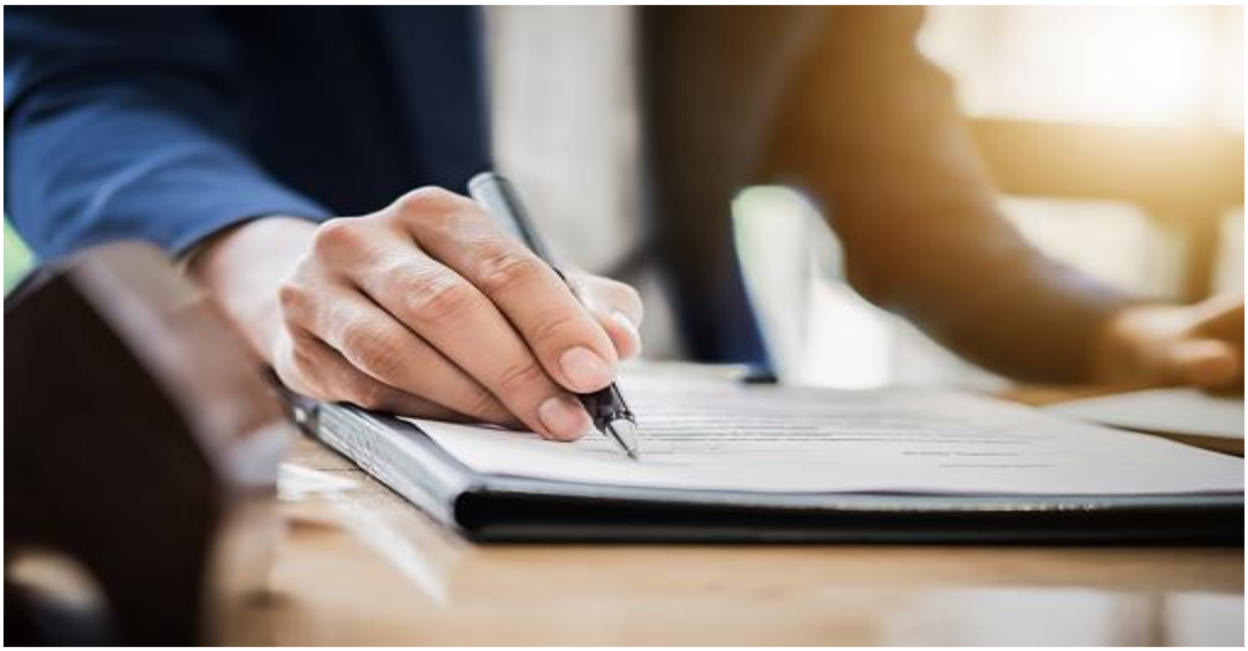
Similarly, office space has several subtypes. It is often characterized as class A, class B, or class C:

- Class A represents the best buildings in terms of aesthetics, age, quality of infrastructure, and location.
- Class B buildings are usually older and not as competitive—price-wise—as class A buildings. Investors often target these buildings for restoration.
- Class C buildings are the oldest, usually more than 20 years of age, located in less attractive areas, and in need of maintenance.

Note that some zoning and licensing authorities further break out industrial properties—sites used for the manufacture and production of goods, especially heavy goods—but most consider it a subset of commercial real estate.

Commercial Leases

Some businesses own the buildings that they occupy. However, the more typical case is that the commercial property is leased. Usually, an investor or a group of investors owns the building and collects rent from each business that operates there. Commercial lease rates—the price to occupy a space over a stated period—are customarily quoted in annual rental dollars per square foot. Conversely, residential real estate rates quote as an annual sum or a monthly rent.



Commercial leases will typically run from one year to 10 years or more, with office and retail space typically averaging five- to 10-year leases. This can be contrasted with more short-term yearly or month-to-month residential leases. A study conducted by real estate market analyst firm CBRE Group found that the term—i.e., length—of a lease was proportional to the size of the space being leased. Further, the data showed that tenants would enter long leases to lock in prices in a rising market environment. But that is not their only driving factor. Some tenants with requirements for large spaces will enter long leases due to the limited availability of property that matches their needs.

There are four primary types of commercial property leases, each requiring different levels of responsibility from the landlord and the tenant.

- A single net lease makes the tenant responsible for paying property taxes.
- A double net (NN) lease makes the tenant responsible for paying property taxes and insurance.

- A triple net (NNN) lease makes the tenant responsible for paying property taxes, insurance, and maintenance.
- Under a gross lease, the tenant pays only rent, and the landlord pays for the building's property taxes, insurance, and maintenance.

Managing Commercial Real Estate

Owning and maintaining leased commercial real estate requires full and ongoing management by the owner. Property owners may wish to employ a commercial real estate management firm to help them find, manage, and retain tenants, oversee leases and financing options, and coordinate property upkeep and marketability. The specialized knowledge of a commercial real estate management company is helpful, as the rules and regulations governing such property vary by state, county, municipality, industry, and size.

The landlord must often strike a balance between maximizing rents and minimizing vacancies and tenant turnover. Turnover can be costly for CRE owners because space must be adapted to meet the specific needs of different tenants—for example, if a restaurant is moving into a property once occupied by a yoga studio.

How Investors Make Money in Commercial Real Estate

Investing in commercial real estate can be potentially lucrative and serve as a hedge against the volatility of the stock market. Investors can make money through property appreciation when they sell, but most returns come from tenant rents.

Direct Investment

Investors can use direct investments where they become landlords through the ownership of the physical property. People best suited for direct investment in commercial real estate are those who either have a considerable amount of knowledge about the industry or can employ firms that do. Commercial properties are a high-risk, high-reward real estate investment. Such an investor is likely to be a high-net-worth individual since CRE investing requires a considerable amount of capital.

The ideal property is in an area with low CRE supply and high demand, which will give favorable rental rates. The strength of the area's local economy also affects the value of the CRE purchase.

Indirect Investment

Alternatively, investors may invest in the commercial market indirectly through either ownership of various market securities, such as real estate investment trusts (REITs) or exchange-traded funds (ETFs) that invest in commercial property-related stocks, or investment in companies that cater to the commercial real estate market, such as banks and Realtors.

Advantages of Commercial Real Estate

One of the biggest advantages of commercial real estate is attractive leasing rates. In areas where the amount of new construction is limited by either land or law, commercial real estate can have impressive returns and considerable monthly cash flows. Industrial buildings generally rent at a lower rate, though they also have lower overhead costs compared with an office tower.

Commercial real estate also benefits from comparably longer lease contracts with tenants than residential real estate. This long lease length gives the commercial real estate holder a considerable amount of cash flow stability, as long as long-term tenants occupy the building.

In addition to offering a stable and rich source of income, commercial real estate offers the potential for capital appreciation, as long as the property is well-maintained and kept up to date. And, like all forms of real estate, it is a distinct asset class that can provide an effective diversification option to a balanced portfolio.

Disadvantages of Commercial Real Estate

Rules and regulations are the primary deterrents for most people wanting to invest in commercial real estate directly. The taxes, mechanics of purchasing, and maintenance responsibilities for commercial properties are buried in layers of legalese. These requirements shift according to state, county, industry, size, zoning, and many other designations. Most investors in commercial real estate either have specialized knowledge or a payroll of people who do.

Another hurdle is the increased risk brought with tenant turnover, especially relevant in an economy where unexpected retail closures leave properties vacant with little advance notice.

With residences, the facilities requirements of one tenant usually mirror those of previous or future tenants. However, with a commercial property, each tenant may have very different needs that require costly refurbishing. The building owner then has to adapt the space to accommodate each tenant's specialized trade. A commercial property with a low vacancy but high tenant turnover may still lose money due to the cost of renovations for incoming tenants.

For those looking to invest directly, buying a commercial property is a much more costly proposition than a residential property. Moreover, while real estate in general is among the more illiquid of asset classes, transactions for commercial buildings tend to move especially slowly.

Pros

- Hedge against stock market
- High-yielding source of income
- Stable cash flows from long-term tenants
- Capital appreciation potential

Cons

- More capital required to directly invest
- Greater regulation
- Higher renovation costs
- Illiquid asset

Commercial Real Estate Outlook and Forecasts Australia

Commercial property prices are likely to suffer stiff declines

The sector is feeling the sting from rising interest rates, and the sharp falls in listed real estate stocks are set to spill into the unlisted market.

Local investors are hastily revising their sums on commercial property, as valuations come under pressure from the inexorable rise in inflation and interest rates.

And it's clear that in the commercial property market – as in the residential real estate market – prices are likely to suffer stiff declines.

After all, with the yield on virtually risk-free Australian government 10-year bonds now at 3.55 per cent, there will be few buyers for commercial properties with a capitalisation rate (net operating income as a percentage of price) of about 4 per cent, or less.

Not surprisingly, listed real estate stocks, such as Goodman Group, Charter Hall, Stockland and Mirvac were hard-hit on Tuesday when the Reserve Bank surprised the market with a larger-than-expected interest rate rise.

Investors were rattled as they digested the message from Reserve Bank governor Philip Lowe that both inflation and interest rates are headed higher.

The glum mood continued on Wednesday, with shares in Goodman Group closing 0.1 per cent lower at $19.43 (down 27.9 per cent from their peak of $26.96 in early January), while Stockland finished at $3.73 (or 24.3 per cent below its 52-week high of $4.93).

Charter Hall Group closed at $12.52 (down 43.8 per cent from its December peak of $22.18), while Mirvac bucked the trend to close slightly higher at $2.13 (which is still down 33 per cent from its 52-week high).

Uncertainties continue

Of course, these big moves in the listed property sector will be replicated, and even magnified, in the unlisted sector, as a sharp rise in borrowing costs changes the dynamics across the commercial property space.

Not only will borrowers be more hesitant to pay more for smaller commercial properties, but banks will also be reluctant to lend to highly leveraged borrowers in an environment of rising interest rates and falling property values.

Especially given the uncertainties that continue to plague the commercial property sector at a time when bricks and mortar stores are having to contend with the growing popularity of online shopping, and while the reluctance of workers to return to the office is crimping demand for office space.

And even industrial property faces a risk, as increasing warehouse automation reduces demand for older-style buildings.

A similar trend is already evident in the United States, with The Wall Street Journal reporting that the formerly red-hot commercial property sector is showing the first signs of cooling.

According to the report, property sales totalled $US39.4 billion ($54.7 billion) in April, down 16 per cent compared with the same month a year ago. April's drop followed 13 consecutive months of rising property sales.

After falling sharply in the early months of the pandemic, US property sales started to rebound in late 2020 as investors rushed to take advantage of ultra-low interest rates and the expected rise in demand as the economy reopened.

But the rise in US interest rates has taken some heat out of the market. According to the WSJ, "hotels, office buildings, senior housing and industrial properties recorded big drops in sales last month".

The jump in borrowing costs has made buyers more cautious about proceeding with property purchases. Some are even walking away, even though it means forfeiting their deposit.

Still, the more difficult market conditions, both locally and in the US, will likely present an opportunity for wealthy investors and property groups to take advantage of marked-down property prices.

What is the difference between commercial and residential real estate?

Residential real estate is used exclusively for private living quarters. Commercial real estate refers to any property used for business activities. Types of commercial real estate include hospitals, assembly plants, storage warehouses, shopping centers, office spaces, or any other location for a business enterprise.

Is commercial real estate a good investment?

It can be. Commercial real estate can have impressive returns and considerable monthly cash flows, and returns stood up well during the market shocks of the past decade. As with any investment, however, commercial real estate comes with risks.

What are the disadvantages of commercial real estate?

Rules and regulations are the primary deterrents for most people wanting to invest in commercial real estate. The taxes, mechanics of purchasing, and maintenance responsibilities for commercial properties are buried in layers of legalese, and they can be difficult to understand without acquiring or hiring specialist knowledge.

Commercial real estate refers to real estate that is used specifically for business or income-generating purposes. It differs from residential real estate because it has the potential to provide rental income as well as capital appreciation for investors. The four main classes of commercial real estate are office space, industrial, multifamily rentals, and retail.

Investing in commercial real estate usually requires more sophistication and larger amounts of capital from investors than does residential real estate, but it can offer high returns.

Publicly traded REITs are a feasible way for individuals to indirectly invest in commercial real estate without specialist knowledge of the sector.

II. Buying vs Leasing Commercial Real Estate

The following table includes a side-by-side comparison of buying versus leasing commercial real estate:

Comparison	Buy Commercial Real Estate	Lease Commercial Real Estate
Ownership Interest	Own the property outright	Use the property without ownership
Down Payment Requirement	Down payment required of at least 10%	No down payment required (small security deposit instead)
Cost of Ownership in Existing Developments	More expensive to buy into existing developments	Easier and cheaper to lease a building in an existing development
Fixed or Variable Costs?	Costs of ownership much more fixed	Costs can go up when lease is renewed
Who Has Equity and Gets Passive Income?	Equity in property and passive income are earned by you	Equity in property and passive income are earned by landlord
Flexibility Provided	More flexibility about what to do with the property (renovations/changes)	More flexibility to walk away from the property if it doesn't meet your needs

Commercial property is the identity of a business and helps to build the brand image and its position in the industry. Entrepreneurs looking for the perfect location for their businesses on Gold Coast have to make the tough decision of choosing between buying and leasing. It is a significant business decision that needs to be made after considering all the repercussions of the step. Although buying commercial property allows the business to stabilise and utilise the space without restrictions, leasing offers the freedom to expand or relocate whenever required.

The financial health of the business also plays a vital role in making this decision because of the huge purchase price that can become a burden on the company. Many business owners prefer leasing for this reason because rent is easier to manage and does not burn a hole in the pocket. Thus, both these alternatives have pros and cons, and you must know them to make an informed decision.

When to Consider Buying Commercial Real Estate

Purchasing commercial real estate allows you to obtain ownership of the property, whether you pay cash upfront or you finance the purchase with a commercial real estate loan. The following are pros and cons to consider when purchasing commercial real estate.

Advantages of Buying Commercial Property

Businesses that have reached the maturity stage and have an established customer base can consider the buying option because they can easily get a low-interest business loan, and their positive cash flow will not get affected by the debt. Here are the pros of buying commercial property.

Buying commercial real estate Gold Coast is often considered a highly rewarding approach because of the asset acquisition, its appreciation in the future, and the benefit of holding a permanent address in a reputed location that increases the credibility and goodwill of the entity.

Many people think that buying a property ties you to it. However, you are not stuck in one place. If you wish to move to a bigger property in the future, you can always sell it. The capital gains earned at the time of sale can help in buying a larger space with ease.

When you own a commercial property, you have the flexibility of making changes to the fit-out and floorplan according to the needs of your business. Also, the additional work done on the property adds to its value and secures a better price at the time of sale.

You can claim tax deductions on the interest paid for the business loan you take out to purchase the property. Also, loan repayments do not keep increasing like rent, which is hiked by the landlord annually. Thus, these are fixed costs that can be managed efficiently.

Disadvantages of Buying Commercial Property

Although adding an asset to your portfolio as an entrepreneur is not a disadvantage, it can become challenging if you are not able to manage the debt. So, here are the cons of buying commercial property.

When you purchase an office space, retail store or warehouse for your business, it requires a massive investment. A lump sum amount needs to be paid upfront because the maximum loan that can be taken for buying commercial real estate is 60%-70% of the purchase price. Also, repayment of a loan includes interest, which can be burdensome for a business that is still in its nascent stage.

The property owner has to bear various other ongoing expenses, such as land tax, building insurance, rates, body corporate fees, landscaping, gardening, repair and restoration. In addition, they have to pay for the maintenance and utilities during the vacancy periods, which can be long during an economic downturn.

- **Tips for commercial real estate acquisition**

Real estate is one of the largest operating cost categories for most small businesses, typically behind only salaries and benefits packages, Kosmont noted. He offered the following advice for those considering a real estate acquisition.

- ✓ **Choose the model that suits your business.** One primary consideration is whether to buy or lease your business locations. If you can afford to purchase, consider the short- and long-term accounting implications of ownership. Will your business own the property, or will a separate entity have ownership and lease the property to you? Should the entity be a corporation or a limited liability partnership? Does it make sense to hold the property under your personal name? You must be aware of the down payment amount required, tax benefits of depreciation, and the effects of positive or negative cash flow from property-related income and expenses.
- ✓ **Evaluate your business needs.** When choosing the right location for your business, you must be mindful of fundamentals such as the locations of your customers, suppliers and employees. Channels for customer service programs, access to various modes of transportation, and neighborhood desirability for employees are just a

sampling of important considerations. The building's physical characteristics are also critical. Overall property shape, square footage, ceiling heights, equipment needs, utility requirements, age, and zoning must conform practically and legally to your business's operations. Amenities and services such as parking and security may be additional drivers for attracting and retaining employees.

- ✓ **Know your financial wherewithal.** The primary real estate acquisition limitation for most small business owners is cost. You must be realistic about your business's financial situation. Whether you're buying a distressed property or one for sale through traditional channels, plan for a down payment between 5% and 25% of the purchase price. Once you know your price range, you can focus on the property search. It's wise to seek out the services of an experienced commercial real estate broker for assistance.
- ✓ **Leverage your financial toolkit.** All small business owners should be aware of government and private-sector financing options. When choosing a small business loan, you should understand the various loan types and sources. For example, SBG Funding offers loans up to $5 million with flexible repayment terms.

When to Consider Leasing Commercial Real Estate

Depending on the needs of your business, it may be to your advantage to lease commercial real estate instead of purchasing. There are many things to consider when leasing commercial real estate. The table below shows some of the pros and cons of commercial real estate leasing.

Advantages of Leasing Commercial Property

A start-up or a business in its introduction stage is not financially capable of buying commercial real estate on Gold Coast. Thus, leasing makes sense for them. Here are the pros of leasing commercial property.

New businesses can enter the growth stage quickly and may need a bigger space to accommodate the growing workforce and operational needs. With leased properties, it is easier to move out and find a new space that suits the business.

A small setup needs more capital in the reserves and for making investments back into the business to grow. Thus, they are better off leasing because they cannot spend a huge amount on purchasing the property.

Buying commercial property may take a lot of time because you need to take out a loan, research different locations, negotiate with sellers, and get the required licenses and permissions. However, no such worries affect you when you lease a property.

The tenant can claim tax deductions for the rent paid to the landlord. If they refurbish the property to suit the needs of their business, they can claim depreciation on the restoration. In addition, they can claim GST credits if the landlord has registered for GST.

Disadvantages of Leasing Commercial Property

As a tenant, you do not have any control over the asset and have to work according to the instructions of the landlord. Here are the cons of leasing commercial real estate.

Commercial property tenants must bear the cost of the outgoings because the lease agreement is usually in favour of the landlord. Thus, you will be paying for the utilities, maintenance, and other ongoing costs, which will add to the expenses.

With leased property, you do not have any flexibility. You will need the permission of the landlord for any changes in the layout, and at times, they may not agree to it.

The rent will increase every year and the lease agreement may not get renewed by the landlord if they have a better rental offer from another business.

The tenant may have to look for a new building if the owner wishes to sell the property and terminate the lease agreement. They may also want you to vacate if they need to refurbish or redevelop the building. Thus, you may feel stranded and face downtime.

Buying vs Leasing Commercial Property - Which Is Better?

The answer to this question lies with the business owner because every entity has its unique needs and flow of capital. The decision rests on various factors, such as the current financial status of the company, its growth stage, future profits, long-term goals, and more. Entrepreneurs should weigh the pros and cons of buying vs leasing to determine which will work in favour of their business to make the final decision.

Entrepreneurs should have the farsightedness to analyse the long-term impact of their decisions on their business. It is also essential to know all the pros and cons related to that decision to avoid making a mistake or bad investment.

10 Tips For Your Next Commercial Lease

Commercial leases are intimidating. What's an NNN? How about a gross lease? Sometimes you're dealing with a landlord-favored market, and other times the market is in favor of the tenant. While the landlord is always seeking the highest profits, the tenant is trying to reduce costs.

Both want to get what's best for them into the lease. Below are the top ten tips you need to know for your next commercial lease.

1. Make sure the lease agreement has essential terms.

Verbal and written agreements are two different things, especially when you're looking into commercial properties for lease. The property representative will tell you as many benefits as they can. Those verbal assurances must be a part of the written deal. Further, a lease should always contain the basic agreements like rent amount, rent due date and the period of the lease offered. The essential terms are key. The meat is in the fine print.

2. Condition your breakaway cost in the lease agreement.

See what stipulations your future landlord has on breaking your lease. You should never go into a lease with the plan to break it; however, things happen. Protect yourself with an out clause. You need to cover your back as ownership will certainly cover theirs. Sometimes the out clause can be stipulations on subletting; sometimes, it's a set fee. Make sure you're comfortable with the terms provided. Talk to your attorney about the best way you can negotiate a lease break clause that works for your business and lifestyle.

3. Engage a commercial real estate broker.

Being a business owner means you know your strengths and weaknesses. It also means you know when to delegate tasks elsewhere. Finding and negotiating a lease is a task you should delegate to a trusted broker. Brokers spend their days learning and navigating the real estate market. Unless you do the same, I recommend having a broker handle your real estate. Trusted and good brokers can land their clients in more favorable properties with better terms.

4. Include additional provisions in your commercial lease.

An agreement should always be completed in its entirety. There should be nothing left for later negotiation, and all future situations must be covered in the lease. Since much of the success of your business relies on the lease, make sure you include further provisions like insurance requirements, hours of operation and a sublet clause. Beware of demolition clauses. These are provisions in commercial leases that require the tenant to pay for significant renovations such as the roof or the parking lot. Try to avoid these provisions at all costs.

5. Always negotiate for the removal of unfavorable terms.

Negotiating is about seeking common ground. Negotiate your lease terms with the general understanding of meeting in the middle. If your potential landlord is being unreasonable, walk away. Never believe that your landlord is entitled to additional benefits that they have inserted into your agreement if, in reality, those terms might jeopardize your business in some manner.

6. Learn from your future neighbors and avoid competition.

Imagine opening a gym with no radius clause, and the landlord lets your next-door neighbor also open a gym. This would be a huge issue. Or even worse: Consider a children's daycare facility next to an adult toy store. The messy combinations are endless. Also, before signing on the dotted line, talk to your neighbors. Ask about crime in the neighborhood and what you can expect from the ownership. Your neighbors will often tell you everything you need to know.

7. Find out if there are any common maintenance fees.

Some areas charge common maintenance fees, which apply to everyone tenanting the property. Therefore it's important to know about these hidden costs. The lease agreement should show how the common area maintenance fee is computed and who's going to pay those costs once incurred. Suppose you sublease the property, and the common maintenance fee is divided. If the property has vacancies, landlords tend to add those extra common area maintenance costs to the tenants. I recommend that you negotiate this out of your lease as it only favors the landlord.

8. Calculate everything before you sign your lease.

Sometimes tenants wholly trust their brokers and the other party, and they sign the agreement without a careful read-through. A healthy dose of skepticism can help you here. Hence, you must calculate everything and make sure that every calculation reconciles with the mentioned terms and conditions. If you find any discrepancies, bring them up and negotiate.

9. Understand the different types of commercial leases.

There are different types of commercial leases. The landlord will generally choose the type of lease, but educate yourself first. A few different examples of lease types are triple net (NNN), full service (FS) or modified gross (MG). All have different ramifications to both you and your landlord. For example, an FS lease has the landlord pay all expenses, while an NNN lease, which is one of the most popular, has the tenant pay part of the property taxes, insurance and common area maintenance.

10. Don't be afraid to walk.

You never know what your landlord wants or needs until it gets to negotiating the lease. There's always more real estate. Don't be afraid to walk away if you feel your landlord is being unreasonable or the terms don't fit your needs.

Bottom Line

Acquiring commercial real estate is a huge step in developing a business. Once you decide to begin the acquisition process, you must consider the pros and cons of purchasing commercial real estate compared to leasing. There's no blanket right answer for businesses. You must assess your needs, your business's financial stability and liquidity, and your short- and long-term business plan to decide which path is best.

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