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INTRODUCTION TO BUYING VS LEASING COMMERCIAL REAL ESTATE

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Abstract

Unlock the complexities of commercial real estate decisions with our comprehensive guide, "Introduction to Buying vs Leasing Commercial Real Estate." This PDF delves into the crucial considerations when choosing between purchasing or leasing commercial properties. Explore the financial implications, strategic advantages, and potential pitfalls associated with each option. Whether you're a seasoned investor or a first-time business owner, this guide provides valuable insights to help you make informed decisions aligning with your business goals. Download now and embark on a journey to navigate the intricacies of commercial real estate, ensuring a well-informed choice that suits your unique requirements.

Getting Started

I. Commercial Real Estate Definition and Types

What Is Commercial Real Estate (CRE)?

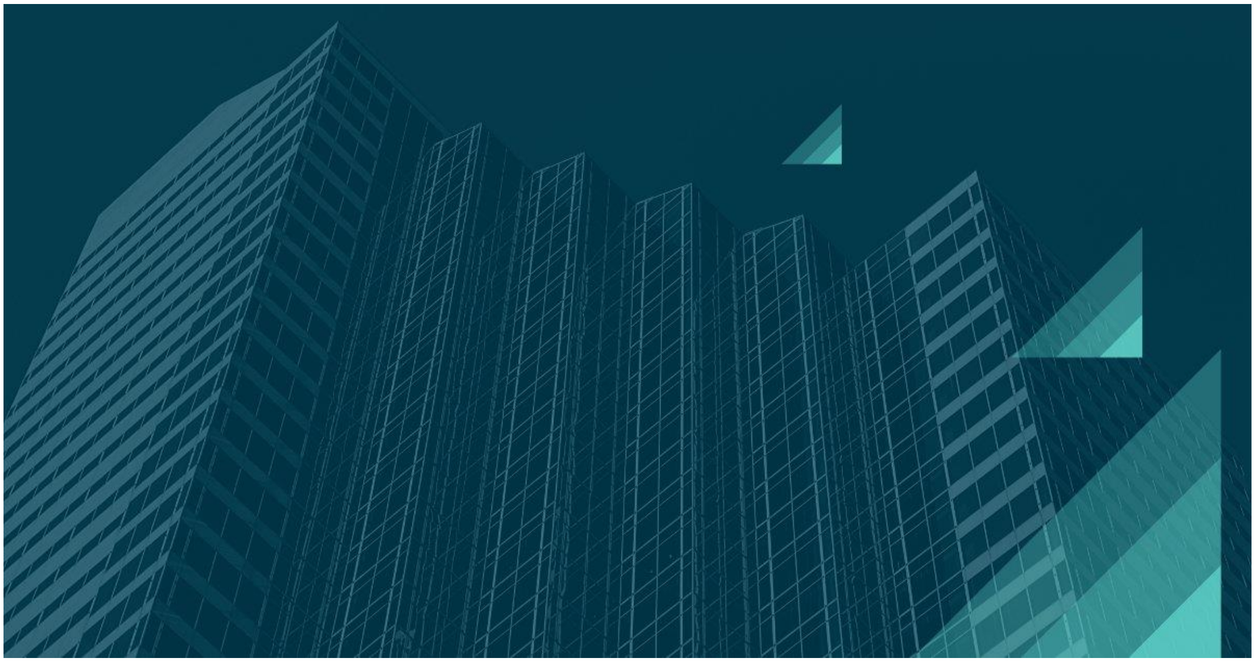
Commercial real estate (CRE) is property used exclusively for business-related purposes or to provide a work space rather than a living space, which would instead constitute residential real estate. Most often, commercial real estate is leased to tenants to conduct income-generating activities. This 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:

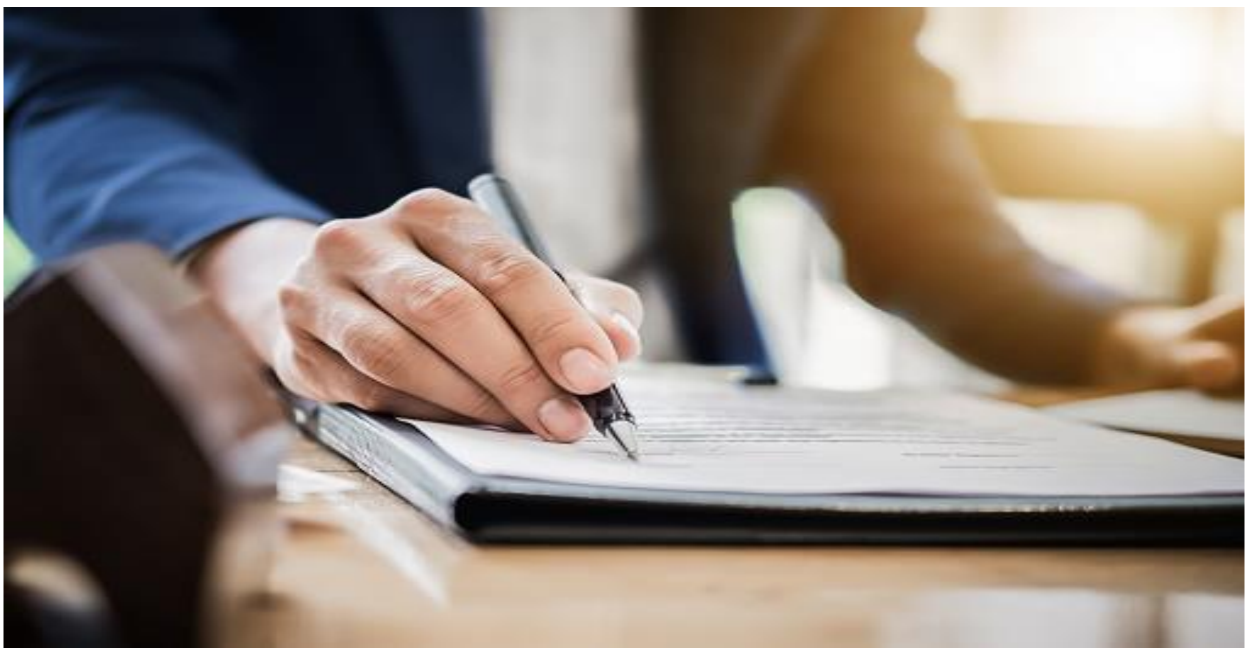
- Class A represents the best buildings in terms of aesthetics, age, quality of infrastructure, and location.

- 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

<u>What Is Stamp Duty and How to Calculate it When Buying Commercial Property?</u>

Buying commercial property involves a significant investment that includes various costs, including stamp duty. Many first-time buyers are unaware of this expense that is levied on property acquisition in Australia. The stamp duty rate changes for every state and is to be paid during the transfer of the asset or within three months after the purchase process is completed.

Stamp duty is known as transfer duty in NSW and must be included in the buying budget when looking for commercial real estate in Sydney. Let us help you understand stamp duty and how it can be calculated when buying commercial property. It will help you plan the investment effectively with an accurate prediction of the total cost.

- **What Is Stamp Duty?**

Stamp duty is a government tax levied on the purchase of commercial property across Australia. Government generates considerable revenue through this tax paid on the transfer of a commercial asset. It is paid on the dutiable value of the real estate, which is the market value of the real estate or the purchase price, whichever is greater. The standard transfer duty rate in NSW for property values between $93,000 and $351,000 is $1,500 plus $3.50 for every $100 over $93,000. It gets refunded if the sale is not completed due to disputes or any other reason.

Buyers must hire a conveyancer to complete the formalities of this tax, which is an obligation when you acquire an interest in commercial property. In case the buyer does not pay it within the timeframe of three months, they will have to pay interest on the amount to be paid and penalties slapped by Revenue NSW. Besides stamp duty, purchasing Sydney commercial real estate also incurs federal stamp duty, called Goods and Services Tax (GST), which is incorporated in the asking price by the sellers. However, the GST expense can be reduced by claiming GST credits if the buyer is eligible.

- **Is Stamp Duty Calculated In Australia?**

Stamp duty amount depends on various factors, such as the state where you are buying the property, the dutiable value of the asset, the utilisation of the building, the nationality of the buyer, and exemptions applicable to the deal. Some tenants also have to pay stamp duty if they offer a huge amount to the landlord to get the lease. The stamp duty on commercial real estate also includes the duty on leasehold fixtures, goods, plant and equipment. However, the NSW Government has terminated levying duty on goodwill and intellectual property.

Since every state has a different stamp duty rate, it is vital for buyers to calculate the cost during the due diligence and property valuation process. They can use the government sites for the state and territory to find the online calculator for stamp duty on the purchase of land or business.

To pay the duty, the conveyancer or the lawyer of the buyer must submit an application with Revenue NSW for assessment. The government body will examine the transfer of property and determine if any concessions can be applied to the cost of stamp duty.

- **Factors to Be Considered When Calculating Stamp Duty**

If you are planning to purchase commercial real estate Sydney, you should be ready to calculate and pay the applicable stamp duty. The cost of this expense depends on the factors listed below.

1. The Value of the Commercial Property

The purchase price of the property or the market value is considered while levying the stamp duty. If the cost of the asset is above $1,168,000, the transfer duty rate in NSW will be $47,295 plus $5.50 for every $100 over $1,168,000. Thus, the higher the value of the property, the higher will be the stamp duty. So, if you are buying a premium office space in Sydney CBD, the stamp duty can prove to be quite high. Thus, it must be calculated in the budget.

2. The Type of the Commercial Real Estate

Commercial property can be divided into several types, and most investors purchase varied assets to diversify their portfolios. It keeps their investment safeguarded in case one of the sectors undergoes a downturn and affects the rental income. For example, the stamp duty rate for buying retail property in NSW is 4.5% of the asset value, while it is 4% for office spaces. It is higher for industrial real estate and stands at 5.25% of the purchase price. The maximum stamp duty is to be paid on the purchase of hotels, which is 5.75% of the purchase price.

3. Stamp Duty Concessions in NSW

Buyers who purchase a commercial real estate Sydney to generate employment are eligible for job creation concession if the asset is valued up to $1 million. Also, those buyers who invest in the regional areas can get a concession if the cost of the asset is $750,000. Hotels and student accommodations also have specific concessions associated with the property types that can help buyers bring down the tax amount. Some concessions are also available to first-home buyers. The government body will inform about the applicable concessions which can help in the settlement.

4. Hire Professionals for Paying Stamp Duty

The transfer duty rates keep changing for every state and territory in Australia. Therefore, it is necessary to have up-to-date information about the rates and thresholds before conducting the calculation. If the property has been purchased off the plan, which means that it will be used for living, the three-month time limit for paying the tax can be extended to 12 months. There are many such parts of the stamp duty obligations that can make an impact on the payment. Thus, it is necessary to hire a conveyance or lawyer to complete the tax planning and payment part effectively.

Many new buyers who wish to purchase commercial real estate Sydney must know about stamp duty because it can add a significant amount to the cost. It must be calculated after understanding the correct rates and thresholds in the state and keeping the factors mentioned above in mind.

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. Is It Better To Lease Or Own Commercial Property? How Entrepreneurs Can Decide

If you run a small business, you might be wondering whether you should lease or own your property. As a partner and executive vice president at a commercial real estate brokerage, one of the most frequently asked questions I receive from clients is, "Should I buy or lease a commercial building?"

Well, like anything in life, my answer is, "It depends."

After all, there are pros and cons to each option that are important to weigh.

Reasons To Consider Leasing

There are a few reasons it could make more sense for your business to lease a commercial property, including:

• Your business is growing and you are not sure how fast you might outgrow the property.

• There are market conditions that are unstable, so only committing to a three- to five-year lease gives you better peace of mind.

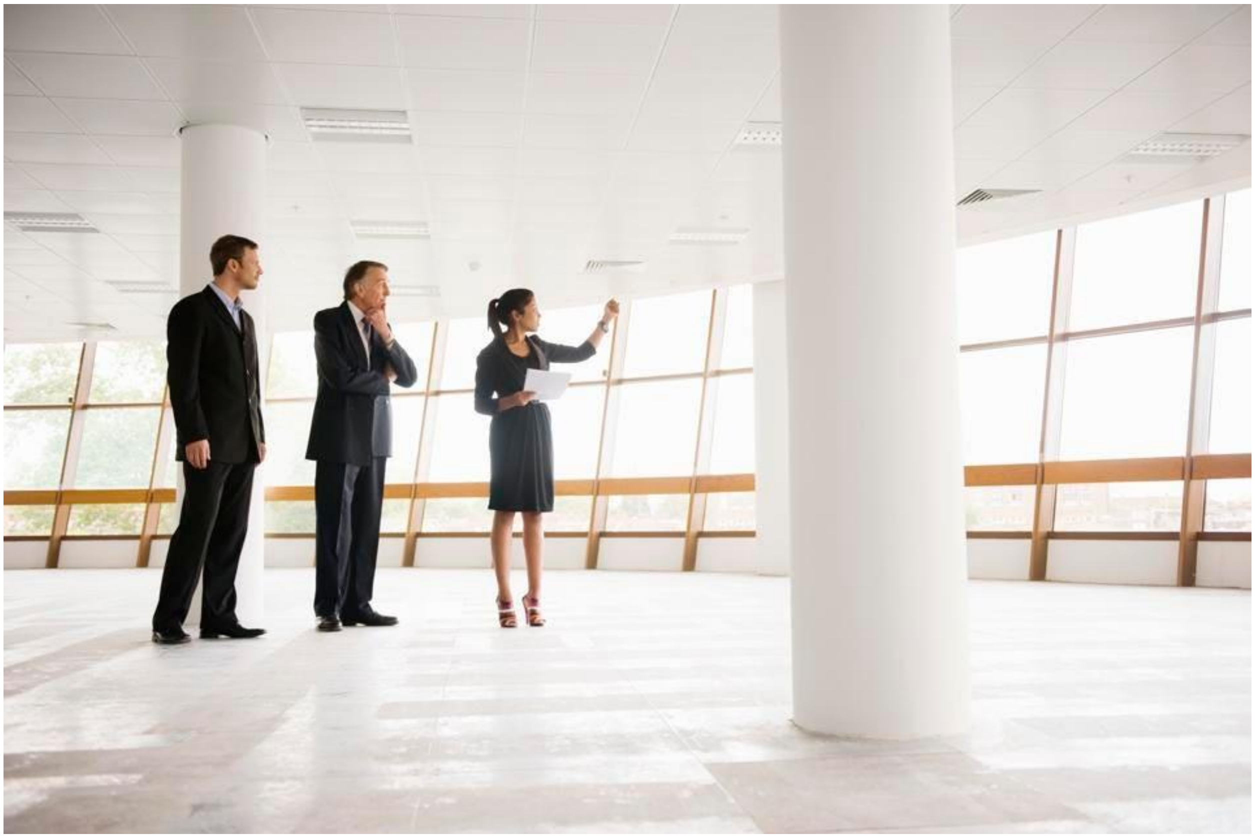
• Capital is tight and you don't have enough for a down payment.

• Your company is young and still in the "building phase."

• Your company is new to a market area, or your customer base is in a tight geographic area, and the only option is to lease without losing customers.

• Your timing is immediate and you need a building within the next 30 to 60 days.

• You have the opportunity to get favorable lease terms.



Reasons To Consider Owning

That being said, there are also times when owning the property could be a better fit for your business, such as:

• Buying allows you to have full control of the property, and you don't have to answer to a landlord.

• You are building equity and long-term wealth.

• Many small businesses, in my experience, can purchase a property with a 10% down payment using a loan from the Small Business Administration.

• If the business goes under, you close or you want to sell it, you have the real estate to fall back on or you can lease the property to tenants.

• You might see certain tax advantages (though you should consult with your accountant first).

Making The Decision To Buy Or Rent

As you can see, there really is no one answer to whether you should buy versus rent. Prior to making such a large business investment, you'll need to consider your business's goals, access to capital and projected growth. By keeping these three factors in mind, you can get a sense of what your business can realistically afford, as well as make a decision that's in line with your vision for the company.

If you're leaning toward buying, it's also worth considering how you would fare in the event of a recession, if you need to close the business, etc. For example, I often think back to the 2008 economic downturn when I saw many businesses go under. The 2008 crash had a significant impact on the economy, and some of my clients who owned their commercial property made out better than those who didn't. Of course, many of those clients had been in business for more than 20 years, and by that point, they owed very little or nothing at all on their properties. So, even though the business might have fallen apart, their real estate investment survived.

In another instance, I had a client who owned a pickle manufacturing plant in Los Angeles. He had no one in the family to pass the business down to, the principal was aging, the business was no longer growing and the facility had become obsolete for any other food business. As the business was slowing down, the real estate he owned was going up in value. The owner was very smart; he not only owned the facility but also had acquired most of the properties adjacent to the manufacturing plant. As a result, he was able to sell the properties to a developer who was planning to build housing.

I have even witnessed clients with real estate that ended up outpacing the business. A number of business owners I know simply made a choice to own their building, and over time, they kept acquiring more real estate.

As a business owner, it is important to think about scenarios like these. Just as you think about your products, your marketing, your sales and your customers, deciding to own or lease could make a big difference.

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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