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Lease, Buy or Build?

You *CAN* make the right decision.

The **Center for Social Responsibility** was having financial problems. Its major program supporter had just reduced the Center's case load by 30%.Belt tightening was going to be needed.

At the same time, the Center's big new office building was just about completed, meaning increased operating costs. The office space market was saturated, so leasing the unneeded space was not looking good. On top of that, there had been unexpected costs for the building's new telephone and computer systems.

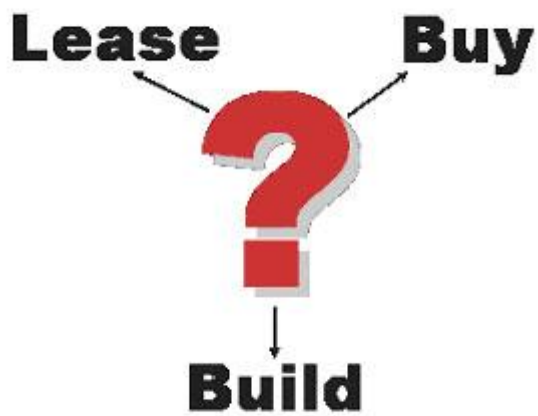
How had this happened?

Across town, the **Metro Treatment Facility** was stuck again. They had just completed more costly improvements to their leased space. They needed custom-designed spaces for the treatments that they provided. Significant electrical power, built-in equipment and lots of parking were needed to deliver their services.

They were already outgrowing their space when it was finished. The building was designed for office use and didn't adapt well to their treatment programs. Clients continued to note how inconvenient the location and the parking were. Now they had spent more money on someone else's building and had no equity to show for it.

Why hadn't they done it right this time?

These two fictitious situations are, of course, exaggerated. But they are not without some truth. These kinds of outcomes need not happen. It is possible, on an organization by organization basis, to determine the best approach to obtaining the facility that you need.



The Options...Lease, Buy or Build

You *CAN* make the right decision.

These options are, in a simplified sense, to rent existing space, to buy an existing building and renovate it or to buy a piece of ground and construct a new building on it.

In order to make the right decision, it is necessary to do three things: Make a projection of the amount and type of space that you will need. Understand the basic finances of the options. Bring this information together with the non-financial factors that are specific to your organization. The answer flows from the third step.

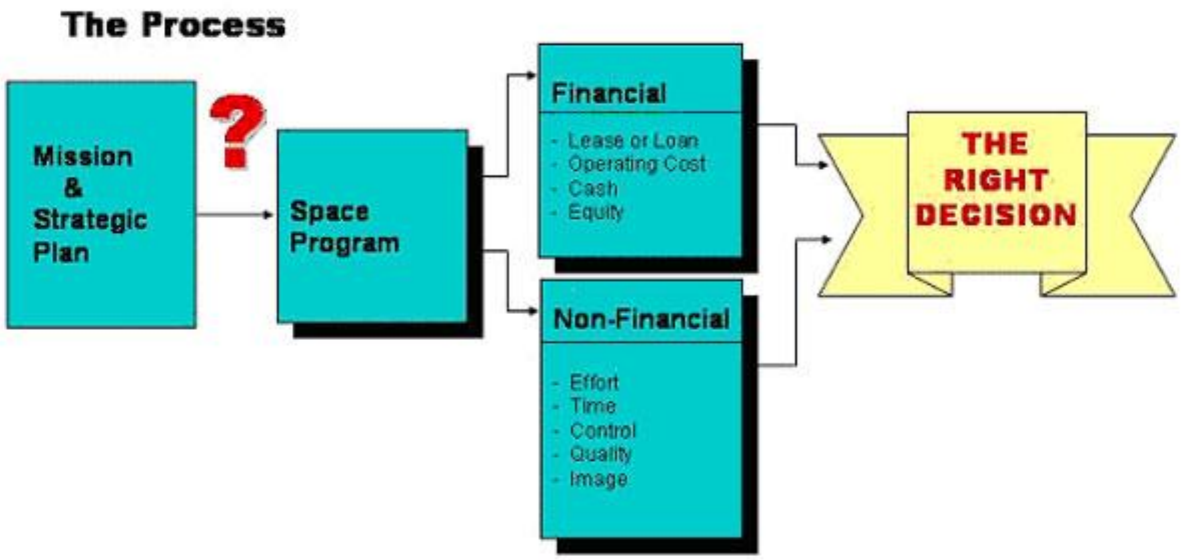
Let's look at the three steps.

A **space program** needs to be generated. How much space are you using? Are there spaces that could be combined or rescheduled to reduce the need? What is the organization's strategic plan for the future in terms of program growth in the next ten years?

The basic **financial factors** of leasing, buying and building need to be compared. They are composed of a few concepts that can be reduced to monthly costs and cash required. They include the rent and/or loan payment and recurring expenses. Perhaps surprisingly, for many organizations there may not be a huge difference in monthly payments between leasing and building a new building. Be cautious, however, since other factors such as the cash required may be more important.

Finally, you must know your organization and you must be willing to look at the **non-financial factors** as well as the financial realities of Lease, Buy or Build.

This comes down to understanding your organization: its needs, its capabilities and its mission. There are no valid generalizations about this decision. It has to be specific to you.



Organizations that do not have sufficient time to plan ahead may find their options limited. Those with unique facility needs may not find the specifics of the comparison that follows useful since it is based on office space. The format, however, should still apply.

Financial Comparison

The financial comparison in the tables below shows the outcome of a lease with some improvements, a purchase plus renovation project and new building project for the same space program.

Lease	Monthly	Capital Costs	
Program			*12,000 sf inc expansion*
Lease Terms			*10 yrs @ $12/sf/yr*
Lease Payment	12,000		
Improvements Cost		150,000	*10,000 @ $15/sf*
Loan Payments	2,308		*25% cash, 60 mo's @ 8.5%*
Recurring Expenses	3,700		*Ins, maint, utils, clean, reserve.*
	18,008	150,000	
Equity		0	
Cash Required		**109,532**	*25% of improvs + 4 mo overlap*

In this comparison, the costs used in the options were based on an organization that needs 10,000 square feet of space. The organization's programs require space that might generally be considered an office environment, but there will be a number of unique requirements. If the organization were to build new it might need a site of approximately two acres of land in a suburban location for the building, parking and other site improvements.

It is assumed that the organization will grow. Therefore, in the comparison the 10,000 square feet is increased for leasing to 12,000 square feet. In the buy option the size of the existing building is increased to 14,000 square feet since the likelihood of finding just the right sized building is low. The build option uses the 12,000 square feet as stated and relies on the site to accommodate expansion. This simple comparison is already becoming a bit complicated.

Buy	Monthly	Capital Costs	
Program			*14,000 sf inc expasion*
Building & Land Cost		1,330,000	*$330k/2.3ac + $40/sf for bldg*
Improvements Cost		400,000	*10,000 @ $40/sf*
Loan Payments	10,453		*Monthly Payment - Principal + Int.*
Taxes	1,458		*$1.25/sf/yr*
Recurring Expenses	6,592		*Ins, maint, utils, clean, reserve.*
	18,503	1,730,000	
Equity		849,425	*After 10 years*
Cash Required		**543,515**	*25% of improvs + 6 mo overlap*

The Lease, Buy and Build options are run in current dollars without an attempt to be more sophisticated in the projection of inflation or the present worth of money. The analysis is run over a ten year period. A typical lease would have a five year term with an option to renew for another five years. Purchasing and renovating a building or building a new building would only be worthwhile if the organization anticipated using the facility for at least ten years.

The key numbers to look at are **total monthly cost** and **cash required**, since even in a lease some cash will be needed to fund improvements.

Lease and loan payments are the basic costs of space. The Lease option includes a Loan for the improvements to customize the space. Recurring costs are significant. They include insurance, maintenance, utilities, cleaning and a reserve for major repairs. Those costs vary depending on the lease or ownership as well as on the age of the improvements.

Build	Monthly	Capital Costs	
Program			*12,000 sf inc expansion*
Land Cost		660,000	*$330k/ac*
Construction Cost		1,560,000	*12,000 @ $130/sf*
Loan Payments	13,413		*Monthly Payment - Principal + Int.*
Taxes	1,250		*$1.25/sf/yr*
Recurring Expenses	5,100		*Ins, maint, utils, clean, reserve.*
	19,763	2,220,000	
Equity		1,090,015	
Cash Required		**605,800**	*25% of improvs + 8 mo overlap*

The Costs

Lease and loan payments are the basic costs of space. The Lease option includes a Loan for the improvements to customize the space. Recurring costs are significant. They include insurance, maintenance, utilities, cleaning and a reserve for major repairs. Those costs vary depending on the lease or ownership as well as on the age of the improvements.

Total monthly cost is probably the most important factor in the comparison. The most obvious conclusion from the comparison is that the total monthly costs for the options are not as far apart as one might think. Therefore, factors other than a straight dollar comparison should also be considered.

An organization should also compare monthly costs in their analysis with their current costs and with their operating budget. This is a reality test for the entire venture.

Cash Required

Buy and Build options require a significant down payment up front. The Lease option requires cash as well although it is significantly less. Lease improvement financing, however, would be at a higher rate than a mortgage and for a shorter period of time.

Most relocations involving construction require some time period of overlapping payments for existing and new space. This is shown in the tables as an additional cash requirement.

The two criteria of monthly costs and cash requirements may tell you if it is possible to step beyond the leasing world into some form of ownership.

Taxes

Nonprofits do not pay real estate taxes. However, they are included as a factor in the Buy and Build options because a common way of avoiding the cash requirement of ownership is to find a friendly investor, or group of investors. The investors provide the cash and are interested in owning the building and leasing it back to you at a rate at or below market.

In this situation, the investor would pay taxes and this cost would presumably be passed on to you. Taxes could be subtracted from monthly cost with friendly investors, but some profit for the investors to cover their risk would be added back.

Equity

Leased facilities provide no equity to the organization. Neither does the friendly investor approach. Ownership does. However, asset appreciation is not guaranteed, so be cautious about this.

It's not worth putting too much emphasis on equity when your primary goal is to provide programs to your clients.

To summarize the financial tables, we have the following:

	Lease	Buy	Build
Total Monthly Cost	$18,000	18,500	19,800
Cash Required	$110,000	544,000	605,000
Capital Costs	$150,000	1,730,000	2,220,000
Equity	$-0-	849,000	1,090,000

So, there is only a minor difference in monthly cost between Lease and Buy. However, the most significant difference between these two is the cash requirement. Buy is somewhat less than Build in both monthly cost and cash required.

As previously stated, the cash requirement for Buy and Build can be reduced to zero by finding a friendly investor. The question is how friendly is the investor and how much will this increase the monthly cost?

The Non-Financial Factors

Financial issues may limit an organization, but having the financial capability to own a building doesn't mean that it's the right solution. Let's look at some other issues.

Time and Effort

The time and effort required to lease a space, including making improvements to it, is cost-effective, and takes perhaps eight to ten months. Finding a building, financing the purchase and making improvements will take more effort and more than a year to accomplish. To locate a site, design and build a new building takes much, much more effort, and about two years.

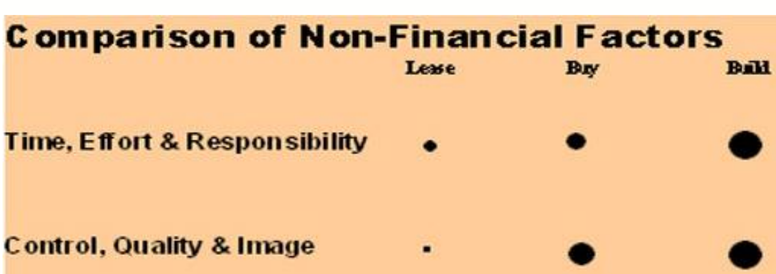
Control and Responsibility

With a solid lease and renewal options, you have a fair amount of control. However, there is little flexibility. If you buy or build, you will have a much higher level of control over the quality, management and expansion of your environment. Control, however, requires the somewhat costly assumption of responsibility.

Quality and Image

Leased space is difficult to justify investing in to achieve quality. You take what you can find and improve it a bit. An existing building will have some limitations to what can be done but few in relation to leased space. A new building can be designed to be whatever the organization wants in quality and customization. New buildings are more costly, but also more efficient in terms of the use of space and cost to operate.

Each of these non-financial factors increases by an order of magnitude from Lease to Buy. There is another increase, although not as large, from Buy to Build. Time, effort and responsibility are negatives. Control, quality and image are positive.



So the conclusion, since all factors increase from Lease to Build, is that you have to put a lot in to get a lot out. A limited exception is the Buy alternative where, comparatively, a lot is gained for a significantly lower level of effort than to Build.

The Answer?

There isn't a simple answer. There is only a process that can be used to evaluate the options.

There's a tendency to think that any organization that is financially and organizationally stable should own its own building, designed from the ground up to suit its needs. Actually, as you've seen, that's not necessarily true. The opposite is also true, that because leasing is least expensive initially doesn't mean its right for you.

Run your evaluation based on criteria that relate directly to the mission of your organization. If the decision can't be justified to directly support the mission, how can it be made? After all, the extra dollars going into your facility might better be spent to provide services.

Get it right!

- **Have your mission and strategic plan firmly stated.**
- **Know how much space you need, what kind, and what it will cost to serve your programs now and in the future.**
- **Go through the evaluation process discussed above, tailoring it to your organization.**

You may need assistance with a strategic plan or you may have had assistance from a consultant. It's a very good investment. You'll need some help with preparing a space study. You'll need a facility planning committee and the services of an architect to do this.

Good architects don't think that the solution to every problem is a new building. A knowledgeable architect can run the financial evaluation of Lease, Buy or Build for you, along with a real estate agent. Select the agent or have the architect select them for their knowledge of the market, their experience with the management of properties and their interest in helping you. Finding a specific building for you can come later.

Throughout your evaluation of the options, keep in mind that a facility is only a means to the end of providing services and programs to your clients.

The **Center for Social Responsibility** recovered from its financial problems. It was able to hold on to its new building by leasing some space at very low rates to another organization. There were some painful times, but it eventually used most of the building since the Center's case load increased.

Across town, the **Metro Treatment Facility** made the best of its inefficient leased space. As the organization grew, they planned for the day when they would again be able to fund the expansion of their space. When that time came they did a feasibility study. They mounted a capital campaign to relocate the entire organization into an existing building that they could renovate in phases. They created a facility tailored to the specific needs of their treatment regimens, their clients and their volunteers.

Providing a good physical facility is an important obligation of any organization. It should be based on an understanding of the economics of the options, the important non-financial aspects of each and, most importantly, on fulfilling the organization's mission.

Background

This article evolved from our experience in working with several nonprofit organizations and with the **Assistance League of St. Louis** in particular. Our firm was recommended by the **Rome Group** who assisted with their strategic plan. We included a real estate firm, the **Hilliker Corporation**, on our team to provide information on site, building and operating costs.

The Assistance League is composed completely of volunteers. It is well run, financially stable and has just completed a strategic plan. The organization appointed a facility committee to take the project through the feasibility phase. In other words, to answer the question: Lease, Buy or Build