CHERRY&ASSOCIATES
the office tenant rep experts

WHEN DOES OWNING MAKE SENSE?

Charlotte's current economic climate is prompting many business owners to examine the option of property ownership. Prior to the conclusion of 2017 and the beginning of 2018, interest rates were the lowest they've been in decades. This prompted many to take advantage of the rates before they continue to rise. Another factor in this decision is a change in FASB accounting standards that will require companies to add operating leases to their balance sheets as liabilities. These changes will affect Public Companies starting in 2019 and Private Companies in 2020. That said, deciding whether to purchase or lease property can be very challenging. There are many interrelated factors, aside from the obvious financial considerations, that should be carefully analyzed. Real estate costs represent significant business expenses, but making an informed and prudent decision goes far beyond the financial considerations and the impact it can have on a business. We advise our clients through careful examination of the following factors:

LEASING VS OWNING

LEASING

ADVANTAGES	DISADVANTAGES
Initial cash outlay tends to be lower than owning	Renting can cost more than owning
Rent payments are 100% tax deductible	No tax savings from depreciation or interest
Less capital commitment can free up financial resources into operations	Less control of asset (less input on image & appearance of building)
Less debt on the balance sheet	No benefit from value appreciation and equity buildup
Remove ownership risks (stability of cash flows & cost)	Rental rate increases
Maintain space flexibility	Less control over operating expenses
Landlord responsible for property issues (allows user to focus on core business)	

OWNING

ADVANTAGES	DISADVANTAGES
No exposure to market rent increases*	Higher initial cash outlay (in most cases)
Property appreciation over the long-term	Possibility of property value depreciation & obsolescence
Build equity	Distracts from core business (property management)
Tax benefits (favorable capital gains treatment, depreciation, interest, etc.)	Capitalization rate & interest rate volatility
Promotes an image of strength & stability (control over image)	Non-liquid asset
Space or equipment is too expensive to move	Reduce flexibility to expand/ contract
Stability of location	Uses up borrowing capacity (depending on financing)
Ability to control operating expenses & maintenance	Increases balance sheet debt (non-issue after 2019 & 2020)

TIPS FOR TENANTS - Q2 2018

COMPANY STRUCTURE / GOALS & OBJECTIVES

The goals and objectives of a company are a key factor when analyzing a lease vs. own situation. The following questions should be answered:

- Consider the consequences of becoming a landlord. What is your core business and how will it be impacted by your responsibilities as a landlord/property manager?
- Is proximity to another location important? For example, many attorneys need to be located near a courthouse. Securing a location near a courthouse through a purchase may be a wise decision.
- Are there plans to sell the company within ten years?
- What are your growth projections? When business growth is unpredictable, it usually makes sense to lease until cash flow and growth levels are stable.
- Is your company a publicly traded company?
- Real estate debt may complicate future borrowing? Owning real estate tends to absorb more cash flow.
- What is your company's cost of capital? This will help determine whether your company should lease or own.

MARKET CONDITIONS

In depth market research is absolutely essential when analyzing a purchase or lease option. Market research should include a thorough property search and analysis as well as economic, social, and demographic studies of the market areas in question. Space markets are very sensitive to economic factors. Variables such as supply and demand, vacancy, rental rates, investor interest, and the lending environment should be examined.

> **"Analyzing the financial ramifications of leasing and ownership is not an easy task. Business owners should seek the help of a professional real estate consultant such as Cherry & Associates."**

SPACE REQUIREMENTS

Companies should consider the physical requirements of their space. By performing qualitative analysis on the physical aspects of a building, business owners can determine if the facility will meet certain functional requirements. Here are items a firm should consider:

- How does the space layout? Is it efficient?
- Are you unsure of future space requirements? If so, leasing probably makes better sense.
- Is your business likely to expand or contract in the in the next 10 years, and if so, will you require more flexibility?
- Conversely, an owner may have greater flexibility in using the property than a tenant. As space needs change, an owner can make choices that support these needs.
- Do you require more control over the image, appearance, use or maintenance of the building? Do you need more control over the heating and cooling systems?
- Is your business highly specialized or is it equipment or space intensive? If so, moving could be too costly?

FINANCIAL ANALYSIS

Without question this segment of the process is the most vital and mistakes made here could be very costly. Analyzing the financial ramifications of leasing and ownership is not an easy task. Business owners should seek the help of a professional real estate consultant such as Cherry & Associates. Cherry & Associates will work with your firm's Chief Financial Officer or accountant to carefully analyze the option to purchase or lease space.

The principal focus of the analysis is to determine if leasing will cost a firm less than buying property outright over some holding period. In a nutshell, that involves calculating the net present value of the cash flows over the term of the lease and comparing this number to the cash flows to purchase the asset. Sound simple? In theory, it is. But there are many factors that complicate the comparison such as estimating future appreciation, lease escalations, operating expenses, the cost of capital, space requirements, and different tax ramifications.

To illustrate, we have modeled a very basic lease vs. own scenario using the following hypothetical data. These assumptions were used in the analysis:

First, let's assume that both options are approximately 5,000 sf in size. The annual rent for the lease option is $80,000 with 3% annual increases. For the purchase option, the purchase price is $1,250,000 with 2% closing costs of $20,000, 1.5 loan points ($15,000), and a 20% down payment ($250,000) to require an initial investment of $290,000. The holding period for both options is 10 years. The assumed opportunity cost of capital or discount rate is 10% and the sales price at year 10 remains flat ($1,250,000).

By calculating the net present value of the cash outlay over the term of the lease and comparing this number to the net present value of the cash flows to purchase the asset, you can determine which alternative is the better economic choice. In this example, owning has a lower present value than leasing after discounting the cash flows of the lease and the purchase at 10% over a 10 year hold period.

Cherry & Associates can help clients analyze all aspects of the lease vs. own decision on a qualitative and quantitative basis.

By Calculating the IRR (Internal Rate of Return) of the difference in cash flows between owning and leasing, a company can determine at exactly what point it is more advantageous to lease vs. own. In this example, the opportunity cost of capital is 10%; however, if it were at 12.81%, the lease and own options would be financially equivalent. At any point greater than 12.81%, it becomes advantageous for a company to lease vs. own and utilize its capital to invest in its business.

Time	Lease	Own	Differential Cash Flow
YR 0	$ -	$ (285,000)	$ (285,000)
YR 1	$ (80,000)	$ (64,419)	$ 15,581
YR 2	$ (82,400)	$ (64,419)	$ 17,981
YR 3	$ (84,872)	$ (64,419)	$ 20,453
YR 4	$ (87,418)	$ (64,419)	$ 23,000
YR 5	$ (90,041)	$ (64,419)	$ 25,622
YR 6	$ (92,742)	$ (64,419)	$ 28,323
YR 7	$ (95,524)	$ (64,419)	$ 31,106
YR 8	$ (98,390)	$ (64,419)	$ 33,971
YR 9	$ (101,342)	$ (64,419)	$ 36,923
YR 10 (Sell)	$ (104,382)	$ 436,580	$ 540,962
IRR			12.81%
PV: 10%	$ (550,700)	$ (487,668)	$ 63,031

IN SUMMARY

No two pieces of real estate are exactly the same, however, a thorough comparative analysis can help companies form a solid decision. Of course, the validity of the decision depends largely on the quality of the assumptions used in the analysis. Using the most accurate facts will produce a more precise outcome.

Cherry & Associates can help clients analyze all aspects of the lease vs. own decision on a qualitative and quantitative basis. If your firm is considering leasing or purchasing property, let Cherry & Associates help guide you through this complex process.

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Charlotte Office Market Stats
Q2 2018

MARKET	Inventory/SF*	Net Absorption YTD (SF)	Gross Absorption YTD (SF)	Direct Vacant SF	Direct Vacant %	Sublet Available SF	Total Available SF	Total Available %	Direct Gross Average Rent**	Sublet Gross Average Rent	Gross Quoted Rents (Range)	Multi-Tenant SF Under-Construction
CHARLOTTE	**46,508,462**	**100,938**	**2,625,295**	**5,896,004**	**12.68%**	**787,845**	**6,683,849**	**14.37%**	**$27.35**	**$23.79**	**$12.50-$40.00**	**2,628,498**
Submarkets												
Southpark	4,284,798	11,040	405,308	460,877	10.76%	134,723	595,600	13.90%	$30.48	$23.66	$23.00-$37.00	0
Downtown	15,722,231	231,965	753,835	2,128,548	13.54%	166,282	2,294,830	14.60%	$32.37	$30.68	$22.00-$40.00	1,610,073
Midtown	3,600,793	(73,864)	224,839	279,794	7.77%	42,576	322,370	8.95%	$29.25	$28.74	$18.00-$36.00	519,956
Airport	7,496,064	(82,318)	439,255	1,403,092	18.72%	170,180	1,573,272	20.99%	$21.49	$16.55	$12.50-$25.50	114,469
Highway 51/ Southeast	5,229,931	47,303	353,989	471,120	9.01%	127,504	598,624	11.45%	$28.44	$25.23	$21.00-$37.00	354,000
North	2,609,853	(40,459)	134,637	166,426	6.38%	121,993	288,419	11.05%	$24.04	$22.16	$13.50-$32.00	30,000
University	4,088,347	(28,115)	196,418	584,765	14.30%	24,587	609,352	14.90%	$22.44	$20.00	$15.00-$25.00	0
Matthews/ Crownpoint	1,065,151	5,065	31,333	96,600	9.07%	0	96,600	9.07%	$16.24	-	$13.00-$25.00	0
Cotswold	114,162	(251)	5,038	251	.22%	0	251	.22%	$21.33	-	$17.00-$23.50	0
Park Road	904,514	43,445	67,844	92,960	10.28%	0	92,960	10.28%	$23.39	-	$15.00-$27.75	0
East	1,392,618	(12,873)	12,799	211,571	15.19%	0	211,571	15.19%	$15.62	-	$14.00-$20.00	0
SC TOTALS	**1,871,338**	**(146,269)**	**120,841**	**452,998**	**24.21%**	**89,164**	**542,162**	**28.97%**	**$21.65**	**$26.00**	**$16.00-$31.00**	**13,484**
SC Border Submarkets												
Lancaster County	417,875	24,660	49,202	112,384	26.89%	0	112,384	26.89%	$23.77	-	$21.00-$24.50	0
York County	1,453,463	(170,929)	71,639	340,614	23.43%	89,164	429,778	29.57%	$21.04	$26.00	$16.00-$31.00	13,484

*derived from multi-tenant, non-owner- occupied buildings, above 10,000 SF

**given landlords do not quote rental rates for fully occupied buildings, this report does not arbitrarily assign rental rates to fully occupied buildings