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PROPERTY  
AUSTRALIA

September 2004

VOL 19 NO 1

## Own vs lease – linking tenure into the CRE strategy

Rodney Timm argues that, when CRE professionals make important real estate decisions, often they're really asking themselves "am I willing to bet the farm?"

Contemplating the development of a new head office or other facility is quickly followed by the 'own versus lease' debate. For companies having a

relatively low cost of capital, the develop-and-own approach looms attractively, particularly compared to the alternative of negotiating with a developer with a higher cost of capital. Why should a company not develop and own the building rather than commit to a potentially higher occupancy cost by paying rental to a developer? Usually in the decision process, discounted cash flows are quickly structured with various real estate input assumptions to support the develop and-owner business case. But what are the traps?

Undertaking any type of real estate development requires commitment, focus and core real estate skills. All of us love to dabble in real estate transactions and all have enjoyed significant capital growth on our primary residences – so why can we not replicate our success in the business environment? Too often in this process the company executive gets diverted from the primary focus of the business into the challenges of real estate development. Focus on the core business is lost – even though it is this core business that is the platform of success, generating cash flow and wealth.

A clear understanding of the business's real estate objectives can help to focus the thought processes. Articulated real estate objectives with mutually exclusive objectives – such as minimising occupancy costs and maximising return on real estate assets – indicate a lack of clear direction. These are obviously conflicting objectives and the presence of both questions whether the company really understands what its core business is. What skills are there in the business and where should these be focused? If maximising return on real estate assets is 'dear to the heart' of the company, the business should probably be redefined in terms of real estate development and investment activities.

The key to the own-or-lease decision lies in understanding the nature of the corporate portfolio and the specialised nature of the asset being developed. The more stable the nature of the business, its core portfolio and the longer the length of tenure based on the projected productive life of the asset, the more defensible is the decision to own. But, ultimately, the business case for the decision needs to be based on rigorous financial analysis and the input assumptions.

The critical assumption in the financial analysis is usually the residual value of the real estate asset at the end of its productive life. At best this estimate is a theoretical calculation based on forward projections. But, more realistically, it is usually a real estate bet waged against the vagaries of the property market and in competition with voracious real estate speculators. The main business (and entertainment!) of the latter is profiting out of unsuspecting companies and government agencies by understanding real estate cycles and corporate real estate inadequacies.

In the cash flow analysis, the residual value of the asset at the end of the cash flow period (the real estate bet in the decision), should be discounted at a rate that reflects the inherent risks in this assumed value. However, too often the corporate discount rate is used for this as well as the other cash-flow entries such as rental, operating costs and interest – the latter items are all more reflective of normal business operating risks. The inherent additional risk in the real estate residual value bet is usually ignored, resulting in sub-optimal decision-making in the own versus lease debate.

In many situations it does make compelling sense for companies to capture the real estate value that the covenant of their lease adds to a development asset – particularly in the current real estate investment feeding frenzy. Provided the appropriate skills are available within the organisation – either internally

employed or contract appointed - to dedicate the necessary time and effort to the cause, there is no reason why not to use the development process to capture real estate value. Even if there is no long term intention to own the asset.

A site can be secured (under option if necessary) and a requirement specification detailed. Engagement with the developer market to secure competitive bids to build and own can then provide a beneficial outcome. Because this process has de-risked the development in terms of location, occupancy and specification requirements, it is realistic to share in the developer's profit or manage the resultant recurrent occupancy costs through a reduced rental structure. Another advantage is being able to set the agenda in the lease agreement negotiations related to landlord performance, rental review patterns and those irritating clauses such as make-good. An integrated fit-out may also be beneficial to both parties. The primary success factors include understanding the real estate market drivers and having dedicated appropriate skills to see the process through to the end. This approach is not for the faint-hearted or unprepared but can be financially rewarding.

For those companies already owning assets, it is a challenge to determine the optimum time to sell. Selling once the building is vacated or such intention is known is unlikely to realise the optimum return. Sufficient residual lease term (linked to the projected asset productivity) should be provided to entice the market into believing that the asset holds real value for them. This could be anywhere between five and ten years dependent on the sector of the market and the state of the real estate cycle. The general principle is not to be left trying to sell an asset that is obsolete and vacant – particularly in a soft market. Leave such speculation to the real estate developers and investors.

The accounting treatments of depreciation, incentives and capital values also needs to be carefully considered in the own versus lease decision.

So back to the challenging question – to own or to lease? Once a company has clearly determined its business objectives, undertaken its financial analysis, focusing on the real estate risks and the accounting treatments, and clearly considered where it wants to put its capital, the answer tends to become much clearer – and the temptation to speculate on real estate bets becomes less compelling!

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