

# The Age-Old Problem: Leasing versus Buying

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**F**ACILITY-INTENSIVE NONPROFIT organizations face a perennial dilemma: whether to lease or purchase facilities. Leasing a facility allows nonprofits to stay flexible, hedge their bets, and potentially minimize financial risk. But constant rental fees can drain finite financial resources and undermine program investment. On the other hand, while purchasing property enables nonprofits to build equity and establish a community presence, purchasing a facility can lock fast-growing or unstable nonprofits into a location and saddle them with financial risk. How can an organization decide whether to rent or buy, and which factors are most important in the decision-making process? This article discusses the various factors in the lease-versus-buy decision and helps organizations make informed decisions based on their financial picture and particular context.

Consider the experience of a Chicago-based nonprofit that provides comprehensive mental health and substance abuse counseling to low-income residents. Over the past 10 years, the organization rented space. At the scheduled lease end, the owner put up the building for sale. This stable agency suddenly confronted the prospect of moving, renewing its lease, or buying the building. Following careful consideration, the agency made the decision to purchase the property. After its purchase, the agency real-

ized net asset growth, more consistent operating surpluses, and a mortgage payment lower than the rent previously paid. After the organization applied for tax-exempt status (a one-year process), the acquisition also enabled the agency to save approximately \$60,000 a year in property taxes. The agency also estimated that rent expenses would have increased 3 percent to 5 percent annually in future years. Ownership was the right decision for this agency, but it's by no means the universal right choice.

After 20 years of working with facility-intensive nonprofits, IFF, formerly known as the Illinois Facilities Fund, has developed considerable expertise in providing real estate decision-making tools for nonprofit executive directors. Many resources on owning real estate paint the picture with a broad brush. But in IFF's experience, the issues vary dramatically for nonprofits of different ages, sizes, and program types. And all decisions must be made in the context of each agency's vision and plans. The needs of a primary health-care clinic in a rapidly growing immigrant neighborhood are quite different from those of a small child-care center in a mixed-income housing development. In terms of lease-versus-buy considerations for nonprofits, IFF has found the following to hold true:

- No organization should own real estate that is not affordable under a

conservative revenue projection of at least five years. "Affordable" means that an organization operates at a healthy surplus; IFF encourages about 5 percent. But just because an organization can afford to own the building doesn't mean that it should. The chosen location may not be right for its mission or clients, or buying property may bring distractions, such as maintenance issues.

- If an organization has experienced rapid growth, expects to grow significantly over the subsequent five-year period, or remains uncertain about the concentration of its client base in the future, it's best to lease space until operations are stable and planning for the future involves fewer unknowns.
- If an organization has stable programs and funding, has occupied the same space for several years, has an excellent planning track record, and understands its space needs and budget, it may be a good time to consider owning real estate.

In addition to these kinds of considerations, nonprofits often choose or decline to own property given their philosophical approach to risk and reward. And in many cases, building ownership reduces stress, stabilizes programs, and strengthens an organization as it builds assets. Others lease if owning means

incurring debt, though in fact resistance to long-term debt often hinders financial stability. Factors such as convenience, efficiency, appetite for risk, and control often play into each side of the rent-versus-buy debate

Rising rent costs create just as much financial pain as unplanned maintenance costs. In both cases, careful and realistic financial and program planning are an absolute must. Owning property in the city may differ from owning in the suburbs because of the quality and commitment of landlords, local practices, regulations, and laws that favor either tenants or landlords.

Thus, the decision to lease or buy depends on various organizational factors, and these factors aren't static. And while an organization may have made the appropriate decision at the time and for a given set of circumstances, the factors influencing the decision—such as the environment, the economy, or the neighborhood surrounding a facility—may change and require new decisions about renting or purchasing facilities.

### Assessing the Situation: IFF's Experience

With few exceptions, new nonprofit organizations should not focus on real estate ownership. Instead they should establish the organization and its value to the community. In some cases, wealthy donors may back the agency and raise funds for capital investment in property ownership, but these situations are the exception. It may be challenging to lease, where an organization must find space to rent and then improve the space to meet the needs of the program, but it's effort well spent while the agency is young. The following questions provide a guide for organizations of any age that lease or rent space.

- Can the organization survive events that require a change or relocation (e.g., rising rents, redevelopment, or sale of the property)? If rents escalate dramatically, an agency in a gentrified neighborhood, for example, may experience

a disconnect with its clients.

- Does the current location provide access to the target client base? If clients do not have access, an organization's fees and income may decline. An agency dedicated to improving health among the Latino population, for example, should be accessible to the community.
- Is the agency committed to a single community? A community-specific service focus may restrict relocation options and favor a long-term lease or ownership.
- Does the organization have enough control of the space to accomplish its goals over the next five years? Control starts with good landlord relations, the ability to secure a long-term lease with options to renew, and a clear grasp of potential rent increases and building operating costs. Moreover, nonprofits often overlook attention to detailed lease negotiations. Some landlords finance build-out of special use space and handle construction.
- Will improving or changing current space be affordable and cost-effective? Whether it is owned or leased, new space frequently costs less than renovating existing space.
- Can the organization cover regular maintenance costs? As a building ages, it is important to assess ongoing energy and upkeep costs. If energy-efficient systems are not installed in leased space, energy costs may rise at a higher rate than revenue.
- Does the space provide for future specialized needs (e.g., a playground, private offices, and soundproofing)? As organizations grow and adapt, their facilities must grow and adapt as well. If existing space cannot accommodate the need for future change, program quality may suffer.

If the answer to most of these questions is no, it is likely time for an organization to consider relocation and ownership. Further, any responsible board of directors should consider the various factors discussed here.

### Steps in the Buy-versus-Lease Decision-Making Process

In the buy-versus-lease decision-making process, many nonprofits make mistakes, but thousands more get it right. They do so by thoughtfully analyzing their situation and priorities. The first step in the buy-versus-lease decision-making process is to examine organizational needs and those of the organization's clients. Programs must dictate facilities needs and not the other way around. Allowing a facility to drive programs can lead to trouble and even financial failure.

It's also crucial to understand an agency's goals over the next three to five years. This examination must include program goals, space, growth needs, revenue streams, and financial stability. For agencies that rely on government payments, examining revenue streams is particularly important. Rarely do government payments increase at the rate of inflation, which means that there will be a gap between cost of services and payment. Before it makes any decisions about a facility, an organization must be in a stable financial position and have a strategic vision for programs. If you know that existing space cannot accommodate program objectives and if you have clear goals, unanimous board support, and identified revenue, you can get even further in the process.

Once these factors are clear, an organization should examine the cost of new operations and monthly cash flow. Projecting the first year of monthly revenues and expenses helps determine whether a new facility makes sense. A five-year projection predicts success further and helps inform other decisions. A nonprofit's year-end figures should be positive numbers.

The next step is to identify sources for up-front capital investment. There are five common sources to pay for a real estate project: agency cash (net assets), foundation grants, a capital fundraising campaign, government funds, and debt. Many capital projects include all these sources. Foundations, capital campaigns,

Table 1: Leasing vs. Buying

Costs	
Buying	Leasing
<i>Up front</i>	
Acquisition and down payment	Renovations (hard and soft costs)
Appraisal and inspection fees	Financing fees
Environmental report	Legal/closing costs
Renovations (hard and soft costs)	Furnishings
Financing fees	
Legal and closing costs	
Title insurance	
Survey	
Furnishings	
<i>Ongoing</i>	
Mortgage payments	Rent payments
Utilities	Utilities (may be in rent payment)
Maintenance	Property insurance
Property insurance	Property taxes (exemption unlikely)
Property management	
Property taxes (exemption possible)	
Benefits	
Buying	Leasing
Building equity and assets	Less responsibility for property management
Flexibility (if relocation needed)	More budget certainty if landlord is responsible and long-term lease
Long-term strategy for property control	No large up-front capital needed
Potential property appreciation	Flexibility
Better control of occupancy costs	
Asset can be used as collateral	
Savings from property tax exemption	

and government funds can take months or years to secure, making cash flow planning a critical component of a building project.

Nonprofits that deliver services should avoid pre-development loans unless they have funding commitments in hand to repay if there is a required construction start date and a timing problem concerning the funds. Part of any comprehensive financial plan includes consideration of construction loans structured—short-term loans, usually interest-only, that cover the costs during construction and get refinanced to fully amortizing loans once construction is complete—or converting to a long-term mortgage.

### Leasing versus Buying

In deciding whether to buy or to lease, the two primary factors are the costs and the benefits. Table 1 helps frame these issues.

### Renovation versus New Construction

If an organization decides to relocate and purchase a property, the next part of the equation is whether to renovate existing space or build anew. This decision may ultimately come down to cost. In some instances, and depending on local building codes and other variables, renovation and new construction may cost the same. For example, an older, well-cared-for building that can be obtained cheaply given its condition may cost more to update and reconfigure. Older buildings often contain asbestos and lead paint, which requires remediation and adds to up-front costs. It is more costly to update older systems. In addition to up-front costs, older, renovated buildings may be more costly to operate in the long run. Current building materials are more energy efficient and can be easier to maintain. A detailed comparison of costs for an old versus a new building is a necessity. The availability of land or property varies widely by community, which may affect the decision.

The other factor is space needs. The footprint of an existing property may

limit an organization's ability to meet all its space needs. Sometimes a facility's use is so specialized it's hard to retrofit existing buildings. Before acquisition, an organization should work with an architect to confirm that an existing property can meet its needs. New construction allows an organization to design its space specifically to meet its current and future needs.

### A Case Study on Buy-versus-Lease Considerations

A recent case study helps highlight the various considerations in an organization's decision to move or stay, buy or lease, renovate or build anew.

A well-established, small nonprofit contacted IFF to analyze whether it should move and whether it made more sense to buy or lease a new facility. The agency was founded more than 30 years ago as a community-based agency serving residents of a nearby public-housing development. Over the years, the agency expanded to provide services to low-income residents throughout Chicago. The services are in the areas of housing, family, and criminal law. In the most recent year for which statistics are available, the agency served nearly 1,000 clients with approximately 15 full-time and five part-time employees.

The initial location of the agency was suitable when its focus was more community based. The agency owned its space in an office building, but as it grew, the location became less desirable. The space wasn't near its client base, the building was dilapidated, and facilities issues drained staff attention. The agency also recognized that, while the amount of space was adequate, it needed additional private offices to handle client meetings in which personal and confidential information was exchanged. Because of these changes, a desire to offer more services to more clients in the future, and a need to reside in a well-maintained property, the organization called on IFF to devise a plan to meet its space needs and best serve its clients. IFF first conducted a

space-needs analysis, evaluating administrative space, meeting and program space, and circulation. The review determined that, with some change, the agency's existing space could support current and future programs.

The second part of the plan involved a financial analysis. The two analyses resulted in three options to move forward:

- **Option one:** Retain and renovate current offices.
- **Option two:** Sell the existing office and purchase a new facility.
- **Option three:** Sell the existing office and lease a new facility.

Next, IFF reviewed the organization's finances to determine what the agency could afford for up-front costs and ongoing expenses, such as debt service. The agency had a strong financial history with an annual operating budget of \$875,000 and net assets of \$300,000. The agency's revenue had grown steadily, at an average of \$80,000 annually. Through this analysis, IFF determined that the agency could support approximately \$750,000 in debt to finance new space. This calculation was based on a standard IFF loan with a 20-year term and an interest rate of between 6 percent and 7 percent. Up-front costs would depend on the chosen option; option one is based on 6,655 square feet, and options two and three are based on 5,650 square feet. The analysis determined that the total development costs for options two and three assumed a sale price of \$1.7 million for the existing office (which had appreciated significantly).

**Option one.** The estimate to retain and renovate the existing space was nearly \$1 million (see table 2). This included removal and replacement of the roof, plumbing repairs, replacement of mechanical systems to enable more efficient service, and reconfiguration of existing space to better meet agency needs. In addition, there would likely be upgrades to meet building codes, such as adding a sprinkler system and improving accessibility. To pursue this option, the agency would need to raise or finance \$600,000 (see table 3).

**Option two.** The second option would cost \$1.9 million (see table 4). More than half of the cost involved acquisition, with other project costs of \$500,000. The costs were based on a location that would provide maximum access for the agency's client base. For this option, the agency would have enough equity available from the sale of its existing property and supportable debt to cover 100 percent of development costs (see table 5).

**Option three.** The third option was the least expensive, at a cost of \$390,000 (see table 6). Similar to option two, the agency would have enough equity available from the sale of its existing property and supportable debt to cover 100 percent of the development costs and save some of the proceeds. At the same time, reviewing the resulting financing scenario indicated that the agency would need another \$32,000 in annual revenue to meet lease payments (see table 7).

To assess the impact of each option on the agency's operating budget, IFF reviewed the organization's 10-year operating pro forma. IFF estimated facility operating costs and included debt service payments assuming a typical IFF financing structure, as noted previously. To determine revenues and expenses, IFF took the most recent actual numbers and escalated costs and expenses by an inflation factor of 2 percent a year. Based on these projections, it appears that the agency can operate the current or a newly purchased facility with approximate annual surpluses of \$12,700 and \$16,600, respectively, increasing by 2 percent annually.

The addition of lease and property tax payments under option three leaves the agency with projected deficits. But the agency will have approximately \$1 million in equity available from the sale of its existing building. IFF estimated the potential income the agency could derive from the investment of the sale proceeds. Assuming a conservative interest rate of 4.5 percent, it is esti-

mated that the agency could fund 100 percent of its projected deficit with interest income by investing the \$1 million.

As part of its recommendations, IFF projected the organization's cash flow over the upcoming 10 years. Under option 1, the agency's cash flow would go from \$13,000 in year one, to \$20,000 in year two and \$31,000 in year 10. Option two shows these figures as \$17,000, \$25,000, and \$36,000, respectively. Option three, the lease option, resulted in negative cash flows of \$26,000 in year one, \$28,000 in year five, and \$31,000 in year 10.

In sum, option two presented the opportunity to exploit existing assets to achieve the agency's goal of moving into a less gentrified neighborhood without requiring the agency to engage in a capital campaign or having an adverse effect on its operating budget. During a board meeting, the options of remaining in the current location as-is or phasing in improvements were discussed. IFF recommended that, unless major maintenance issues were addressed in the near term, the agency move from its existing facility to better meet program goals and maintain the financial viability of the asset.

The agency recognized that it was time to consider a move, but its work with IFF enabled the agency to develop a strategic direction. After reviewing all options and working with its board, the organization decided to follow the advice of IFF and sell its existing space and purchase an office condominium (option two). In making the decision, the organization considered its need to extract itself from a poorly maintained building, its desire to move to a more accessible location for its clients, and its ability to sell its property for a good price. The space will be affordable and allows for privacy during client interaction. For any organization considering a move, an analysis of space needs, client needs, and location, along with a review of estimated up-front and long-term financial costs, is necessary.

**Table 2: Estimated Costs for Renovation of Existing Facility (Option One)**

Construction/hard costs		\$720,000
Maintenance, systems, and code issues	\$506,000	
Reconfigure space and upgrade finishes	\$184,000	
Replace windows	\$30,000	
Soft costs (25%)		\$180,000
Project contingency (10%)		\$90,000
Total development costs		\$990,000

**Table 4: Estimated Costs for Purchase and Renovation of a New Facility (Option Two)**

Acquisition	\$1,130,000
Construction/hard costs	
Building renovations	\$565,000
Soft costs (25%)	\$141,000
Project contingency (10%)	\$71,000
Total development costs	\$1,907,000

**Table 6: Estimated Costs for Renovating a Leased Facility (Option Three)**

Construction/hard costs	
Reconfigure/build-out space	\$283,000
Soft costs (25%)	\$71,000
Project contingency (10%)	\$35,400
Total development costs	\$389,400

**Table 3: Financing Scenario (Option One)**

	Three-Year Averages
Total available to support all debt service	\$70,000
Less existing debt service	(\$35,000)
Available for new debt service	\$35,000
Total supportable new loan amount	\$376,000
Funding gap	\$614,000

**Table 5: Financing Scenario (Option Two)**

Total available to support all debt service	\$70,000
Total supportable new loan amount	\$758,000
Proceeds from sale of existing property	\$1,700,000
Less payoff of existing loan	(\$286,000)
Total available for purchase/renovation	\$2,242,000
Funding gap	\$0

**Table 7: Financing Scenario for Leasing a New Facility (Option Three)**

Proceeds from sale of existing property	\$1,700,000
Less payoff of existing loan	(\$286,000)
Less renovation costs	(\$389,000)
Total available for investment	\$1,025,000
Annual lease payment (year one)	\$102,000
Annual amount of supportable lease payment	\$70,000
Annual amount needed from investment or other income to cover lease balance	\$32,000

## Conclusion

Nonprofits want to ensure that they have the facilities needed to accomplish their goals and the ability to serve their clients. And as the previous case study indicates, purchasing new facilities can be the right decision for an organization with stable finances and a relatively certain future. But the decision to lease or buy

depends on many factors specific to a nonprofit's situation.

Financial considerations play a critical role, but so do less quantifiable factors such as presence in the community, an organization's five-year goals, appetite for risk, and more. Before making this important decision, a nonprofit must conduct a thorough analysis of its needs. Only after it

examines all relevant factors should an agency decide to lease or buy.

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