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Buy, Build or Lease?

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Introduction

Planning whether to buy, build or lease should be a thoughtful and planned decision. It should be based upon the needs of your business and your personal financial goals. Real estate ownership for an orthodontic practice is not the basis of wealth; company cash flow is. Real estate is a capital asset (or personal asset) that allows a company to create cash flow. That said, building ownership can hold a distinct financial advantage over leasing over the long term for a number of reasons, including financial.

Keep in mind that no matter how successful your practice is, it is not likely to alter the value of the building or office your practice occupies. Real estate value is a product of other market factors including location, quality, condition, availability, and other local, regional, and national economic conditions. The success of your practice will hinge on a number of business factors, but your physical office will most likely not be the major reason for success regardless if you own or lease.

Which is Best for Your Practice?

Strategic Planning

How much time have you invested into developing a strategic business plan? If you do not have a strategic business plan, it is very difficult to select the best option for you and your practice. Since you have a small business (usually with one owner), keep in mind that your business strategy goes hand-in-hand with the planning of your personal financial goals. Do not plan one without the other.

Plan well in advance in any event. Finding a new lease space can take months. If you have to remodel the space, design and construction can take another 6 months or more. The planning process should start a year before your expected occupancy date.

For new construction, it takes much more time. It can take months to find property. Design and construction can take 12-16 months (normally). If building new, start the process at least 2 years prior to your expected occupancy date.

See the advice of your accountant, attorney, and personal financial advisor before deciding which is best for you and your practice.

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Buying or Building New

Profile of Building Owner:

- They are at least somewhat established in their profession for 1-3 years (most over 5 years).
- They have an established (and usually growing) patient base.
- They have created a business plan (and follow it).
- They know what they want out of the profession, both personally and professionally.
- They have established long-term goals.
- They may be buying or building a new main office or a new satellite office.
- They have considered the pros and cons of buying and/or building new.
- They are located or have found a location near new schools.
- They have found an area under-served by orthodontists.
- They want to diversify their investment portfolio.
- They understand and have a tolerance for risk.
- They want to take advantage of tax laws.
- They want to establish a strong and unique image in their community; brand their practice.
- They understand the effects on their practice cash-flow as rent usually increases for their practice (but is gained back as a personal investment and building owner).

Advantages of Building Ownership

- Excellent long-term investment potential.
- Having the ability to brand your professional image.
- Your practice can become more publicly visible.
- Tax advantages.
- Ability to design for future growth.
- Choice to build a multi-tenant building to gain a greater investment return.
- Chose your own location.
- Increase the value of your practice when retiring/selling.
- You build equity every month.
- Maximize patient accessibility.

Disadvantages of Building Ownership

- High initial cost (though some leases can also have very high initial costs).
- Fluctuation in real estate values.
- Difficult to move or sell in slow market.
- Desirable property hard to find.
- Maintenance and upkeep responsibilities.

When to Consider Building New or Buying

- When value versus leasing is more advantageous
- Cannot find good, cost-effective, leasable space.
- Outgrowing current space.
- Current space is outdated; requiring costly remodeling.
- Interest rates are low.
- Seeking new ways to recapture lost revenues.

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- Found a highly desired property in a highly desirable location.
- Reinforce, recreate, or newly create your practice's image.

Understanding Ownership Responsibilities

Do not forget that building ownership and being a landlord has a number of responsibilities, such as:

- Building maintenance
- Parking maintenance
- Snow removal
- Landscaping
- Utilities
- Security
- Taxes
- Insurance
- Others

Steps in the Building process (Buying is similar)

1. Determine that building ownership is best for you and your practice.
2. Consult with family, attorney, accountant, personal financial advisor.
3. Set a realistic comprehensive project budget; know out-of-pocket costs.
4. Create a realistic project schedule.
5. Determine total project costs (land, design, taxes, construction, permits, legal, etc.).
6. Determine total costs of equipment, furniture, and fixtures.
7. Seek lenders. Review costs/requirements.
8. Create LLC/seek legal advice for building ownership.
9. Find property. Enlist help of independent realtor.
10. Complete due diligence planning for property (check codes, setbacks, soil conditions, drainage, utilities, etc. In other words, make sure your project works). If purchasing a condo, check for hazardous materials, complete preliminary floor plan, determine how utilities will serve your suite, review legal issues, etc.). Hire professionals to assist. DO NOT PURCHASE UNTIL THOROUGHLY RESEARCHED.
11. Find experienced architect/designers.
12. Determine how you will have the project built (competitively bid, team build, design-build, etc.).
13. Complete project program (wants and needs of building, floor plan, equipment, etc.).
14. Start design
15. Finish design.
16. Have lender appraise project to start final lending process.
17. Complete construction documents.
18. Bid work.
19. Send work to permitting agencies.
20. Obtain permits.
21. Complete bidding process.
22. Enter into contractual relationship with contractor. Have architect oversee construction.
23. Construct
24. Certificate of occupancy & move in.

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Leasing

Profile of a Tenant:

- They have a desired location.
- They enjoy lower risk than building owners.
- They do not care to realize financial advantages of owning.
- They are recent graduates, mid-career professionals, and mature professionals.
- They enjoy a landlord having building maintenance responsibilities.
- They are comfortable with their business plan and strategy.
- They remain flexible; keeping future options open. They can move easier than a building owner.
- They do not typically have a large outlay of cash to enter into a lease.

Advantages of Leasing

- It is initially less expensive (but this is not always the case…depending on construction build-out costs).
- There is less building management than in building ownership.
- There is the opportunity to move at the end of a lease.
- There are typically numerous office location options available.
- There is little to no building maintenance.

Disadvantages of Leasing

- Common (shared) area lease costs (building lobby, toilets, hallways, etc.).
- Parking options may be tight.
- If you need to move quickly, it can be challenging and expensive to break a lease.
- Having undefined lease terms (having to renegotiate if you do not want to move at the end of a lease.)
- Building accessibility may not be optimal.
- Unresponsive landlords are a headache.
- Mechanical systems may be hard to control.
- Utility costs are hard to control.
- Storage options may be limited.
- There may be high tenant improvement (remodeling) costs. If the landlord does not give a leasehold improvement allowance, initial move-in costs can be very high. Typical orthodontic office remodel construction costs start at $70 per square foot and go up to $200 per square foot or more, depending on your location. These costs do not include design fees, permit fees, equipment, furniture, IT, etc.
- Depending on the suitability of the space, there may be some wasted, inefficient space.
- You may outgrow your space with limited options for expansion.
- Long-term costs are typically higher than owning.
- Lack of control over neighboring businesses hours, clientele, or types of business.
- May not be as publicly visible from the street as a stand-alone building.

When to Consider Leasing over Building

- When value versus building is more advantageous
- Cannot find desirable property for a new building.
- If you are on a limited move-in budget (depending on the lease terms).

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- If you are a recent graduate or your future in the area is in question.
- If you have an urgent need to move quickly.
- Land costs are very high.
- If you have a number of offices in a region.

Steps in the Leasing Process

1. Determine that leasing is best for you and your practice. If you have doubts, try to craft a lease which has a shorter term. It may be more expensive; you will have to weigh the options.
2. Determine a general location.
3. Work with an independent leasing agent who represents you and not the building owner.
4. Determine a rough suite size. If you do not know, hire an experienced orthodontic architect or designer to assist.
5. Make a building wish list (parking requirements, what floor you want to be on, if you want to be in a strip mall or professional office building, etc.).
6. Find a number of office location options.
7. Complete project program (wants and needs of building, floor plan, equipment, etc.).
8. Work with an experienced orthodontic architect to determine which suite suits your needs the best.
9. Select the best option for your practice.
10. Work with your attorney to review your lease. Everything is negotiable in a lease. Everything. Try to negotiate the option of working with the design professionals you want and that you have control over the contractor selection.
11. Determine financial requirements and review with lender.
12. Execute lease.
13. Work with experienced architect to design your suite based upon your needs.
14. Complete design.
15. Complete construction documents.
16. Bid the work.
17. Complete construction.
18. Certificate of occupancy.
19. Move-in.

Recent Graduates or First Practices

Most often, recent graduates or those entering into their first practice usually either join an existing practice with the chance for ownership or start their own, usually on a smaller scale in order to build a patient base.

Recent graduates are more likely to change the professional direction during the course of their practice. This could be due to a change in location or to pursue a better opportunity elsewhere. They will also go through many changes including practice growth, the consideration for satellite office expansion, and personal lifestyle changes. They are also the most cash strapped in the industry. Due to these reasons, recent graduates do not choose to buy or build new buildings.

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For those that want to build or buy, there are many opportunities. Lenders are typically very open to lending orthodontists money for buildings and starting new practices. Though the total amounts a lender will approve may be lower than those given to established orthodontists, obtaining financing is normally not a large obstacle.

Recent graduates should be thoughtful in their approach to building new; it is a large investment. If you are not absolutely sure that your practice will be stable, you plan on residing in the area for the foreseeable future, you accept the responsibilities of building ownership, and you have determined it is beneficial to both personal and professional aspirations; it may be a strong consideration.

Comparing Costs of Leasing Versus Owning

Comparing costs of leasing versus owning is a comprehensive process. You should seek the assistance of experts to accurately calculate the comparisons. An example of a comparison (over 25 years) is outlined below for a 5,000 square foot orthodontic building. The comparison does not include tax considerations, cost for equipment, furnishings, IT, electronics, artwork, etc. and is an example only. It also does not include refreshing of finishes over the years (new carpet, paint, etc.) as costs would be roughly the same under each scenario.

Ownership Example

Total project costs including: construction, taxes, permits, inspections and testing, reimbursable expenses, attorney fees, construction loan interest, signage, site survey, legal costs, professional design and engineering fees, and contingencies is roughly $950,000 or $190 per square foot. We will also add the cost of land at $150,000 to the total cost for a total project cost of $1.2 million.

We will assume a lending rate of 6.00% with a 25-year amortization with a 20% down payment:

TOTAL PROJECT COSTS	$	1,200,000
Less 20% down payment		240,000
Total amount financed	**$**	**960,000**
Monthly lease payment ($23/square foot)		9,200
Monthly lender payment		(6,185)
Monthly operating costs ($5/square foot)		(2,000)
Monthly 1st year cash flow	**$**	**1,015**

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Projected Returns on Original Investment of $240,000

Year	Monthly	Yearly	% Return
1	$ 1,015	$ 12,180	5.08
2	$ 1,231	$ 14,768	6.15
3	$ 1,453	$ 17,438	7.27
4	$ 1,682	$ 20,192	8.41
5	$ 1,918	$ 23,020	9.59
6	$ 2,161	$ 25,938	10.81
7	$ 2,412	$ 28,947	12.06
8	$ 2,670	$ 32,038	13.35
9	$ 2,935	$ 35,225	14.68
10	$ 3,209	$ 38,509	16.05
11	$ 3,491	$ 41,891	17.45
12	$ 3,781	$ 45,374	18.91
13	$ 4,080	$ 48,962	20.40

Year	Monthly	Yearly	% Return
14	$ 4,388	$52,658	21.94
15	$4,705	$56,464	23.53
16	$5,032	$60,385	25.16
17	$5,369	$64,423	26.84
18	$5,715	$68,652	28.58
19	$6,072	$72,867	30.36
20	$6,440	$77,279	32.20
21	$6,819	$81,824	34.09
22	$7,209	$86,506	36.04
23	$7,611	$91,328	38.05
24	$8,025	$96,294	40.12
25	$8,451	$101,410	42.25

Also, if we estimate that the property averages 3% appreciation per year, we find that after 25 years, the property would be worth $2.3 million; $1.3 million more than it cost to build.

Lease terms back to tenant (leased back to your practice)

- Leasable area = 5,000 square feet
- Full-service lease rate = $23 per square foot, including taxes ($18 per square foot NNN (triple net)
- 25-year lease
- Yearly CPI (Consumer Price Index) increases (assume 3% yearly)

Total Lease Collected Over 25 Years (w/escalation):	$3,150,000
Total Operating Expenses Over 25 years:	$ 875,000
TOTAL COST	**$4,025,000**
Total Cost in Lender Payments:	$1,856,000
Total Profit to Building Owner after 25 Years:	$1,295,000

Total Return on Investment	
Total Profit to Building Owner after 25 Years	$1,295,000
Building Value (Asset) in 25 Years	$2,300,000
TOTAL RETURN	**$3,595,000**
TOTAL OUT-OF POCKET INVESTMENT	**$ 240,000**

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Leasing Example

Terms

- 25 year lease term
- $30 per square foot tenant improvement construction allowance (actual construction cost = $60 per square foot)
- $23 per square foot per month (full service) with yearly escalation clause (CPI)
- 15% common space rent (5,000 square feet x 15% = 750 square feet)
- Total lease square footage = 5,000 square feet + 750 square feet = 5,750 square feet

Total Lease over 25 Years of lease (w/escalation):	$4,820,000
Construction Cost ($30/SF Difference):	$ 150,000
Opportunity Cost Gain ($70,000 @6% X 25 Years)	$ 243,000
TOTAL COST	$4,727,000
Total Return on Investment	
TOTAL RETURN	$ 0

Initial Cash Outlay for New Lease Space	
First and last month's rent	$ 20,000
Construction Cost ($30/SF Difference):	$ 150,000
TOTAL OUT-OF-POCKET INVESTMENT	$ 170,000

Summary

The comparison above shows the potential investment strength of building ownership. In the above scenario, the total cost of leasing is over $4 million in an owner-occupied building and roughly $4.8 million in the leased office. The main difference is that in the owner-occupied building in the first example, the building owner makes a return of over $3.5 million and the strictly leased suite has no return at all. The out-of-pocket costs are relatively comparable. In the lease example, if there was no tenant improvement allowance for construction of the suite, the out-of-pocket costs for the lease would be higher than that of the new building.

In the long run, all things equal with stable returns, building ownership has its financial rewards. Ultimately, the decision is a personal one and as with all investments, there is risk involved. It is worth carefully considering the pros and cons of each. Do your research, use the expertise of professionals and make informed decisions. Do not base decisions on the opinions of a single colleague as the final decision requires thoughtful input from many. Your accountant may strictly look at the decision from a tax perspective; not taking into account wealth or personal financial planning goals. An attorney may give legal advice, but they may not be experienced in providing investment advice. What works for one orthodontist is not solution for all. Plan to make your decision work best for you personally and professionally.