

# LEASE OR OWN: A STRATEGIC BUSINESS DECISION

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**A**s companies contemplate real estate and facility growth plans, the question of building ownership arises. In the past, businesses considered owning as the smart financial option for most all of their facilities. Today, leasing makes more sense in many situations.

Leasing provides opportunities, challenges and outcomes that affect the overall facility planning process. With a developer as the new team member, collaboration and communication between the end user and the development, design and construction teams is integral to the success of the project.

## The business decision

The answer to the question of lease or own is directly related to business strategy. While individual financial implications create pros and cons on each side, other considerations allow companies to determine what choice best meets their strategic objectives.

In the past, companies took pride in owning their buildings and controlling the design of their specialized, personalized facilities. Today more companies are examining whether it makes strategic sense to invest their dollars in real estate or to invest in the growth of the companies by allocating these funds to marketing, sales and research, and development. Leasing also allows companies to locate in close proximity to customers or in vital downtown areas, thereby accommodating customers while also addressing employee attraction and retention issues.

"We find the best location we can," said Russ Weyers, President and Chief Operating Officer for Johnson Financial Group. "We make our site selection based on traffic flow and neighborhood demographics, and then look at the building availability. We will work

with a developer to build when we need to."

## Reasons to Lease

- Ability to change with changing space need
- Ability to respond to business needs and customers as they relate to location
- Ability to use cash for business needs

For some companies, a combination of ownership and leasing makes the most sense. "Facilities need to examine their own businesses and look at where they want to invest their money. If the cost to build a new corporate center is \$100 million dollars, would you prefer to invest that into real estate or the development of product and services, your company's core competencies? Leasing gives a company flexibility," said Mark Colananni, Manager of Global Facility and Equipment Development for GE Healthcare.

GE Healthcare currently leases the majority of the sites in their portfolio. Colananni finds owning to be crucial for buildings integral to the infrastructure of the company such as data centers or manufacturing facilities. Leasing sales offices, distribution centers and warehouse spaces allows the company greater flexibility to react to business conditions.

"We lease more than 50 percent of our buildings," said Weyers. The buildings they own are based on the tradition of owning. Weyers finds that mentality to be changing. "As companies try to grow rapidly, leasing offers more flexibility. Operating on a lease basis gives you the ability to open offices faster. Most of the buildings we lease are bank offices." Leasing affords Johnson Bank the ability to put capital back into their business

rather than real estate. From the development team perspective, Mark Irgens of Irgens Development Partners finds that a company is able to have more flexibility and use their capital in more profitable areas. "Leasing a facility is good for the end user as it gives them long-term flexibility, and financially it allows them to customize a financial package that meets their needs with purchase options built into the lease. I believe it is a lower cost method for them to occupy real estate."

Scott Weas of Weas Development Company said, "Typically it comes down to cost of capital, can the prospective tenant find better rates than the developer can receive? If they can, then ownership may be the answer. The company also needs to consider the alternate use of cash. Are you better off spending it on the physical assets, the real estate, or marketing, sales and research and development?"

Weas Development and other developers often deal with companies looking for incremental space who may own their corporate facility but need additional sales and other office space. Many clients are looking for five-year leases with three-year buy-out options, allowing for fluidity and risk management. Companies used to look five to 10 years into the future, but now need to react faster and want shorter terms in order to support their changing business plan.

## The partnerships

Companies who build their own buildings develop partnerships with architects and contractors who understand their corporate values, mission and business functions. With the decision to lease, the developer is brought in as another decision maker and team member directing design and construction. While considering the importance of design to the end user, decisions also need to take into consideration the marketability of the building and

the possibility of future tenants. Due to the financial implications of the deal, contractors and architects are brought into the process earlier to offer budget numbers and determine building flexibilities and allowances. Both parties aid the developer in allocating costs while assisting the tenant in understanding cost, design and construction lease ramifications.

According to Irgens, "When the company is designing a building they will own, the architect, the contractor and facility management team work together with a focus on the built environment. In a leasing situation, financial considerations come more into play: the financial package, the lease package and the building package are all part of the decision-making process."

All team members share in the responsibility to communicate, keeping abreast of decisions and informed on details while never losing sight of the objectives.

"You need to understand the developer's business objectives and honor them while accommodating the needs of the tenant, which can sometimes be a difficult balancing act. Working with a reputable, quality developer is critical because the developer has significant say and control over what the client receives for a given lease rate. We like to partner with a developer early in the process to help clarify and define the specific building parameters for the end user," said Mikelis Abuls, vice president of CG Schmidt Construction.

For the design team, educating the end user is essential. When the end user is the owner, decisions are made to suit their wants and needs per their criteria and budget. With leased space, building allowances and lease terms are the guides. The designer must work between the developer and end user to communicate what is within the scope and allowance of the project. Questions to ask include, what will the end user receive for the allowance, and will the end user achieve a look that suits their culture? The design team must understand the objectives of the developer and clearly communicate them to the end user throughout the process. At times and if agreed upon, changes are made to the scope. These changes impact allowances and the economic understanding as stated in the lease.

The best way to proceed with leasing projects is open communication. "We attempt to be

as transparent as possible with our negotiations," comments Weas. "Everyone needs to understand how the relationship is being built and what the drivers and constraints are in the transaction. If there are constraints, then we all work to find a solution that fits."

The experience level of the developer, contractor and architect and their successful completion of similar projects are important considerations in the selection of each member of the team.

### Questions to Raise When Selecting a Developer:

1. What is the developer's on-time, on-budget track record?
2. How do the developer's buildings rate in overall quality?
3. Is the developer respectful of the other team members (i.e., architect, contractor)?
4. What is the developer's commitment—do they hold buildings, or turn buildings? Is the developer in it for the long run?
5. Does the developer listen and respond to the desires of the tenant?
6. What is the developer's financial position?
7. What is the developer's depth of experience?
8. What projects have the developer completed that are similar?
9. What is included in the costs represented?
10. Are tenants who occupy the developer's buildings happy?

### The developer

"It is best to work with an experienced and professional developer, otherwise the process will be more complicated," said Weyers.

"Don't let the best first cost or deal blind you to the rest of the deal," said Irgens. "Do your due diligence to bring in the best experts to get the job done." As the developer, Irgens finds many clients first focus on the rental costs when presented with a lease proposal. Tenants need to look at what the developer is putting into the building. If you make a

selection based on great lease terms, are you sure the building systems and maintenance are what you are looking for? End users need to understand the services and treatment they will receive. They want to work with developers who will understand their financial as well as physical operation needs.

### The design and construction team

When a client company decides to lease a building, the design and construction team must satisfy two clients. The developer requires a design to meet both their investment needs and future marketability, while the tenant wants their functional, aesthetic and brand considerations to be fulfilled.

"Whether we lease or own, we work with the same architect and contractor," said Weyers. "We bring them in from the beginning to represent our needs. You need the architect to help you control what it will look like, so that it is appealing and comfortable whether you lease or own. The customer should not notice the difference."

While some may think there could be sacrifices in the design and construction of the building to be leased, decision makers like Colananni believes it is the company's responsibility not to sacrifice. Whether a company leases or owns, the building should suit their needs with best results occurring when facility managers run the project, as if their company were going to own the building.

### The facility manager point of view

According to Abuls, the transition from owning to leasing can be difficult for some facility managers. Decisions made by a company when owning a building may not be the same decisions a developer makes. For example, building systems with extended life cycle financial returns may not be what the developer has in mind. The developer may need to recover his investment in less time, while the facility manager may be accustomed to looking for value in a different way.

The design process and space plan must also be carefully addressed. The location of core areas and the actual footprint of the building have to be configured to accommodate future tenant needs. In terms of mechanical systems, a developer may choose a system such as electric reheat with a low first-cost and more expensive operating costs, while

## Important Facility Management Considerations:

1. Understand team roles and responsibilities
2. Articulate company concerns clearly
3. Insist on regularly scheduled meetings
4. Communicate with the external and internal project teams
5. Keep management informed
6. Require regular financial updates
7. Develop a project management system specific to the project
8. Keep on top of the schedule
9. Create enthusiasm
10. Know that problems occur in any project—participate in solving them

a building owned by a facility may choose higher upfront costs with low operating

costs such as with hydronic heat systems. "In the case of GE Healthcare, we were dealing with 506,000 square feet," said Irgens. "You have to think about what you are going to do with that kind of space. We spent a lot of time designing the building to work with the end user, but we had to create a space that is able to be re-leased. The divisions of the space, exiting and building systems are all considerations in this type of design situation. The space is customized for GE, but we are comfortable that if they would ever leave, the building still will maintain value. The question is can you get there all the time? Risk is always on the mind."

"Development projects can sometimes get a bad name. People may think it cheapens the project," said Abuls. "I don't think this is an accurate observation—in fact, the opposite is often true. The marketplace determines the building you get based on what tenants will pay. The focus of the development effort is to put value in places that benefit the customer. When done properly, the process optimizes the facil-

ity design and function of the building."

The developer and end user need to have common values and share a level of sophistication. In addition, a tremendous amount of trust between all team members is needed throughout the process.

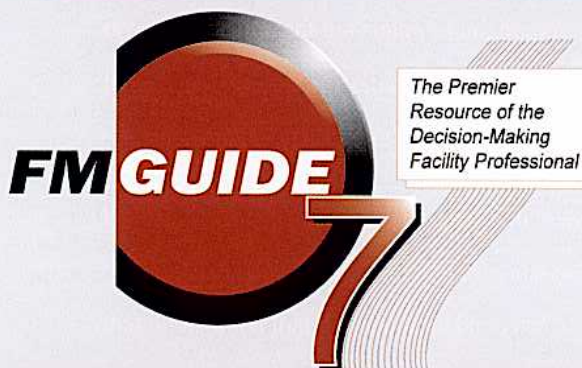
### Bottom line

Stable businesses, as well as those that are growing and evolving with mergers, acquisitions or divestitures in play, need business strategies that specifically address how they deal with facilities. When to own and when to lease are important questions that have a direct relationship not only to the bottom line, but also to basics of positioning and running a business. **FMJ**

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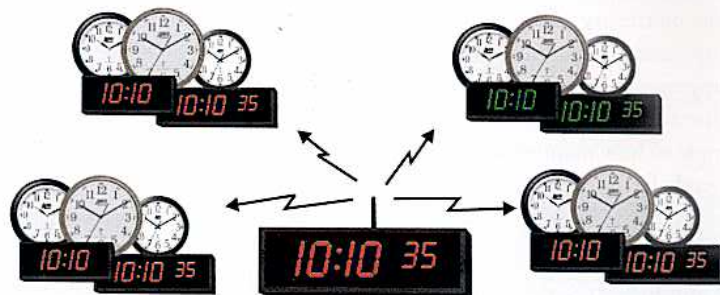
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