Owner-occupants pay more, but why?

A commercial real estate buyer who plans to inhabit the space will usually pay a premium, as compared to an investor.

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Also referred to as a user premium, an occupant premium is the price an occupier of commercial real estate will pay as compared with a commercial real estate investor.

As both occupiers and investors "invest" in the commercial real estate, the distinction I draw here is an occupier who owns the building and operates a business there vs. an investor who owns the building, doesn't occupy it, and relies upon the rent by a tenant to underpin the investment.

Historically, owner-occupants pay more for commercial real estate than investors – in some cases 20-25 percent more. So why would that be the case? I believe the following factors motivate the pricing difference.

Financing. Generally, a buyer of commercial real estate who will occupy the building has more options with which to finance the purchase. He can employ conventional financing, which requires a 20-25 percent down payment, a 90 percent loan through the U.S. government, or private funding through friends and family.

Typically, investors must rely upon debt with much lower loans to value – 60-70 percent – which means much more cash invested. Certainly, there are well-heeled investors who can stroke a check for the entire purchase without the need for financing but these investors want a "deal" for tying up cash.

OK, you might ask, why does the cost and availability of money motivate a buyer to pay more? The easy answer – payments. If money is cheaper, the resulting payment will be cheaper. An owner-occupant can pay more because they can frequently borrow more.

Assumptions. An investor buys an income stream – a leased building – which is generated through a tenant's rent. Assumptions must be made as to the sustainability of the income, whether the income is above or below the current market lease rates, and the likelihood the tenant will remain in the building after his lease expires.

If an investor believes he will suffer a vacancy because the tenant can't pay the rent or believes the tenant will vacate at the end of his lease, he must hedge his purchase by paying less for the building. Because an occupant buyer is the tenant, all of these costly assumptions are avoided.

Return on investment. The way in which an owner-occupant views a return on investment is varied from the investor. An owner-occupant takes a look at the payment his loan creates, adds the operating expenses (property taxes, insurance, and maintenance) and compares the total payment to a comparable market rent.

If the total payment is within a reasonable range – doesn't exceed the market rents by 20 percent – boom! He's in. A much more complicated analysis is performed by the investor. What is the income? If the income is above market, he discounts it. How much can he borrow based upon the income – or discounted income? Now, the income must provide a sufficient return for the risk being taken by the investor – around 5-6 percent.

Utility. The way in which the building currently is or will be occupied is of little consequence to the investor. His concern is the marketability of the building if it becomes vacant. How long will it lay fallow? Will the building's features appeal to a wide range of prospective tenants? Can he cause the income stream to increase over time? An owner-occupant views the building akin to the purchase of a machine or the addition of a key employee – will the building allow my business to grow and make money? If so, the expense of the real estate is a cost of doing business.

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