

Property worth more than company?



Owning a property and renting it to your own company come with some advantages when the property market is hot.

Owning the building from which your company operates can be a great deal. After all, the enterprise needs an address from which to transact business. Rent must be paid to someone. Why shouldn't that someone be you?

It generally works like this. A suitable location is identified and negotiations for its purchase commence. Owner-occupied financing is originated from the Small Business Administration. Banks love this, BTW. Why, you may wonder? Under an SBA 504 program, banks only loan 50% of the purchase price. The other half is made up of a government second trust deed of 40% and a 10% down payment. A lender's risk is minimized and insulated by the Fed's involvement.

From a buyer standpoint, you own for a pittance — only 10% plus points and closing costs. If the resulting mortgage payment — called debt service in a commercial buy — is proximate to market rent, you're golden!

Don't forget the tax advantages. If structured properly, the ownership entity leases the building to the business. Rent is paid by the occupant to ownership. Bank debt gets paid by the owner. Bingo! Depreciation of the building improvements over 39 years allows a tax break. Expenses related to the operation of the real estate are deducted from the rent. And don't forget, real estate appreciates over time.

Meanwhile, the resident — your company — enjoys a stable payment and is protected from market rate swings. It's a beautiful arrangement.

I have many family-owned and operated manufacturing and logistics providers whose real estate value far eclipses the worth of the company that lives there. How can this be, you may be wondering? Allow me to walk you through an example.

First, let's talk about the real estate.

Let's say your enterprise needed a 50,000-square-foot building. If you bought from 2000 to 2010, an investment of around \$4 million was typical. Back then, interest rates were a smidge higher than today. You could borrow a 30-year fixed residential loan for around 6.25% and 10-year treasuries weighed in at between 4% and 4.5%. In contrast, the rates today look mighty good!

But in 2005, if you financed 90% of your \$4 million acquisition at 6%, your payment was \$27,031 per month.

If we add \$3,300 per month for property taxes, \$750 for insurance and \$1,000 monthly for miscellaneous expenses, your all-in figure was \$32,081.

If we divide this up by the square footage, your cost was 65 cents per square foot. Today, that rental figure is \$2!

Even if you set up the occupant, your company, with a lease that increased by 3% per year, today that rent would be \$53,025 or just over \$1 per square foot.

Therefore, because of your smart move in 2005, your company has benefited from under-market rent for 17 years. Presumably, this delta allowed the operation to function profitably.

Now let's pivot to the company's value.

Recall that a business's worth is a multiple of the profit generated. Sometimes this profit is given a fancy formula called EBITDA or EBIDA and further defined this way by Investopedia:

“EBITDA, or earnings before interest, taxes, depreciation and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances. EBITDA, however, can be misleading because it does not reflect the cost of capital investments like property, plants, and equipment. This metric also excludes expenses associated with debt by adding back interest expenses and taxes to earnings. Nonetheless, it is a more precise measure of corporate performance since it is able to show earnings before the influence of accounting and financial deductions.”

Thus a company paying rent in an owner-occupied scenario would understate its building expenses by almost half. Recall, it's paying \$1 per square foot versus a \$2 market rent. When the profit of the company reflects a market amount, the profit is less and EBIDTA suffers making the company's value less as well.

On the commercial real estate front, values have far eclipsed a 3% annual kicker in rents. Today, a 50,000-square-foot building — if you can find one — would be in the \$22 million range. That's a whopping 450% increase over 17 years!

Next week, I'll describe the conundrum created by this imbalance.

Allen C. Buchanan is a principal with Lee & Associates Commercial Real Estate Services in Orange. He can be reached at abuchanan@lee-associates.com or 714-564-7104.