

COMMERCIAL REAL ESTATE: OVERCOMING YOUR FEAR OF OWNERSHIP

BY KEITH MERKLIN

The severe drop in property values that accompanied the Great Recession has caused many small business owners to be skeptical of commercial real estate investment. They have lost faith in the adage that property values tend to increase over the long haul, shying away from real estate purchases in favor of lease arrangements that insulate them from the unpredictability of the market. Yet there has never been a better time to purchase the business property on which your dental practice resides. The significant opportunities available to small business owners through investment in commercial real estate warrants a second look at the pros and cons of leasing versus purchasing your office space.

WHEN TO CHOOSE A LEASE

For new dental practitioners who are uncertain of future space needs and want to ensure maximum cash flow as they grow their business, leasing may be a wise option. In general, it's far less costly up front to lease commercial space compared to a real estate investment, making leasing a better choice for those who lack equity as only one to two months lease value is typically required as a security deposit on a leased space. A lease arrangement can also free up cash that can help fund the growth of your practice through equipment purchases or marketing. In addition, practitioners with lease arrangements will not be tied to the responsibilities of property ownership, such as onsite maintenance and tenant rentals, and can focus more fully on their practice and patients.

However, there are also significant disadvantages to leasing that need to be carefully considered. Most importantly, with a lease arrangement *you are not investing in your own future*. You do not have as much to show following years of investment in your office space. Should there be significant appreciation in property values over the next 20 to 30 years – which is likely given that CRE property values are currently at all-time lows – your landlord will be the beneficiary of that investment, not you.

In addition, some landlords are inflexible in allowing space modifications and may have the right to disapprove of changes or negotiate specific enhancements in exchange for permission to make alterations. The unique infrastructure requirements required in the dental practice can be costly to incorporate in a leased space, and may not be allowed. Also, if the building you are leasing does not have the proper electrical output and thermal insulation requirements to effectively support your equipment needs, the cash flow gains you may realize from leasing could be significantly diminished by excessive energy bills.

If you do choose to lease, be sure to contract a lawyer specializing in dental lease negotiations to help ensure your current and future rights are protected. While you may avoid the risk of fluctuations in property values by leasing your space, you are still at risk of being taken advantage of by your landlord.

BUILDING A FOUNDATION FOR GROWTH

Owning your dental business property, along with your practice, has the unique advantage of laying a broader foundation

for future growth. The three most significant advantages to owning your business real estate are:

- **Control.** When you own the business property as well as the practice, you have complete control to develop, operate and modify the building to your needs as the practice evolves, and as zoning regulations allow. You are no longer at the mercy of your landlord's guidelines for space modifications, and can adapt your building infrastructure to accommodate future developments in dental technology. This gives you maximum flexibility to build the practice you want with the building and equipment enhancements you need.
- **Stability.** When you own your own property, whether a home or a business, you enjoy greater long-term stability in the costs associated with the property. You can more easily project the annual costs for your practice investment according to your mortgage contract, insurance and estimated property tax, without the vagaries associated with lease agreement renewals. This helps practice owners conduct long-term planning without having to worry about increased lease payments or a cancelled lease.
- **Financial benefits.** Property ownership confers a variety of tax benefits such as depreciation allowances and mortgage interest deductions. Combined with potential appreciation of your property, the opportunity for rental income from tenants, and the generation of retirement income upon sale, your business property has the potential to work as hard for you as you work for your patients.

WHY NOW IS THE RIGHT TIME TO BUY

There are several key reasons why now is an excellent time to invest in commercial real estate.

- **Property prices have bottomed.** As with the residential market, commercial property values seem to have bottomed out. In most markets today, a typical mortgage payment is equal to or less than a rent or lease payment. At today's CRE prices, you can retain more of your cash flow or acquire much more real estate for your investment than you

might have just five years ago – all while investing in your future growth.

- **Abundant inventory.** In addition, commercial properties are currently available in abundance in most markets, providing an excellent opportunity to secure a prime location at a very reasonable price.
- **Rates at historic lows.** While business property rates will never be quite as low as those for residential properties, they are nevertheless mimicking the housing market with rates that are now at historic lows for commercial real estate. Your CRE loan today will cost you significantly less than it would have five years ago. As the economy and real estate markets continue to recover, rates will only go up.
- **Flexible terms and payments.** Some lenders today – particularly those specializing in dental practice financing – offer flexible loan packages that may include up to 100% financing with payment terms extending up to 25 years.

TAX ADVANTAGES OF OWNERSHIP

Real estate property owners enjoy tax advantages unique to ownership, including the ability to write off mortgage interest as well as depreciate the value of any owned buildings over a 39-year period on a straight-line basis. Both of these types of deductions reduce overall taxable income, saving cash flow that can be reinvested in the business. When these tax write-offs are combined with Section 179 deductions for purchasing equipment, the small business owner has a meaningful toolbox sponsored by the IRS for decreasing their tax burden and offsetting the inherent costs of property and business ownership.

CREATING A RETIREMENT OPPORTUNITY

With careful planning, an investment in commercial real estate can help fund your exit strategy. Given today’s undervalued real estate market, your business property is likely to increase in value over the long-term, creating equity that can be directed towards retirement. For instance, you can choose to sell both your practice and real estate outright at the time of retirement for maximum cash output, or sell the practice only, leasing back the real estate to the new owner to generate ongoing passive income. If you purchased commercial property that has additional space for tenants and choose to retain your property upon retirement, you will not only collect rent from the new practice owner upon sale of your practice, but also from your existing tenants.

BE AWARE OF THE DOWNSIDES

Naturally, as with any investment, there are inherent risks in purchasing a business property, as well as predictable headaches that come with ownership. For example, if the real estate market loses value over a long period of time after your purchase, or the character of the neighborhood changes for the worse, you risk losing equity and your practice may suffer. Also, making a real estate purchase may require a large cash down payment that could be otherwise put to immediate use in growing your practice. And of course, as a property owner you bear all the inconveniences and costs associated with property ownership, including maintenance and repairs, property taxes and impacts of zoning regulations.

But be aware that despite the various disadvantages, many dentists have made the leap to commercial property ownership in less favorable markets than the current one and realized significant success over time.

SPECIALTY LENDERS MAKE BUYING POSSIBLE

Some lenders that specialize in dental practice financing have the flexibility to provide up to 100% financing for real estate purchases, eliminating the requirement for a large cash down payment. These lenders understand the dental profession and have confidence in its performance history for debt repayment. They are therefore more willing to offer aggressive loan packages that include zero down payment and 25-year terms. New dentists with little equity and cash flow may find that it is feasible to purchase a commercial property when working with a dental financing specialist.

In closing, when the many opportunities in today’s commercial real estate market are taken into account – low purchase prices, historically low rates, flexible financing terms, meaningful tax advantages and retirement funding opportunities – it’s easy to see why this might be the right time to put aside any fears of property ownership in order to create a solid foundation for the growth of your practice. **DE**



KEITH MERKLIN joined Live Oak Bank in early 2010, bringing with him over 14 years of experience as a commercial lending officer. He has spent

the majority of his career working with small healthcare practices. Keith originated loans for veterinarians and dentists who were acquiring a practice or property, consolidating debt or expanding their businesses. Keith is a top producer, a testament to his understanding of healthcare practice challenges as well as his dedication to helping small practitioners acquire financing to achieve their professional goals.

ADVANTAGES OF PROPERTY OWNERSHIP VS. LEASE

BENEFIT	PROPERTY OWNERSHIP	PROPERTY LEASE
Maximum cash flow		X
Flexibility to expand practice	X	X
Flexibility to relocate practice		X
Maximum time with patients		X
Full control over practice development	X	
Long-term cost stability	X	
Asset appreciation	X	
Tax advantages	X	
Potential for passive income / retirement funding	X	
Favorable environment for negotiation	X	