BUSINESS BROKERAGE

Buy a business or real estate?

Whether to invest in a business or commercial real estate comes down to balancing returns, risk and capital

Whether for commercial property or an operating business, it becomes a question of managing or qualifying risk and taking into account the scope of capital investment necessary to realize those returns

In my capacity as a merger and acquisition adviser I often get asked by investors, "Should I invest in commercial real estate or that of an operating business?" As you can appreciate, that query comes with more questions than answers – but fundamentally, it will come down to operating returns, return on investment and risk.

Buying commercial real estate

In commercial real estate, a common metric of return is the capitalization rate (cap rate), the rate of return on a real estate investment property based on the income that the property is expected to generate.

The capitalization rate of an investment can be calculated by the following formula:

Capitalization rate = net operating income (NOI) / current market value

And as per respected industry reports, the current nominal cap rate for industrial property revolves around 4 per cent to 5.25 per cent. This is a low number as measured by historical standards, indicating that relative to NOI, market values are high.

The cap rate is a ratio that gauges profitability. The proportion of NOI relative to the current market value must remain constant for the capitalization rate to remain the same. If NOI rises while the market value does not, the capitalization rate will rise and, if the opposite happens, the capitalization rate will decline. If the capitalization rate is declining, it may be a wise to simply sell the property and reinvest elsewhere.

Buying a business

In the matter of business performance, the key metric of return on invested capital (ROIC) is the percentage return that a company makes over its invested capital:

ROIC = net operating income – dividends / total capital

Most assessors will define total capital as total amount of long-term debt, plus the total amount of equity and excluding cash. While earnings of privately held corporations are not often reported, desired ROIC performance will be 10 per cent or greater. However, the invested capital is measured by the monetary value needed instead of the assets that were bought. Since value is the present value of future cash flows, this factor is what makes businesses valuable – all else being equal.

Another related key metric is the return on equity (ROE) as earnings before interest, taxes and depreciation (EBITDA), relative to the market value of the business.

Therefore: ROE = EBITDA / business value

The ROE is similar to the cap rate of real estate, as both are a measure of income (NOI for real estate and EBITDA for businesses) and the current value of either the real estate or the business.

In business transactions, I routinely observe ROEs in business values in excess of 22 per cent.

So – whether for commercial property or an operating business – it becomes a question of managing or qualifying risk and taking into account the scope of capital investment necessary to realize those returns.

Commercial property investors will look at cap rates as a useful tool when it comes to comparing similar properties. For example, a property with an 8 per cent cap rate compared to one performing at 4 per cent could both generate the same net operating income.

Higher cap rate investments will have a higher net operating income but more risk; lowest cap rate properties are often those with the highest possibility of price appreciation and lowest risk of tenants leaving.

The key assumption here is that the property is zoned in its highest and best use class. Windfall land appreciation due to rezoning is a further risk of speculation. Investors need to be wary that the potential windfall may not be realized.

In an operating business, ROE rates of 10 per cent, or more (annualized) will obviously outperform the net operating return of land ownership.

Whether buying a business or a real estate investment, always seek the guidance of professional advisers before committing. ■

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