

Corporate Lease vs. Ownership Strategy

Under The Proposed Lease Accounting Standard

The proposed changes to the Lease Accounting Standards by the FASB and IASB have generated significant interest in the potential impact on public companies and on private businesses that follow GAAP accounting. While much of the preliminary discussion has revolved around the impact to financial statements, ratios and debt covenants, it has not addressed the need to revise corporate lease or own strategies.

Major corporations lease a large percentage of office, industrial and retail space around the world. While exact numbers are unknown, educated estimates would be that 35% to 50% of office and industrial space, and as much as 70% of retail space is occupied by public and private corporations that will be affected by these changes. These proposed accounting standards will dramatically affect the decision to lease vs. own, as well as the length of term and the frequency of relocation.

The ripple effect across the real estate industry will spread to occupancy rates, financing and new development. Perhaps more importantly, there will be compelling reasons for companies to consider owning strategic, high value assets such as headquarters, data centers, manufacturing plants, call centers or anchor stores, rather than leasing these locations. For current Landlords, this change could remove some of the best assets and best tenants from their portfolios as companies shift away from leasing.

Unintended Consequences

The primary objective of the proposed standard is greater transparency in reporting future obligations. Under current accounting rules, companies can craft lease agreements as Operating Leases and report annual Rent Expense as a line item on the income statement. The information on future lease obligations can be summarized in a short paragraph or disclosed in footnotes. The proposed standard is designed to provide

transparency and comparability across companies by putting all future lease obligations, whether real estate or otherwise, on the balance sheet as a Right of Use Asset, and corresponding liabilities for the obligation to make lease payments. The major change on the balance sheet will affect ratios and return on assets. But the more significant change will be on the income statement. Since the proposed standard utilizes a financing approach to account for the leases, rent expense on the income statement will be replaced by depreciation and interest. This change will increase EBITDA over the term of the lease, but the cost of transparency is a decrease in net income in the first half of the projected lease term.

As illustrated in Figure 1 below, the amortization of the obligation will front-load the expenses, whereas the current straight line approach evenly distributes the expense over the lease term.

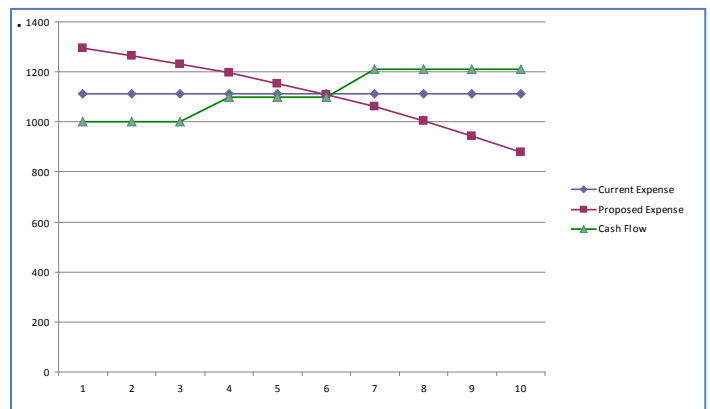


Figure 1 – Comparison of Annual Expenses

The chart in Figure 2 illustrates the first year impact on occupancy costs (current rent expense vs. depreciation and interest expense) under the proposed standard, based on the expected remaining term of the lease. Since the proposed standard is not expected to include any grandfathering provisions, the remaining payments under all leases will be analyzed as of the first day the standard

goes into effect. The amortization of these payments could impact net income for certain businesses by as much as 20% to 30% in the first year of transition. The other deceptive characteristic of these graphs is the reality of a going concern. All of these lease analyses assume that the end of term is predictable. In reality, for most businesses that are continuing to operate, the line will continue to bounce above the straight line as decisions are made to continue operations. The impact is a permanent increase in occupancy costs.

Remaining Lease Term	Present Accounting - Rent Expense	New Accounting - Interest and Depreciation Expense	Percentage Increase
1 year	\$1,000	\$1,000	0.0%
2 year	1,000	1,027	2.7%
3 year	1,000	1,051	5.1%
4 year	1,000	1,074	7.4%
5 year	1,000	1,095	9.5%
6 year	1,000	1,115	11.5%
7 year	1,000	1,132	13.2%
8 year	1,000	1,149	14.9%
9 year	1,000	1,164	16.4%
10 year	1,000	1,178	17.8%
15 year	1,000	1,230	23.0%

Figure 2 – First Year Impact on Occupancy Costs

The Exposure Draft issued by FASB in August, 2010 does not establish the effective date of the proposed changes. But it does include the expectation that public companies provide 3 year comparative financials using the proposed standard. This comparison will reduce the shock of comparing net income under the old rules to the proposed standard, but will also require significant work by the reporting entity to begin managing this process well before the standards take effect. With a planned issuance of the standard in Q2-2011, expectations are that the first year of transition will be 2013 or 2014. Therefore, companies may be required to track financials under both the current and proposed standards for periods as early as 2011.

Sawtooth or Snake?

Planning for and managing the impact is further complicated by the requirement to amortize the rent over the “longest term more likely to occur than not”. Based on the net income effect illustrated in Figure 2, it would seem beneficial to keep the lease term shorter to minimize the negative income effect. However, there are two key elements to consider under the proposed standard. First, the amortization schedule for a short initial lease term may have to include the renewal periods. Second, to avoid fraud and manipulation, the process of determining the term needs to be auditable and consistent. A three-year term may be reasonable for a small branch office, but not for a one-million square foot headquarter building. Perhaps more importantly, due to the downward slope of the expense curve, a last minute decision to renew creates a “saw tooth effect” on the expense of the new term. This effect is illustrated in Figure 3 below which assumes a ten year initial term with two five year renewals when the decision to renew is made in years 10 and 15.

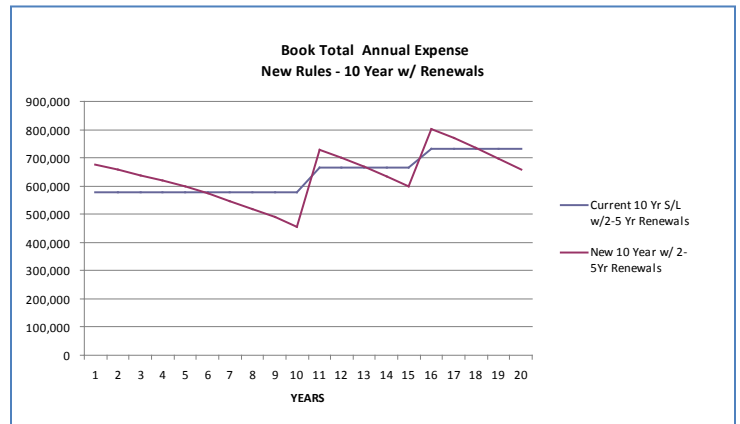


Figure 3 – Expense Effect of Unplanned Renewals

These significant year-over-year increases in occupancy expense, and radical variations in net income over the long term, show that going short on all leases may not be the best strategy. Figure 4 shows the same lease as in Figure 3, but with an expected likely term of 20 years. While the curve is smooth and predictable, it greatly increases the expenses over the short term, and does not cross the current straight line expense line until after year twelve.

Therefore, the most important decision is how long a business expects to operate in a location, not the length of term or number of options.

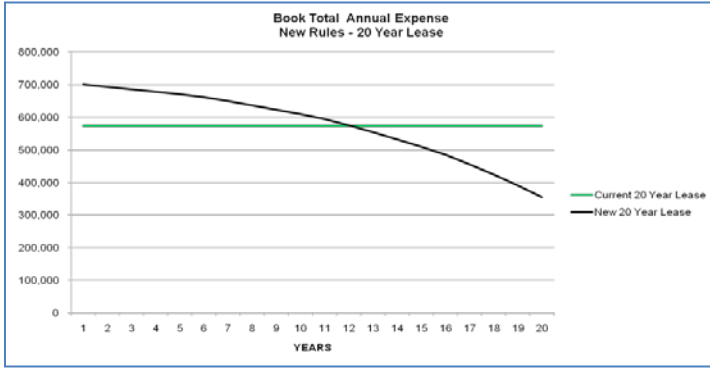


Figure 4 – Expense Effect of Long Term Inclusion of Renewals

While Figures 3 and 4 are informative, the practical application is more complicated. Both the short and long “likely term” amortizations will be subject to revision during the term. Rent may be adjusted by changes in the Consumer Price Index, a property’s Fair Market Value, or increases in retail sales. These variables are based on currently available information, and may change, over the term of the lease. When they change, companies will need to adjust their calculations, causing the expense line to change its slope, and “snake” its way across the expense graph. The difference between the original and revised expense amounts must be recognized as an increase or decrease in net income. Making these adjustments across a portfolio of hundreds or thousands of leases could have a material impact.

Finding the Right Strategy

Although the proposed standard will present numerous challenges to corporations, there will still be many reasons to lease property. In certain instances, size, term, flexibility, availability or location will dictate a decision to lease rather than own. But the elimination of off-balance sheet financing may make owning core assets a better strategic decision than leasing them. Owned assets are depreciated over a longer period, and the associated expenses are not subject to quarterly adjustments.

The one item that will still weigh heavily in the Lease vs. Own decision will be the allocation of capital. For most businesses, investing available cash in their operations or expansion provides a much better rate of return than investing in real estate. Companies with a heavy dependence on real estate (e.g. retailers) simply may not have enough available cash to acquire a significant number of properties. In order to maximize its return on real estate, a company can use a combination of three ownership options: direct, financed, and joint-venture.

Direct ownership may present the lowest annual book expense to the company. It also allows a company the most control over site selection, payment terms, and use. This approach does require the largest up-front commitment of cash, however, and could compete with other required allocations of capital.

Companies that want to leverage available cash may choose to finance the purchase of its core properties. Mortgages are available to companies with good credit at up to 80% loan-to-value. At that LTV ratio, a company can either purchase assets worth five times the amount of cash on hand, or spend one fifth of the cash necessary under a direct ownership model to own the same asset. The financing cost is generally equivalent or lower than corresponding rental payments, and is not subject to regular increases incorporated into most leases.

The third alternative would be to create real estate partnerships with real estate investors and lenders. The structure of the partnership could vary based on the type of property, credit of the corporate partner, amount of equity and debt required, and other functions of the partners. In cases where the corporation does not have internal resources to provide asset or property management functions, the equity partner (e.g. a REIT) might also provide other services for a fee as part of the partnership agreement. Although each partnership will be unique, this structure requires the smallest initial contribution from the corporate partner.

Unlike pre-standard structures under FAS 13 where the corporate entity did not want to have a consolidated interest that would have been put on the balance sheet, these new partnerships would be structured so the corporate partner would be able to treat their interest as ownership of the asset.

The corporate demand to purchase leased properties may coincide well with upcoming maturities of the Commercial Mortgage Backed Securities (CMBS) that fueled the increase in Sale / Leaseback and Single Tenant Net Lease (STNL) transactions over the past 15 years. Many of these loans will come due over the next five years, and debtors may need to sell properties to raise capital, making the potential for ownership more viable.

Moving from a lease-heavy corporate occupancy strategy to a more balanced strategy of leased and owned assets will be the most effective way to mitigate the increased book expense under the proposed standard. In its simplest terms, a 10 year or 20 year likely term amortizes the NPV of the lease payments (with imputed interest) over that shorter term. In an ownership model, most real estate is depreciated over 39.5 years, and land is not depreciated. While this creates an expense line that resembles that of the 20 year lease term in Figure 4, the annual depreciation and interest expense can be 10% to 50% lower under an owned scenario depending on financing. That differential is further enhanced when you include the residual value of the property.

Over the life of the asset, the fixed depreciation schedule will both reduce compliance costs and help smooth out any saw-tooth or snake effect other leases will have on the expense curve. As illustrated in Figure 5, the ownership alternative presents the lowest cost and most stable curve. The green line, which represents the annual depreciation and interest expenses under the partnership model, starts lower and stays lower throughout the property life cycle. This lower cost is calculated without the benefit of the residual value of the asset.

An equally compelling benefit of ownership is the Net Equity impact of leases under the proposed standard. Since the right to use asset, and associated liability amortize at different rates, the company is in a negative equity position throughout the term. In the illustration in Figure 6 – the difference in net equity between ownership and a 20 year lease is almost 36% of the asset value or \$9,000,000 on a \$25,000,000 asset. When spread across an entire property portfolio, the cumulative effect will dramatically impact shareholder equity and the company’s corresponding market value.

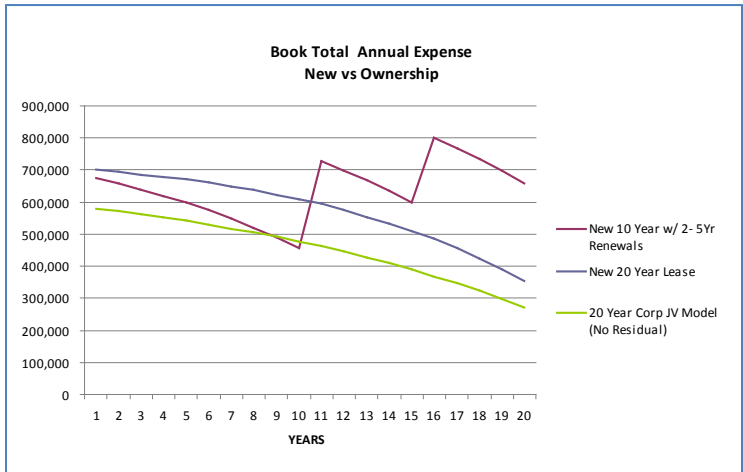


Figure 5 – Own vs. Lease Comparison Based on Proposed Standard

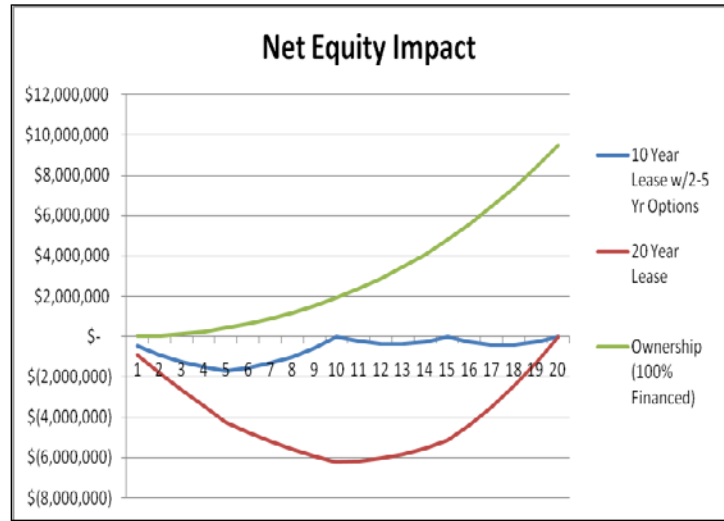


Figure 6 – Net Equity Impact of Proposed Lease Accounting Standard

Ownership Assumptions

The assumptions that have been utilized to model this concept are as follows:

Property Size: 500,000 SF

Property Type: Warehouse

Property Value: \$25,000,000

Closing Costs: 5%

Total Cost: \$26,250,000

Equity: \$5,250,000

Debt: \$21,000,000

Ownership

Equity Limited Partner: 20%

Corporate Partner: 80%

Equity Return: 8.25% Annual

Debt: 20 Year Amortization @ 6.0%

Corporate Partner Duties

- Operates & Maintains the Property
- Pays Debt Service
- Pays Annual Interest to Equity Partners
- Provides Asset Management

Options at End of Use

- Buy / Sell Agreement between Partners
- Outright Sale
- Lease of Property

Possible Additional Terms

- Accrued Interest in Residual for Equity Partners
- Early buyout of Partners
- Finite term of Equity Bond

Based on these assumptions, the corporate partner would pay annual debt service of \$1,805,000 and annual interest to the Equity Partner of \$433,000, which equates to \$4.47 per square foot per year. This is relatively equivalent to a market rent for the facility at an 8.5% cap rate.

The Occupancy Cost Comparison (assuming Zero Residual Value), based on the Corporate Partner taking 100% of the Depreciation is illustrated in Figure 7.



Figure 7 – Own vs. Lease Comparison Based on Assumptions

This partnership model is designed as a financing vehicle for the corporate occupier, rather than utilizing internal sources of funds. It may be structured as participating debt for accounting purposes, rather than as a separate entity. Given the interest in corporate bonds from the investment community, coupled with the additional security of the real property asset, these new structures should have an appeal to the investment and lending community. The ultimate structure of the arrangement should be reviewed and analyzed by corporate finance and audit groups for its applicability and impact on the corporate entity.



Jackson Cross Partners has begun to identify corporations, lenders, and equity partners to covert leased properties to owned properties. For more information on this “Lease/Saleback” concept contact:

Louis J. Battagliese Jr., Partner

610-265-7700 Ext. 112 ljb@jacksoncross.com

Or

David B. Dilworth, Esq., Associate

610-265-7700 Ext. 134 ddilworth@jacksoncross.com

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