New Financial Statement Treatment of Leases
Calls for Fresh Corporate Property Strategies

Issue. During the first quarter of 2016 the Financial Accounting Standards Board (FASB) will issue new rules governing the way corporations account for leased real estate and equipment. While current rules generally treat accrued rent like other annual expenses, the new rules require a company to add to its balance sheet the present value of rental payments over the lease term—as both a liability and a right-of-use (ROU) asset. The liability generates charges for imputed interest, while the ROU asset generates charges for amortization, against earnings. For "finance" leases, the category defined to encompass most equipment leases and certain real estate leases—primarily those with very long terms or bargain options to purchase the building or extend the lease—these combined earnings charges are front-loaded in much the same way that interest on a home mortgage decreases from year to year. For other leases ("operating leases" as defined by FASB) such charges are averaged over the lease term, with the company taking each year a level charge against earnings that approximates rent expense under current rules. Lease accounting standards announced in January 2016 by the International Accounting Standards Board (IASB) omit this distinction, imposing on virtually all leases what FASB calls finance lease treatment.

Example. Assume Company C leases a warehouse for 15 years at annual net rent of $800,000 initially, escalating 10% every 5 years. The present value (NPV) of monthly rents, discounted at C's incremental borrowing rate of 4% is approximately **$9.8M**. Upon commencement of the lease C would record an ROU asset of $9.8M and a lease liability $9.7M, the difference being first month's rent. If the lease is classified as a finance lease (e.g., because it gives C a bargain option to purchase the building), then in Year 1 C reports an imputed interest expense of $382,000 on the lease liability and a $651,000 level amortization expense on the ROU asset, for a total charge against earnings of $1,033,000 (rounding to the nearest $1000). In Year 2 interest decreases to $365,000, which combined with the $651,000 ROU amortization expense generates total earnings charges of $1,016,000, an amount that continues to decline each year. The new rules work as if the landlord loaned C $9.7M to buy the right to use the warehouse for 15 years, and C repaid the loan monthly over 15 years.

If instead operating lease treatment applies, total imputed interest and ROU amortization are averaged over the 15 year lease term, generating each year a combined lease expense of $883,000 that is allocated first to accrued interest (which decreases over time) and then to ROU amortization (which increases over time). Over a 15 year period the NPV of earnings charges would approximate **$9.9M** applying finance lease treatment and **$9.8M** applying operating lease treatment. The new rules eliminate an advantage that leasing traditionally had over ownership, namely, avoiding the "gross up" that occurs when a building is added to the asset side, and a mortgage to the liability side, of C's balance sheet.

Comparison to Leveraged Purchase. Both the balance sheet and earnings effect of a lease under the new rules are less desirable than the effects of a traditional mortgage-financed purchase. Suppose C purchases the warehouse for $10M inclusive of transaction costs, financing 70% of its purchase with a 15 year mortgage bearing 4.5% interest and using a 25 year schedule to amortize principal. Annual charges to earnings, consisting of depreciation of the warehouse, amortization of financing fees, and interest would approximate $602,000 and $595,000 in year one and two, respectively.[1] Eventually C's gain on sale of the warehouse serves as a partial offset to even those expenses; for example, assuming a

[1] This comparison disregards operating expenses that would be the same whether the building is owned or net leased.

conservative sale price in Year 15 equal to 60% of original cost C generates a $1,548,000 gain in Year 15. The resulting 15 year NPV of annual earnings charges and gain on sale approximates **$5.2M**, while the present value of monthly net cash flows approximates **$7.1M**.

Key factors contributing to these NPV savings of **46.4%** and **26.8%** in earnings charges and net cash flow, respectively, when compared to an operating lease are: (i) the lower cost of capital that C enjoys as an investment grade company vis-a-vis a market cost of capital embedded in market rents; (ii) 15 year amortization of the ROU asset versus depreciation based on a remaining useful life of 30 years for C's warehouse; (iii) interest expense decreasing over time while rents increase; and (iv) the GAAP gain and positive cash flow from selling the building in Year 15. In the new lease accounting environment, these advantages significantly tilt the scale toward ownership of core real estate assets such as headquarters, data centers, manufacturing, high-producing stores, and major distribution centers.

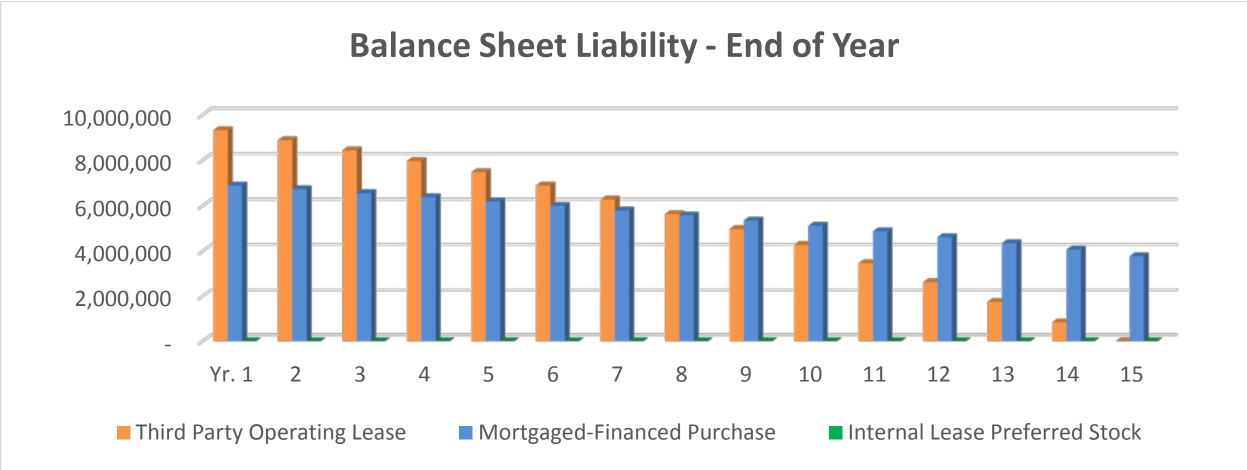
Comparison to Internal Lease Preferred Stock. In the years between FASB's initial proposal and announcement of the new rules Leasehold Equities LLC (LE) developed and patented an innovative financing technique, Internal Lease Preferred Stock (ILPS), that offers companies like C an alternative to the new balance sheet liability.[2] The ILPS structure also provides C substantial savings in earnings charges. In a representative ILPS financing, parent company C establishes finance subsidiary F and operating subsidiary O. F is capitalized with $3M of common stock (Common) funded by C and $7M of preferred stock (Preferred) funded by third party investors. F uses its $10M to purchase the warehouse and pay costs associated with issuing the Preferred. F then leases the warehouse to sister company O on a 15 year lease (Internal Lease) guaranteed by C, which has an A credit rating. The Preferred enjoys a Preferred Dividend of 4.5%, reset every 5 years to achieve a spread of 2% over the yield on ten year Treasury bonds, as well as a distribution preference over the Common with respect to proceeds of any sale or refinancing or release of F's cash reserves. F has the option of redeeming the Preferred in whole or part on dividend reset dates and after Year 15. Annual rent on the Internal Lease (Internal Rent) is set initially at $808,000 and adjusts on each dividend reset date if necessary to maintain Internal Rent equal to at least 120% of the annual Preferred Dividend. F uses Internal Rent , first, to pay Preferred Dividends, then to pay a targeted 5% dividend on the Common, and then to add to F's cash reserves for future redemption of the Preferred. If the Preferred is not fully redeemed by the end of Year 15, the Preferred Dividend resets to a significantly higher rate—e.g., 3.5% over Treasuries—and the Internal Lease renews for an additional 10 years at a rate set to cover the increased Preferred Dividend.

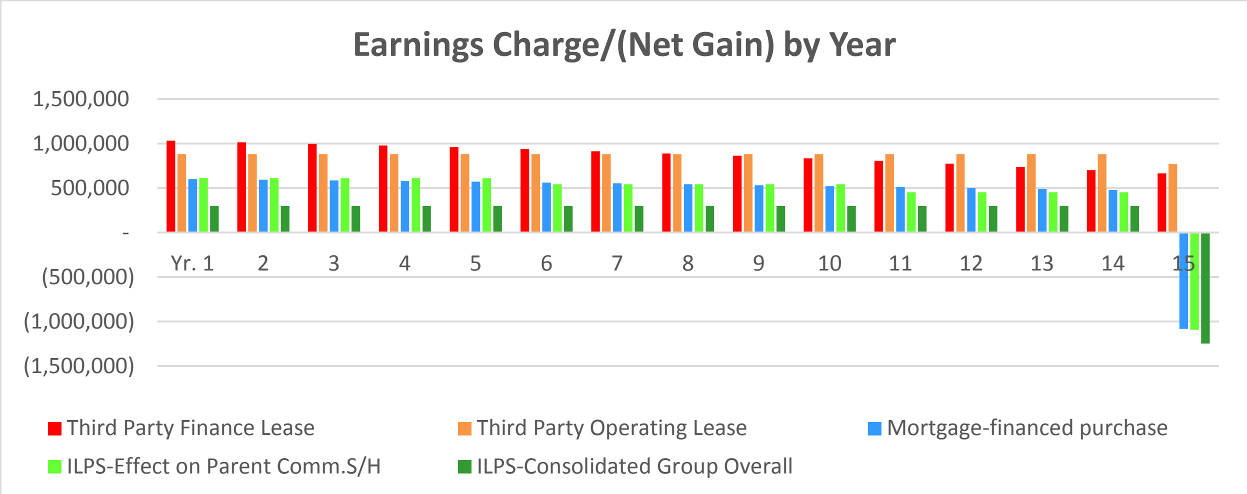
In the patented Internal Lease Preferred Stock structure, Internal Rents backed by the investment-grade credit of C provide Preferred shareholders a reliable source of funding for their Preferred Dividends and eventual redemption of their shares. The flow chart on page 4 illustrates these cash flows. Since C, F, and O are part of a consolidated group of corporations (the Group) reporting results on a combined financial statement, the obligation to pay Internal Rent is eliminated from both the earnings statement and balance sheet of the Group, avoiding the balance sheet liability under the new rules. Moreover, ILPS Preferred Dividends are not charges against earnings; rather, C reports such dividends as an *allocation* of Group earnings to Preferred shareholders.[3] The only charges to Group earnings are depreciation of the warehouse, amortization of financing fees, and the nominal cost of administering the Preferred. As in the case of a leveraged purchase C's gain on sale of the warehouse eventually serves as a partial offset to even those expenses. Preferred Dividends reflect C's cost of capital as an investment grade company—not the market cost of capital embedded in market rents. The ILPS technique starts with LE's proprietary long-term financial model that compares the earnings, balance sheet, and cash flow effects of an ILPS

[2] ILPS is protected by U.S. Patent Number 8,548,891.

[3] A typical presentation would be "Net Earnings Attributable to Non-Controlling Interests."

financing to a third party lease or mortgage-financed purchase. Using the example of C above, the model demonstrates 15-year NPV savings in earnings charges and net cash flow equal to **74.6%** and **28.4%**, respectively, vis-à-vis a third party operating lease. If—in order to isolate the earnings improvement to its effect on C's common shareholders—we treat Preferred Dividends as though they were earnings charges, ILPS still achieves a **46.2%** earnings advantage (NPV) over an operating lease. LE's model demonstrates the following balance sheet and earnings advantages of ILPS under the new rules:





Notes:
(1) In order to isolate the earnings improvement realized by C's common shareholders, ILPS-Effect on Parent Comm. S/H treats Preferred Dividends as though they were charges against earnings.
(2) This chart shows gain on sale of the warehouse in Year 15, net of Year 15 annual expenses, as a negative charge.

Leasehold Equities. Leasehold Equities is a joint venture formed by principals of Impost Research LLC, a consulting firm focused on commercial real estate (CRE) tax planning and finance, based in Wayne, PA, and Jackson-Cross Partners LLC, a CRE advisory firm based in King of Prussia, PA, to develop alternate strategies for corporate users of CRE in light of FASB's and IASB's lease accounting changes and new capital market dynamics that impact financing of CRE. For more information please contact Glenn Madere at 610-574-3296 or Lou Battagliese at 610-265-7700.

Internal Lease Preferred Stock

Diagram Derived from Figure 10, U.S. Patent No. 8,548,891