ANALYZING THE IMPACT OF THE NEW LEASE ACCOUNTING

STANDARDS ON COMMERCIAL GROUND LEASES

Among the myriad of issues that have been created by the changes to Lease Accounting by the FASB and IASB, companies that utilize the Ground Lease in their portfolio may want re-evaluate that strategy. Under current accounting, the Ground Lease is generally classified as an Operating Lease and the straight lined rent expense is charged annually over the term of the lease.

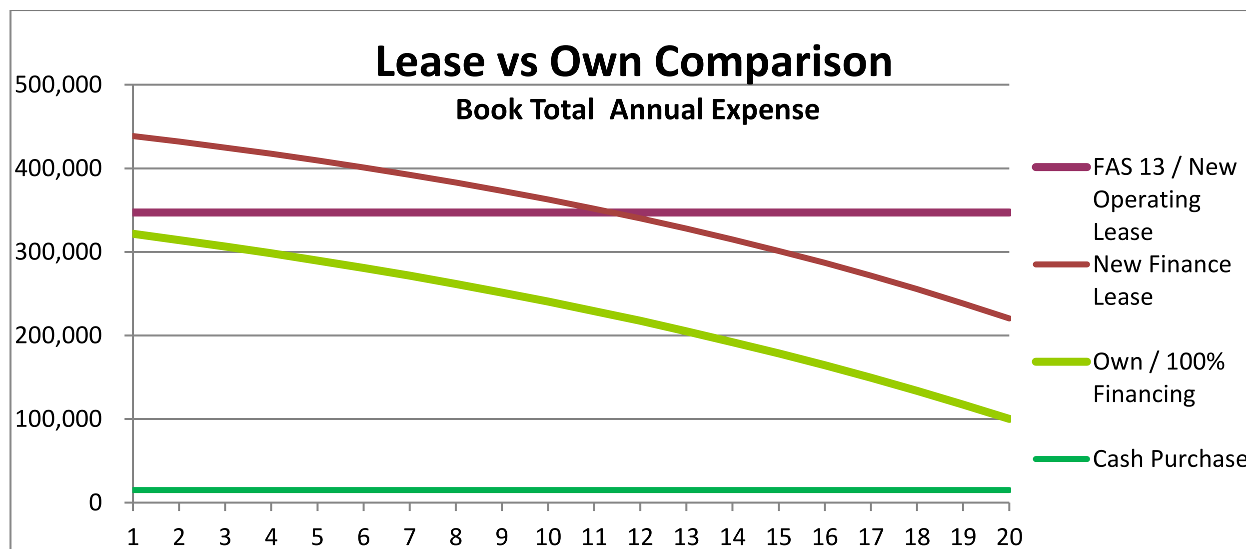
Under the new standards the Ground Lease would be considered a Right of Use Asset, and the net present value of the rent obligations would be placed on the Balance Sheet. Since a Ground Lease is generally for a term in excess of twenty years, plus options, these longer term leases create a number of additional consequences:

1. If classified as a Finance lease, there would be higher front end interest expense which creates a negative P&L impact that could exceed current straight line rent expense (Operating) by more than 25% in the first year of transition to the new standard.

2. Uneven amortization of the Asset and Liability create a negative net equity impact that can reach as much as 25% of the overall asset value for each lease at the midpoint of the term.

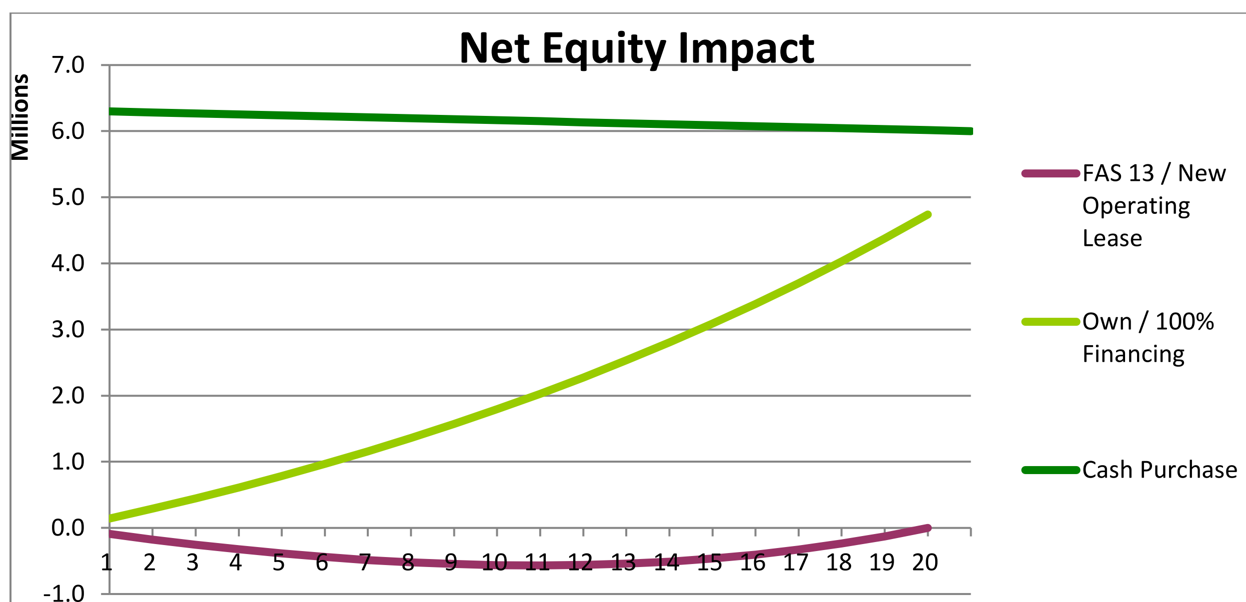
3. Since the expected definition of term involves "economic incentive" to include renewal options, the accounting term may be impacted by economic life of Lessee constructed improvements that revert to the Lessor at the end of the term. This could increase both the Balance Sheet values, and the front end imputed interest expense.

The most compelling reason to re-evaluate the Ground Lease strategy is that owned land is not depreciated, and therefore owned land creates no annual depreciation expense. An analysis of a variety of Ground Leases under current and the new Standards provides an illustration of the variations.



The chart above illustrates the annual book expense for a Ground Lease over a twenty year term. The dark and light red lines show the book expense for a Lease under the Operating and Finance accounting standard ASC 842. The Finance lease is the only option under IFRS 16.

The dark green line illustrates the book expense under an outright purchase of the ground, where there is no depreciation expense. Since many companies would prefer not to use available cash to invest in land, the light green line illustrates the interest expense of financing 100% of the ground purchase. Given this wide variance, it is difficult to envision a scenario where a Ground Lease would be preferred over direct or financed ownership unless there are restrictions on sub-division or a land owner refuses to sell.



The Net Equity impact of the difference between the booked asset and liability is illustrated in the second chart. The slight decline in the dark green line of outright ownership reflects the amortization of acquisition expenses. The increasing light green line reflects the pay down of the financing, and the negative loop of the red line reflects the unequal amortization of the right of use asset and corresponding rent liability under the new accounting standard. If the lease is accounted for as a Finance lease over 20 years, the negative equity impact would reach almost 25% of the asset value in Year 11.

Multi-location companies that utilize Ground Leases (e.g. Retailers, Banks and Restaurants) could make a material impact on both Net Income and Net Equity by developing a strategy to acquire current or future sites instead of ground leasing the property. By way of illustration, if a business has 200 ground leases with an average site of 1.5 acres, and an average annual ground rent of $75,000, the annual rent expense is $15,000,000. Assuming an average remaining economic term of 15 years (which may be short), the company would place approximately $145,000,000 on its Balance Sheet under the proposed lease accounting standard. The first year amortization and interest expense for the ROU asset, based on a 5.5% cost of funds, would approach $18,000,000.

If the Company owned the 200 sites, since ground is not depreciated, there would be an $18,000,000 positive Net Income impact in Year 1. Assuming that the Company did not want to utilize its own capital, the same $15,000,000 of cash flow could finance 100% of the cost of acquisition. In that case, the first year interest expense would be approximately $8,300,000 (based on 15 year amortization at 5.5%), and decline each year. Thus for the same cash outlay, the Company owns the sites and picks up an average of $10,000,000 per year in Net Income. The ground leases under the new standard would also create a negative equity trough as described earlier that reaches almost $16,000,000 in Year 7. There are a number of companies that have significantly more than 200 ground leases. In some cases, the annual income and equity impacts could be in the hundreds of millions of dollars.

With the date of transition to the proposed lease accounting standard in 2019, we do not expect to see wholesale elimination of the Ground Lease concept in the short run. In addition, with the large number of Ground Leases already in place, there will not be an opportunity for a large scale conversion of these leases to ownership before the transition date. However, there are a number of strategies that forward thinking companies can begin to employ that will assist in developing and implementing a conversion strategy:

1. Identify all Ground Leases in the Portfolio

2. Isolate all Ground Leases where there is a Purchase Option or Right of First Refusal

3. Evaluate direct vs. financed purchase alternatives and thresholds

4. Model a specific subset of leases

5. Develop pre-transition date acquisition / conversion strategy

6. Evaluate all new projects under new standard

7. Include purchase option where practical in all new leases

Jackson Cross Partners is developing a partnering program with specific clients to identify and acquire leased properties which includes a conversion to ownership provision at a future date. This structure allows for operating lease treatment under current FASB standards, and provides the client the opportunity to own the site at a future date. This unique program is done in collaboration with the client company, rather than as a simple investment purchase of property and offers 100% transparency.

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