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# Off-Balance Sheet Lease Financing: An Overview

Gil Sandler

**In many cases, capital markets funding can make leasing the best alternative.**

Major business enterprises have long utilized off-balance sheet leasing as a means of financing large capital assets. Privately owned companies often structure fixed-asset purchases through major stockholders or other affiliates to provide both tax and personal economic benefits. Publicly owned companies are more concerned with balance sheet and operating ratios, reported earnings and cash flow statements.

A number of established large blue-chip companies—many with "A" or better credit ratings—have relatively broad capital access and large amounts of internally generated cash. These companies often consider incremental purchases of capital assets to be immaterial to their balance sheets and profit-and-loss statements. They tend to think that their market valuations and perceptions are largely unaffected by minor changes in ratios and the substitution of noncancellable lease obligations for debt.[1] Most companies, however large, can benefit in some degree from a carefully structured lease financing program as part of a broader policy of balance-sheet and asset management. Over time, the cumulative impact of such structuring can be both beneficial and material.

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### *Advantages and Disadvantages*

This discussion begins with the assumption that a well-managed growth-oriented company can find profitable business reinvestment opportunities for its internally generated capital [2] so that cost-effective financing to fuel that growth should be desirable. With that premise, the major advantages of off-balance sheet lease financing compared to direct financing are:

- Reduction in leverage ratios (e.g., debt/EBITDA or EBITDAR and debt/net worth).
- Increase in Return on Assets ratio.
- Increase in GAAP earnings both on a net present value and a current cash basis.
- Increase in tax deductions for long-life assets, such as real estate, which are not fully depreciable (e.g., land) and require longer tax depreciation schedules than financing amortization schedules.
- Insulation from charges to earnings resulting from "impairment" of devalued real estate assets.[3]
- Ability to generate additional earnings from reinvestment of capital otherwise invested in real estate.[4]

The typical disadvantages of off-balance sheet lease financing in comparison to direct ownership are:

- *Cost.* Rental expense often exceeds the sum of interest on a direct borrowing, *plus* lease depreciation.
- Potential loss of long-term control of key operating assets.
- Loss of residual value.

While these factors are predominant in commercial leases and leases funded by real estate investors, capital markets-oriented lease financing programs, most notably the short-term synthetic lease[5] and hybrid lease financing programs like COLTS[sm,6] have substantially mitigated most of these disadvantages.

## *Forms of Operating Leases*

There are a few common lease alternatives. Though they are all operating leases under GAAP, the source and nature of the underlying financing substantially affects rent costs—and the lessee's bottom line. Standard commercial leases are generally provided by real estate developers or operators and funded by mortgage loans. Synthetic leases and CTLs are offered by banks and investment bankers who provide agent services for bank and capital markets financing, and raise or contribute equity when required.

### Standard Developer/Investor/Commercial Lease

This lease is typically for a 15-year term, though sometimes longer, at higher rents dictated by, and financed in, the real estate market.[7] Moreover, "build-to-suit" and special-purpose properties leased in this manner charge large rental premiums to compensate for the higher cost of capital in relation to estimated residual value. Developer leases are usually triple-net —often with carve-outs for roof structure, parking, and condemnation and casualty loss—but do not contain credit or financial covenants.

Since developer lease projects usually require 20%-35% equity —depending on property type and residual value—purchase and renewal options are usually at or very near "market" rates,[8] preserving virtually the entire residual for the lessor. Thus, long-term control of the asset and residual benefit remain with the developer/investor, and not with the lessee.

### Synthetic Lease

This lease is usually for a short term—typically five years —possibly with one or two one-year renewals though 10-15 year synthetics can and have been utilized by strong credit lessees.[9] It offers off-balance sheet treatment under GAAP with low rental charges (i.e., interest and little or no amortization) during the initial term. The lessee is the owner for tax purposes and receives the depreciation and interest deductions in the early years of occupancy. Synthetics are 100% financed in the bank market[10] with maximum leverage, resulting in low LIBOR-based short-term funding costs. The lessee retains the long-term residual benefit through direct and third-party purchase options which retire the lessor's debt.

Synthetic leases require a "contingent rent obligation"—also known as a "residual value guarantee"—of 85%-89% of the original project cost. This limits the bank's risk to the highly remote scenario where the Property's residual value is less than the guaranteed amount. However, since synthetics require a residual value guarantee by the Lessee, they cannot be used in sale-leaseback situations.[11]

The synthetic has certain disadvantages. First, there is the risk of potential reclassification as consolidation accounting interpretations evolve.[12] In addition, multinational companies subject to European/Canadian or other international accounting principles require consistent tax and accounting treatment. Moreover, a synthetic lease must ultimately be refinanced or "taken out" with both tax[13] and transactional costs. Thus, the synthetic is used most often as a "warehouse" or interim financing vehicle pending the lessee's ultimate determination as to the lessee's ultimate use or disposition of the asset.[14]

Subject, however, to these constraints, and the need to adjust unamortized loan amounts to estimated residual values of the Property, the synthetic lease's low funding cost and reduced amortization can produce attractive rents; when combined with the omission of depreciation the impact on earnings can be extremely positive.

### Bondable and Credit-Tenant Leases

Such leases (collectively referred to as "CTL's")are long-term credit leases financed in either the real estate or bond markets[15] or a combination of both. For example, specialty bond investors might purchase mortgage or lease-backed bonds for 15-

25 year terms (at a rate exceeding the lessee's outstanding bond rates). CMBS[16] investors would buy 10-15 year bonds at secure loan-to-value ratios (65%-75%), reflecting substantial equity and limited refinancing risk. The CTL lessee's credit is typically investment grade and the properties tend to be relatively generic—headquarters/office and warehouse/distribution facilities.

CTL financing can also be highly leveraged against the lessee's credit and can therefore be more efficient than customary real estate financing. However, lessees must still pay higher rents to support true equity for special purpose properties,[17] and the higher interest rates required in the fixed-rate bond private placement markets. They also surrender most—though not necessarily all[18]—the residual benefits, and their operating flexibility can be limited by substantial prepayment and "make-whole" penalties for early termination or sale.

The CTL is often used in packaged sale-leaseback transactions, along with investor leases funded in the real estate markets.

### "Hybrid" Lease Structures

Hybrid capital markets leasing structures such as COLTS[sm19] seek to combine the primary benefits of the synthetic lease and the CTL into a "lessee-friendly" form of long-term lease. Like the CTL, COLTS is a *long-term* lease that is off-balance sheet for *both* tax and GAAP. However, like the synthetic but unlike the CTL, COLTS obtains low funding costs through the high-grade CP market at or below bank loan rates. Again, like the CTL, COLTS eliminates the need for, and the tax and transactional costs of, a "takeout" through a sale of the property. Yet, like the synthetic, COLTS preserves for the lessee much—though not all— of the residual benefit lost in the CTL through carefully formulated "non-bargain" purchase[20] and renewal[21] options.

In certain cases where bank credit support for COLTS' primary CP funding vehicles is unavailable, a COLTS hybrid lease can be designed to access the CMBS or private placement bond market for all or a major portion of the transaction. Although interest rates and corresponding rents are likely to be substantially higher, the access to additional capital may be a paramount consideration.

Structural variations may range from multi-tranched rated debt in the CMBS market to splitting the lease receivables assigned sold to one lender from the mortgage assigned to another.

COLTS' flexible leasing structures can also be custom-crafted to a company's preferences in terms of financing vehicle, lease term, operational flexibility, and degree of residual interest. For example, long-term rents can be reduced in many cases by a corresponding reduction in principal amortization, supported by either or both the lessee's limited residual value guarantee and/or third-party residual value insurance.

### Types of Leased Assets

In determining which assets to own or lease and in selecting a leasing program, consideration should be given to the nature of the asset, its expected useful life in its present form, its importance to the company's operations and its estimated long-term residual value. For example, "core" assets like corporate headquarters, key distribution centers and important business locations, should be controlled through long-term purchase and/or renewal options. This would suggest a hybrid lease program like COLTS or some combination of a short-term synthetic with a COLTS-type takeout. Both the developer/investor lease and CTL–even if financed efficiently by means of a strong residual—are likely to require more than nominal equity which will, in turn, require a surrender of control and much of the lessee's potential residual interest.

By contrast, however, "non-core" assets, which may not be an important part of the company's long-range business plan, may be best suited to a developer/investor lease for a shorter term of 10 years, particularly if the lessor is able to offer low to moderate rents by means of a strong residual value. The company retains the flexibility to move or sell its business and does not need to secure its long-term interests by providing long-term credit support.

Special-purpose properties which are core assets can best be financed on a credit basis through a hybrid or a combination synthetic/hybrid. This is because the uncertain residual value of the property—or its high conversion and re-leasing cost, is likely to command more expensive debt and equity financing, resulting in higher rents. A CTL structure may be available for investment grade lessees, but the CMBS market typically limits or shuns special-purpose properties.

Another property-specific factor is anticipated technical obsolescence as it may have an impact on residual value. Properties built with less modern design or structural features, or incorporating older technology, may require complete reconstruction or a major upgrade within a short time

frame. If these are core assets, the need for long-term control suggests ownership or a "lessee-friendly" lease. In the case of a noncore asset, however, the company should prefer a shorter term developer/investor lease, even at higher rents. In any event, an operating lease would protect the company from a probable future write-down of the asset. This type of property can also be a prime candidate for a sale-leaseback.

The land value component of a property may also be relevant. In general, the higher the initial land cost, the greater the residual value. This would suggest that both a short-term synthetic lease with a residual value guarantee and a long-term credit lease present little risk to the company as lessee. The reduced building improvement component tends to reduce the company's depreciation as a tax owner, but simultaneously requires a smaller depreciation charge for profit and loss reporting. On balance, however, properties with high land components and correspondingly high residuals can probably be leased as efficiently as owned—especially on a after-tax basis—through reduced amortization lease structures.[22]

## *Sale-Leaseback Option*

The decision to own or to monetize assets through a sale-leaseback also involves a number of interactive factors, most notably, the cost of capital and the company's after-tax reinvestment rate. If the net rental cost is less than the net profits which are generated by reinvestment of sale-leaseback proceeds, the economics favor financing generally, and, in many cases, lease funding.23 If however, the funding cost to the prospective purchaser/lessor using real estate financing is more than nominally higher than the company/lessee's direct borrowing cost in the credit markets, the net rental cost may, indeed, be lower than the net reinvestment rate, but higher than the true cost of financing business expansion through direct borrowings.

This potential dilemma is precisely the reason to consider CTL and CP-conduit financing options which compare more favorably to lower funding costs available to corporate lessees in the CP and MTN (medium-term note) markets. While many large "blue-chip" companies regard capital as a readily available, fungible commodity, others, including growth-oriented technology companies, will turn to leasing options if the off-balance sheet financ-

**Exhibit 1 Comparison of Financing Alternatives**

| | 1. Direct Unsecured Borrowing | 2. Direct Mortgage/Real Estate Financing (Secured) | 3. Capital Markets Lease Financing (Secured) – COLTS/CTL |
|---|---|---|---|
| **Amount of capital available** | 100% of required amount for strong credits only (generally "A" or better). Capital access for lesser credits depend on such factors as pro forma-leverage and cash flow, ratios, industry and company prospects and perceived capital access. | 65% - 80% of Appraised Value of Property | Up to 100% of Appraised Value, subject to credit. |
| **Term** | 5-10 years for low to mid-investment grade ("BBB-" to "A") 10-30 years for high investment grade ("A+" or better) | 10-25 years, depending on leasing status and terms, balloon and residual value property type. | Up to 25 years, subject to credit. |
| **Rate** | T + 150-300 for low-to-mid investment grade ("BBB-" to "A"); T + 75-150 for high investment grade ("A+" or better) | T + 225-350 depending on term, equity cushion, property type, balloon and residual value. | Typically 25-50 bps over Direct Financing Rate. (Col 1.) |
| **Balance Sheet Treatment** | On-Balance Sheet Debt | On-Balance Sheet Debt (even if mortgage is non-recourse) | Off-Balance Sheet |
| **Tax Benefits** | Company deducts Interest and Depreciation of Building Component only (39-year schedule) | Company deducts Interest and Depreciation of Building Component only (39-year schedule) | Company deducts Rent – including interest and principal amortization on amount financed (usually on 20-25 year schedule) |
| **Residual Benefits** | Company retains full residual benefit subject to SFAS 121 impairment charges | Company retains full residual benefit subject to SFAS 121 impairment charges | Company shares upside potential through fixed purchase and/or renewal options; no SFAS 121 impairment exposure |

**Exhibit 2 Comparison of Operating Lease Structures**

| | 1. Synthetic Lease | 2. Real Estate/Investor Lease (Sale-Leaseback) | 3. Hybrid/COLTS Lease | 4. Credit-Tenant Lease (CTL) |
|---|---|---|---|---|
| **Typical Lease Term** | 5 years | 15-25 years | 10-25 years | 20-25 years |
| **Lease Type** | Credit-Bond-type | "NNN" or "NN" Commercial | Credit-Bond-type | Credit-Bond-type |
| **Financing Structure** | Leveraged: 3%-5% Equity; Non-amortizing Debt; Rate = LIBOR + Credit Spread. | 20% - 35% Equity; Amortizing with substantial balloon @ year 10-15; Rate = T+ 225-350 bps. | Leveraged: 3% - 5% Equity; Amortizing with 20% - 50% balloon at end of Term; Rate = CP + Credit Spread or T + Credit/Swap spread. | Leveraged 1%-5% Equity; Fully amortizing (or up to 5% balloon); Rate + T+ credit spread, usually 25-50 bps above Lessee's Fixed Direct Financing Rate |
| **Purchase/Renewal Options** | Purchase Option @ 100% of unamortized balloon (usually 100% of amount financed). Occasionally, 1-year renewal option. | Purchase/Renewal Options @ 100% of Fair Market/Rental Value determined at end of Term; in some cases, @ 125% - 135% of Original Cost | Purchase/Renewal Option @ Estimated Future Fair Market/Rental Value determined at Lease inception – generally 50% - 90% of originally cost. | Purchase/Renewal Options @ Fair Market Rental Value, *usually*, determined at end of Term; in some cases, at negotiated % of Original Cost (above 100%) |
| **Lessee Responsibility** | Residual Value Guarantee @ 85% - 89% of Original Cost Lessee must purchase or arrange takeout | None | None in 20-25 year Leases. If requested by Lessee, 10-20 yr. Leases may include partial Residual Value Guarantee @ 20% of Original Cost. Lessee must maintain credit | None |
| **Tax/Accounting Treatment** | Off-balance sheet (Operating) Lease for GAAP Capital Lease for tax purposes. | Off-balance sheet (Operating) Lease for GAAP and tax purposes | Off-balance sheet (Operating) Lease for GAAP and tax purposes | Off-balance sheet (Operating) Lease for GAAP and tax |

ing cost is only slightly higher—perhaps as little as 25-75 bps.

Recently, the sale-leaseback market has expanded to accommodate the capital needs of well-recognized specialty industry companies in hospitality, healthcare and entertainment businesses. Credit tightening by banks and capital markets financing constraints have made expansion, consolidation, and modernization difficult to finance. Thus, the critical need for capital has sought new markets—and a return to time-honored structures like the sale-leaseback—to obtain a lower cost of funds and a longer amortization term than are available in the high-yield and subordinated debt markets.

## Conclusion

There are, of course, many other differences among these forms of lease financing, some of which may be important to a prospective lessee. As noted previously, if a company has no available bank support—either within or beyond its relationship bank group—both the synthetic and typical COLTS lease structure are unavailable. A company's inability or unwillingness to provide credit assurances in the lease would also preclude the lessee and its developer from access to the capital markets and require substantial equity investment for either CMBS or conventional mortgage financing. However, Lessees with very strong credit can choose from among the synthetic, a CTL or a COLTS-type hybrid structure, or a commercial lease program depending on their long-range plans for their real estate assets and their interest rate perspective.

Each company has its own unique approach to the "own-vs.-lease" decision, and may wish to consider other factors in selecting a leasing structure. Financial and real estate management teams must carefully analyze available options and coordinate their respective functions in order to measure and secure the very real benefits of off-balance sheet lease financing. In the final analysis, however, a structured long-term credit lease program like COLTS or a CTL—often as a takeout for, or in tandem with, a synthetic lease—can be financed most efficiently in the capital markets. The result is, invariably, after-tax rents lower than real estate market rents, and,

over the long term, occupancy costs that compare favorably with direct ownership costs. ■

## Notes

[1] Rating agencies add a multiple of current-year rents in non-cancellable operating leases to pro-forma debt. Banks and other senior lenders often deal with such leases in earnings/fixed-charge ratios or EBITDAR (earnings before interest, taxes, depreciation, amortization and rents) to interest plus rents ratios. However, qualified operating leases are generally *not* included as "indebtedness" in leverage ratios (i.e., debt to equity; pro-forma debt to EBITDA) or in analytic operating ratios which measure a company's performance, such as return on assets.
[2] Obvious uses of capital include expansion of an existing business or acquisition of new or related businesses. In addition, stock buyback programs of undervalued companies can improve earnings per share and improve market perceptions.
[3] Statement of Financial Accounting Standards (SFAS) No. 121 requires regular reviews of fixed asset carrying values.
[4] See Note 3 supra.
[5] Among the common acronyms for synthetic leases are "TOOL" ("Tax Ownership Operating Lease") and "TROL" ("Tax Retention Operating Lease") popularized by certain major banks.
[6] COLTS and Corporate Operating Lease Term Securities are proprietary service marks of RealVest Capital Corporation.
[7] Developer/Investor leases relate to projects built by developers, usually to the lessee's specifications. Upon completion, the property may be "flipped" to real estate investors (most often to IRC investors seeking a Sec. 1031 property exchange) or to joint ventures that include the developer, a REIT, or an institutional equity partner.
[8] On occasion, fixed-price purchase options may be offered, but usually at 110%-125% of original cost or more.
[9] SPE Lessors owned or created by banks are generally reluctant to make long-term credit commitments to all but the strongest credit Lessees.
[10] Whenever an SPE is the lessor, the 3% equity required to meet EITF (Emerging Issuers Task Force) 90-15, as interpreted in EITF-96-21, is "contributed" by the bank.
[11] SFAS 98 prohibits a lessee's "continuing involvement" in the property's ownership, including attributes such as major risk and reward. Thus, both residual value guarantees and purchase options are precluded.
[12] The FASB (Financial Accounting Standards Board) Consolidations Task Force has issued several pronouncements centered on a benefits-burdens analysis. See FASB, Proposed Statement of Financing Accounting Standards-Consolidated Financial Statements; Purpose and Policy (Feb. 23, 1999), particularly Example 7. The typical bank SPE lessor in a synthetic lease has no upside and virtually no downside risk.
[13] A sale to a third party will be taxable to the company to the extent of its cumulative depreciation .
[14] Of course, the lessee could elect to "repurchase" the property at the end of the synthetic lease term, but this would nullify the off-balance sheet benefits originally sought. Moreover, if a repurchase were originally intended, the initial lease classification would be questionable.
[15] Although "bond-type" and "CTL" lease types are distinguished in National Association Issuance Commission (NAIC) regulatory interpretations, they are grouped together for purposes of this discussion. For information regarding CTL's qualifying for bond-type investments, see NAIC Securities Valuation Office (SVO) Purposes and Procedures Manual, Pt. 7, Sec. 4(a); Securities Valuation Office, NAIC, Credit Tenant Loan Documentation Requirements (Nov. 9, 1994).
[16] CMBS or commercial mortgage-backed securities are securitized mortgages packaged into large diverse pools and carved into tranches for sale to bond investors.
[17] This category includes entertainment (movie theaters) and recreation facilities, as well as hospitality (hotel, restaurant) and healthcare properties which are not readily convertible to alternate uses. More generic property types would include office buildings, warehouses and "big box" retail stores.
[18] A CTL bond structures can be used in tandem with full leverage. The reduction in true equity can permit a negotiated sharing of potential gain through structured renewal and purchase (except in sale-leasebacks) options.
[19] COLTS and Corporate Operating Lease Term Securities are service marks of RealVest Capital Corporation. For purposes of this general discussion, COLTS is referenced as primarily a generic example of hybrid long-term lease programs funded on a highly leveraged basis in the capital markets.
[20] Purchase options may not be offered in sale-leasebacks under SFAS 98. See N.11.
[21] Renewal options can be based upon the parties' estimate of future fair market value, supported by appraisals or professional expenses.
[22] Longer lease terms, with correspondingly lower rents, can also be utilized in high land value properties, since SFAS 13 allows for more favorable computations of the 90% test where land exceeds 25% of the total project value. Higher estimated residual values also permit reduced amortization lease financing schedules.
[23] See R.L. Nessen, *Real Estate Finance & Taxation: Structuring Complex Transactions* 149-156 (1990).