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Real Estate Finance Leases: On- or Off-Balance Sheet?

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Many articles in professional publications use graphically depicted data and econometric analyses of market factors to support their observations. These are often interesting and provide an invaluable means of documenting new trends and analyses. This article reports no new data or statistical trends. Its sole purpose is to stimulate meaningful analysis of the key accounting issues of reporting finance leases in financial statements.

After commenting on the impact of the Enron Debacle on structured leases,[1] and major accounting rule changes, it is time to return to the fundamental question of why analysts, the accounting profession, and Wall Street have made such a fuss about whether leased real estate is reported on financial statements as "on-balance sheet" or "off-balance sheet." In the financial statements of many mammoth, well-run public companies, this debate is "much ado about nothing." Others with a less secure investor following have been spooked by fear of being lumped in with the hucksters of structured finance, and opted for transparency, robotically pulling all controlled real estate onto their swelling balance sheets. A third group, including a number of well-capitalized companies, still welcome the debt to equity and return on assets ratio boosts provided by synthetic and similar leases.

As the reexamination of accounting for leases is anticipated, the objective here is to suggest that classification of a real estate lease transaction be based exclusively on the economic substance of the transaction, rather than a measured, and often manipulated, calculation of rents as a percentage of property values. This article also suggests that the distinction of on-versus off-balance sheet is itself less meaningful to an analysis of a lessee's business or risk profile than other forms of analyzing risk and reward and full disclosures of structured transactions.

BACKGROUND

2004 was a third year of overreaction to the Enron Explosion—the sudden public realization that earnings and stock prices were being brazenly manipulated by misleading financial statements involving disguised debt and distorted applications of ambiguous accounting rules. The real estate leasing sector appears to have digested accounting rule changes and settled into a comfort zone in which large public corporations can choose a synthetic or "true" operating lease of real estate, or own properties outright, for that matter, without ruining their credibility with investors or rating agencies. Although many corporate lessees let their synthetic leases expire or purchased their leased properties, others have renewed them, and appear content to disclose their effects.

The Financial.Accounting Standards Board (FASB), the authors of GAAP,[2] issued Fin 46[3] in order to prohibit some of the more egregious of thinly capitalized special-purpose

entities (SPEs) to hide risk and fabricate income, but soon learned that their broad brush had also impacted the huge, and mostly legitimate, business of synthetic and structured leases of real estate. FIN 45[4], which closely preceded FIN 46, was designed to report the risks involved in the lessee's residual value guarantees. These guarantees are commonly used in synthetic and related leases in order to enable commercial lenders to bridge the gap for between real estate risk and corporate credit risk, and they quickly became the key to a mega-billion dollar business for banks. As reported in other articles,[5] the major bank leasing companies have been able to accommodate these rules and continue to provide synthetic leases, at least to their more creditworthy customers.

More recently, the FASB has followed the lead of the International Accounting Standards Board (IASB) and announced that in 2005, it will re-examine FAS 13, "Accounting for Leases," which has been largely unchanged for over 30 years. IASB announced it would commence such a review in 2004, but has not yet issued any preliminary statements. Preliminary indications seem to focus on the bright-line "90 percent test" in Paragraph 7, in which leases whose rents aggregate to a net present value of less than 90 percent of the fair market value of the leased property can be classified as "operating leases."

The well-known abuses that triggered Sarbanes-Oxley and multiple criminal and civil prosecutions by Elliot Spitzer and the Securities and Exchange Commission were not directed toward real estate leases. Enron, Worldcom, Qualcomm, Tyco, and other high-stock-multiple energy traders and telecoms manipulated their earnings to meet Wall Street projections by pretending to move money around controlled circles through fabricated sales of assets. Wall Street and major banks were only too happy to "purchase" overvalued assets on condition of a guaranteed repurchase. Typical was the Merrill Lynch "purchase" of the infamous Liberian barge from Enron backed by a concealed repurchase guarantee from CFO Fastow.

Ironically, neither this bogus deal, nor most of the "round-trip" telecom cable capacity swaps, would have been prevented by the new SPE rules, since they all required concealment of the economic substance and true facts from accountants and investors. True, the telecom swaps slipped into the crack of accounting inconsistencies, since the sale of capacity generated instant revenue while the purchase was allowed to be amortized over the term. However, the simultaneous timing of the sale and purchase—like the classic circular check routing game—and the identical parties and amounts were bold, "skull and crossbones" warnings that no true economic exchange had transpired. At the very least, these so-called deals deserved an explicit disclosure. As it happened, they were recorded as independent, meaningful transactions.

SYNTHETIC AND OTHER STRUCTURED LEASES

None of these types of fraudulent schemes appear in synthetic and other finance leases. To begin, SPEs are widely used by real estate owners and lessors in ordinary leases. They permit owners to separate investors and lenders in, and to segregate liabilities from, distinct parcels of property. Thus, the decision to use an SPE is not in itself suspicious. Then, too, all real estate financing does not require substantial equity capitalization. For example, property leased for the long term under a credit-tenant lease (CTL) may require little, if any, true equity,[6] since the rents can usually amortize substantially all of the acquisition or development cost and the property should have some residual value.

The unique feature of the synthetic lease that made it an instant success among publicly owned companies is not the balance-sheet treatment or tax advantages, which have essentially been ignored by both lenders and rating agencies. Rather it is its ability to minimize the expenses charged to a lessee's profit and loss statement by avoiding both the book depreciation charge for owned real estate and the amortization component built into developer/investor leases.

Here is an example:

> ABC Corporation, an "A" rated pharmaceutical manufacturer with $50 billion in annual revenues, commissions a "build-to-suit" developer to build a new $250 million corporate headquarters in a suburban New Jersey office park.
>
> a. If ABC chooses a synthetic lease from one or more of its banks that have affiliated leasing companies, the rent is the only charge to its profit and loss statement, which in the classic synthetic, amounts to "interest-only"—perhaps LIBOR + 50 basis points or less than 3 percent—on 100 percent financing for a short term of, perhaps, five years. This floating rent of $7.5 million annually could be fixed via a LIBOR swap, but in any case produces a rent level well below the 8 percent to

10 percent of cost rental in a conventional short-tem lease, because a non-bank lessor would charge a premium rent for a shorter term, given the need to re-lease and re-fit the property.

b. If ABC elects to purchase or build the property, its P&L would have to include charges for both interest on the loan used to finance the property and a book depreciation charge—usually straight-line over approximately 30+/- years, based on the estimated life of the various non-land components of the property. This would produce a book charge to earnings of at least 6 percent of cost, assuming a similar financing oat LIBOR + 50 bps.

c. If ABC leases the property from a developer, investor or REIT, the rent for a long-term CTL suitable for a corporate HQ would still be in the range of 7.5 percent to 9 percent of cost. Even though the lessor could obtain a low interest rate based on the reduced credit and residual risks, the rent would still include an amortization factor on the debt financing and a return on even minimal equity of 5 percent to 10 percent.[7]

The synthetic lease financing structure described above works, in part, because the bank leasing company affiliated with ABC's lead bank can comfortably lend at low short-term rates (floating or swapped) for a short-term lease, and can look to the lessee's credit, rather than the residual mortgage value, lessee-leasing, refinancing and related costs, for repayment of what would otherwise be a non-recourse mortgage.

In order to enable the bank leasing company to have full access to the lessee's strong credit, the synthetic lease includes bank-type covenants accelerating the rents and rights of the lessor in the event of any early warning of credit problems, and, most significantly, the residual value guarantee (RVG). Under the RVG, upon expiration of the lease, including a termination upon default, the lessee is obligated either to arrange for a take-out purchase covering repayment of the lessor's total investment (loan plus equity), or pay a "contingent rent" equal to 85 percent of the amount financed. In effect, ABC is guaranteeing the lessor that, even if it chooses to walk away from the property at the end of the lease, or it runs into some serous credit problem during the term, the property will have a residual value sufficient to repay the lessor. This contingent rent becomes a *first-loss* guarantee, so that ABC and any other lessor would sooner sell or refinance the property, even for less than original cost, rather than pay 85 percent of $250 million and walk away, leaving the lessor to retain and auction the property for the remaining 15 percent.

There are two other notable benefits of the synthetic and certain other structured leases. First, like other operating leases, these leases remove the real estate asset and corresponding financial liability from the lessee's balance sheet. In the past, this feature aided corporate borrowers in their calculations of debt to equity ratios for compliance with bank requirements and rating agency analyses, and improved return on assets ratios. Although these benefits have been discounted in more recent analytical tools used by banks and rating agencies,[8] they are still valued by many supporters of leasing, including ABC's CFO.

Finally, the synthetic and certain other structured leases[9] leave the lessee as the owner of the real property for tax purposes, enabling it to take tax deductions for both the interest component of the debt, which is usually 100 percent of the rent, and depreciation on the various building components. Thus, by comparison to other financing scenarios, the synthetic enables ABC to book a lower charge against earnings, to maintain better debt-to equity and return on assets ratios and to get a greater tax deduction.

OWN VS. LEASE: THE ECONOMIC DIFFERENCE IS DEPRECIATION

As indicated, corporate lenders, rating agencies, and now institutional equity analysts and investors are looking through the form of lease to find its substance, and equate non-cancelable lease obligations to debt, at least for balance-sheet purposes. What remains to be seen is whether the FASB and IASB will overhaul the lease accounting rules to obliterate the balance sheet distinction and, if so, what will replace it.

As a preface to this discussion, compare the economics of ABC's five-year synthetic lease with its other financing options.

The Own vs. Lease Decision. ABC did not care all that much about booking the asset and liability, as $250 million would not have a material effect on its already sophisticated lender and investor following. Direct ownership could have been financed either

through its bank lines or conventional mortgage financing, but at a higher interest rate in the latter case, and with a higher charge to earnings.

The Synthetic vs. Conventional or CTL Lease. Conceivably, several billion of real estate assets and recourse debt[10] exposure might be material, but ABC's CFO balanced the P&L benefits against the "transparency" benefit of direct ownership and chose the synthetic lease. This decision was facilitated by the fact that ABC had a clean reputation and the disclosure seemed relatively innocuous. Of course, the CFO and his audit committee had to be satisfied that there was no real residual risk to be charged off in future years, and that they could—and very well might—resell the headquarters in five to ten years at a profit. They would not have relished post-facto criticisms by future boards and analysts that they swept future charges under the proverbial corporate rug.

As a matter of economic reality, ABC knew that it would have to renew the lease, perhaps with some higher rent, eventually including an amortization component to reflect potential declines in residual value, or purchase the HQ building. ABC has retained the full residual value risk of declines in asset value, but has neither written it down through book depreciation to reflect a potential decline, nor amortized any of the debt. This is acceptable because ABC makes this decision based on a well-documented estimate of future value from a qualified appraisal firm and has no reason to believe that the net asset value of the real estate will be impaired in the foreseeable future. Other companies, however, routinely used non-amortizing synthetic leases to finance special-purpose properties like plants and poorly sited properties, assuming their credit will support the ultimate refinancing, regardless of residual value. The new rules, and common sense, have made this less common, and more difficult.

In many respects, the choice of the non-amortizing synthetic over a long-term amortizing lease is closely analogous to the preference by major public companies to issue five to ten year "bullet" notes, which must be continuously rolled over.[11] Both non-amortizing structures offer the tax advantage of deductibility for all cash payments for debt service (*i.e.*, interest only) but like leverage generally, it multiplies the risk of a liquidity crunch. One important difference in the case of a valuable parcel of real estate is that the market and rental value of the real estate substantially—if not fully—secures the lessee's financial obligations under the synthetic lease, while the bullet note must be refinanced based solely on the borrower's credit. Also, since the synthetic lease rent is below market, a true market rent payable by another user will likely support a conventional mortgage takeout or enable the lessee to sublease if it were forced to renew the lease.

In the standard medium term 10-year lease, the lessor might be a developer, pension fund or REIT. Whether the property is financed with 100 percent equity or in the mortgage market, the rent paid by the lessee includes: (i) a return on the lessor's equity; (ii) a return of equity capital; (iii) interest on any mortgage debt financing; and (iv) the repayment of the principal of the mortgage. The mix of these components in rent is heavily impacted by the risk and reward elements, as follows:

A. *The Risk Element.* The higher the percentage of the property's cost or value covered by a secure committed rental stream, the lower the rent. A longer-term lease to a strong credit, stable tenant always commands a lower rent than a shorter term lease to a weaker tenant. Lessees that are operationally sensitive often pay higher rents because the lessor has to reserve for frequent re-leasing and fit-up. Even large "big box" retailers often pay higher rents for the flexibility of shifting locations after shorter-term commitments of 10 years or less, rather than be stuck with locations that become secondary to changing business profiles. Also, a longer term lease of say 20 years can fully amortize a lessor's financing, and leave only upside.

B. *The Reward Element.* The greater the residual value upside retained by the lessor, the lower the rent. This favors more generic, well-constructed, well-located properties in which the lessee has not insisted on a favorable purchase or renewal option. If an owner knows the property can be re-leased after five or 10 years at a higher rent without major work, it will be more willing to accept a lower rent, or reduce the penalty for shorter-term commitments. By contrast, a real estate investor would have less interest in a long-term credit lease to a strong lessee if the upside were substantially reduced by below-market purchase and renewal options.[12]

In most respects, the CTL is a conservative, but advantageous alternative to direct ownership. It has a lower rent than a conventional true lease from a developer, REIT or pension fund and usually, a lower charge to earnings than the sum of interest on a long-term amortizing bond plus depreciation. The lessee's strong credit and long term commitment reduces the CTL bond interest rate and minimizes the higher-cost contribution required of the lessor, often to 5 percent to 10 percent, thus reducing the rent well below a "market rate" driven by real estate forces. The operating lease classification eliminates the need to book a depreciation charge. Finally, the use of the CTL structure attractive to bond-type investors enables the lessee to negotiate favorable renewal and purchase options of the type disfavored by conventional real estate investors. The benefit to the CTL lessee here is it can recoup a portion of its higher rents through long-term control and reduced ownership costs in future, once the lessor's capital has been returned.

The hybrid lease[13] combines several features of the synthetic with a more conservative approach to residual value, and produces a rent that is lower rent than the CTL, much lower than the conventional true lease, and avoids the perceived residual value and rollover risks of the synthetic lease. As an operating lease, the hybrid lease is still attractive for its ability to avoid book depreciation. Like the CTL, the rent consists of a credit-based bond-type interest rate, which is usually much lower than a real estate financing rate, and a small amount of equity. The difference, however, is that this lease incorporates a variant of the RVG from the synthetic lease. Depending on the type of property, the perceived residual value risk to the lenders and the term of the lease, the hybrid lease might utilize a lessee RVG of 50 percent to 75 percent of the original cost of the property—instead of the usual 85 percent, resulting in a credit-based balloon financing. This feature would produce a lower rent than the CTL, due to its smaller amount of required amortization to reach the balloon. It also enables the RVG to be structured as a deficiency, instead of first-loss, guarantee, making it more palatable to liquidity-conscious lenders and rating agencies, and much less vulnerable to FIN 45 charges.

CONCLUSION

Lease vs. Purchase: The Accounting Distinction. Under current accounting practice,[14] the synthetic lease's low interest-only rental charge against earnings requires analysis of the RVG risk. If that risk is mitigated by a qualified appraiser's estimate of future value at the end of the lease term in an amount greater than the financed amount, the RVG exposure can be valued at virtually zero, no annualized RVG cost charged as a lease-related expense. Otherwise, the lessee would have to book an additional liability for the fair value of the RVG, and amortize that liability over the term of the lease as an added charge to earnings. As indicated above, ABC and its accountants were confident hat their brand-new HQ on well-located property was built efficiently on under-valued land and will be worth at least as much as the $250 million it cost[15] in five years, and perhaps much longer. They had no difficulty obtaining the future value estimate from a qualified appraiser. Why then, should ABC be penalized by forced deprecition not required by economic reality if it had elected to own and finance the property directly?

If accounting rules are to be revised to penetrate form to find substance, they should begin by leveling the playing field for newer, readily marketable properties that are unlikely to decline in value. It is a long-established accounting rule that real estate can never be booked at more than depreciated cost, regardless of higher market values. Yet, accountants can recognize the appraiser's future value basis for devaluing the RVG as not reflecting true real estate risk, but cannot reduce or waive the depreciation charge for the same rock-solid real estate when it is owned by the lessee.

Understandably, many properties will decline in value, or may ultimately be abandoned or become knock-downs. Industrial plants have costly, installed equipment that is difficult to remove or replace, and often present environmental issues in changing use. Special-purpose properties like hotels, movie theaters, hospitals and nursing homes may have a significant conversion cost. Destination retailers or offices in remote locations and older properties with technological or configuration problems will have very limited marketability. These factors can all be measured in the same type of appraisal that supports an RVG devaluation, or for that matter, in an FAS 121[16] analysis, resulting in substantially the same P&L impact on the lessee whether it chooses a synthetic lease or direct financing and ownership.

The *Debt vs. Lease-Related Obligations.* What has been most disturbing to the recipients of professionally prepared financial statements of the companies caught in the Enron aftermath is the realization that many financial transactions disguised as trades, sales and even leases contained liquidity default triggers which were not disclosed. Rating agencies now scrutinize financial statements and records for such default triggers. It should, however, be noted that the many

bankruptcies and domino collapses caused by these hidden time bombs were not the result of concealing debt in the form of leases. These default triggers were not activated by failing to properly depreciate or reserve for declining real estate in synthetic leases, but the multiples of debt hidden in non-real estate transaction without the underlying value of real estate to support the debt. Reviewing a company's classification of real estate finance with debt, compared to real estate leased under properly classified operating leases would not have prevented any of these meltdowns.

Finance-type leases and non-cancelable lease commitments with acceleration clauses may or not be debt—although they come closer than conventional or true leases. The better solution is not to classify them as debt, but to disclose and reserve for the risk, as necessary, as additional supplemental rent. Even if the real estate assets and liabilities become balance sheet items, future impairment will still come as an unwelcome charge under FAS 121. Classification of rent as an operating expense assumes that it is the full cost for the use of the leased property for that period, and that there is no hidden or deferred cost that will have to be written off or charged later when the perpetual rollovers of short-term financing facilities fails because the music stopped in the lessee's business. Whether a lessee amortizes an RVG charge in a synthetic lease, or pays higher rent to enable the lessor to amortize property having a greater residual value risk, the alternative charges of rent or interest plus realistic depreciation should measure that cost.

The true risk of long-term use of real estate, whether leased or owned, can best be measured and reported by frequent and consistent valuations of residual value. If properties are rented at rates below fair rental value, those leases should be examined for hidden or deferred charges, *e.g.*, an RVG that is likely to be invoked—but should not be reclassified merely because the lessee has placed its strong credit solidly behind the lease obligation. For example, if the accounting rules were to be modified to classify the net present value of long-term lease commitments as debt, they should also recognize the fair market value of those properties as reductions of that debt, as well as the presently unrecognizable long-term appreciation of other assets as a cushion against hidden or deferred charges.

In the simple, direct approach taken by regulators, whatever looks and smell like debt should be booked and accounted for as debt because, as in the case of a bond or loan, debt, there is an unconditional obligation to repay that debt from any and all assets of the borrower. However, financial obligations which are fully secured by real estate are materially different because they do not require the disposition of other assets to repay them. Another material distinction is that debt for money borrowed is usually spent, often to repay other debt that has become due, well before the repayment cycle begins, and certainly before it is ended, so there is no matching of the periodic repayment obligation to the use of borrowed funds. .By contrast, lease-related debt secured by real estate is repaid over the useful life of the real estate and is not an absolute, unconditional repayment obligation. Assuming compliance with the financial terms of a credit lease, payment of rent is conditioned on continuing use and access to the leased property, and even at the end of the lease term, final payment of a "balloon" will not reach other assets unless the residual value of the mortgaged asset is insufficient. To reclassify credit or finance leases as debt merely because the lessee has purified and strengthened its commitment to a property that fully supports related debt would be a distortion of the lessee's financial position.

Accordingly, different treatment is warranted for lease-related debt under credit or finance-type leases than automatic reclassification as debt and aggregation on a lessee's balance sheet. Perhaps, only the net cost or asset value of a leased property in excess of related debt should be carried as an asset, and only recourse debt in excess of well-documented residual value should be listed as a liability. Maybe operating lease treatment should be retained with closer analysis of hidden or deferred rental expense. Or, the net present value of the sum of committed rentals, as currently performed under FAS 13, should be measured against the value of the leased asset and not trigger an automatic balance sheet reclassification at 90 percent, but shown as a liability only if exceeds that value. Perhaps the depreciation rules for owned tangible assets should be allowed to recognize that certain types of assets over certain periods do not suffer diminution in value.

Even in this risk-conscious era when a conservative, cynical view is summoned to restore tarnished credibility to financial statements, GAAP should not ignore the ability of real estate to repay recourse or non-recourse financial obligations, whether in lease or mortgage form. The lines between leased and owned real estate have indeed been blurred, but any redrawing should not ignore a basic economic reality. Leased real estate, unlike most other assets used to generate income, can have substantial residual value to support related financial obligations. This value, whether in the form of a "balloon" in a non-recourse mortgage

financing, or an RVG in a structured credit lease, can legitimately reduce the rent component that would otherwise be required to amortize financial obligations.

NOTES

1. Recent commentaries by the author include: Sandler, "Finance Leasing Under the New Accounting Rules: An Update," *The Real Estate Finance Journal*, Fall 2004; "Real Estate Leasing: A New Chapter on Synthetic and Other Leases Post-Enron," *Real Estate Finance*, December 2003; and Sandler, "Synthetic or True Leases: Business As Usual," *The Real Estate Finance Journal*, Fall 2003.
2. "GAAP" refers to generally accepted accounting principles used by public accountants in auditing public companies.
3. As used herein, FIN 46 refers to FASB Interpretation No. 46: Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51 (January 2003), as supplemented by FASB Interpretation No. 46 (R) (December 2003).
4. FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (November 2002).
5. See articles cited, *supra* n.1.
6. Although 10 percent equity is standard, CTL acquisitions often can be financed in the Rule 144A institutional bond market with 5 percent or less on occasion. In most cases involving strong investment-grade companies (except for hidden volcanoes like Enron), credit risk is minimal. Residual value risk is usually minimal, unless the property is special purpose and the rents cannot substantially amortize the investment and debt.
7. Depending on the type of property and the extent to which renewal and purchase options retain residual upside for the lessee, an institutional investor might accept a minimal cash return of say, 6 to 8 percent, en route to a long-term IRR of 10 percent to 15 percent.
8. Corporate lenders now include lease-adjusted debt in their ratios and ratiug agencies consider non-cancelable lease obligations as tantamount to debt for certain purposes. Even cash flow debt coverage analyses such as EBITDA (earnings before interest, taxes, depreciations, ands amortizatiou) have been supplemented by considering rents as debt-equivalents to account for the use of credit-type leases in lieu of direct loans.
9. Certain hybrid lease structures enable the lessee to retain ownership for tax purposes because, as in the synthetic lease, the lessee receives and retains the primary economic benefits of ownership.
10. Another option would be for ABC to borrow directly, but on a non-recourse basis. This would increase the amount of true "equity" required to finance the project and raise the interest rate.
11. Long-term bonds or debentures with sinking funds to amortize the debt are less often, but still, found to finance utility projects and other long-term ventures.
12. As a result of these favorable purchase and renewal options, the CTL and small-property § 1031 markets have come to be populated by risk-adverse, bond-type investors.
13. It should be noted that the author's investment firm, Realvest Capital Corporation, utilizes various proprietary hybrid finance leases known as COLTS[sm] (Corporate Operating Lease Term Securities).
14. *See* FIN 45.
15. It is important to note that well-managed companies like ABC finance their special fit-up and equipment costs outside the synthetic lease, so the unamortized lease investment balance subjected to the RVG risk is not inflated by costs that do not build or retain residual value. If these costs are included in the lease, they should be amortized over the life of the lease.
16. FAS 121 requires that write-down of impaired assets to reduce market value, and charges earnings in the year of the action. Real estate is periodically valued and updated by appraisers.