Perspectives on leasing

2015

A tenant's guide for evaluating ownership versus lease decisions

Questioning historic strategies

Corporate real estate directors are constantly challenged to balance the opportunities in a dynamic capital markets environment with the operational and financial goals of their company.

While certain companies have stayed the course and continued with an ownership or leasing strategy driven by long standing financial policies, others have implemented proactive strategies for selected properties, such as sale-leasebacks of owned assets or acquisitions of short-term leased assets, to take advantage of the current capital markets environment that is defined by an asymmetric risk reward relationship between lease term and value.

Many of these financial decisions have historically been driven by chief financial officers and treasurers. Over the last five years, we have seen corporate real estate directors take a more active role in surfacing these opportunities and evaluating the various economic, financial accounting and tax consequences in order to recommend structures that best match up with the company's operating and financial strategies.

Within this article we will focus on the spectrum of decision criteria for evaluating ownership versus lease decisions for both portfolios and individual property transactions, and the potential benefits of alternative leasing structures and sale-leaseback transactions.

Ranking the critical criteria

It is essential for corporate real estate directors to clearly understand the philosophies and objectives of the senior finance team within the organization, in addition to the operational objectives of the company as a whole and its different business units. Guidelines are commonly established for ownership versus leasing decisions, but operations and finance may have differing viewpoints as to the most critical criteria.

The following are the primary considerations that should be addressed in a collective manner by the organization to establish its guidelines and seek an efficient process for making decisions.

Operations – Factors such as providing flexibility for a growing or contracting workforce should be considered for any real estate decision. Although a company policy may favor ownership, certain locations warrant consideration for leasing if the particular business unit has volatility in staffing or production, or if there are indications of declining real estate market conditions or potential obsolescence. Alternatively, locations requiring significant capital investment in equipment and infrastructure may favor ownership due to the relocation constraints created by such investment.

Cost of capital – For any company, determining the appropriate cost of capital in preparing discounted cash flow/net present value comparisons for ownership versus leasing decisions is a critical variable. In general, there are two schools of thought:

> Companies with **large reserves of cash** and **short-term investments,** plus a **high investment grade debt rating** may lean towards ownership. The utilization of cash is viewed as merely a reduction of invested funds earning nominal returns or the use of a low-cost corporate debt facility, compared to a rent factor on a lease. If a company can borrow at 4% interest only under an existing credit facility and the initial rent factor on a new building is 6% of the project cost, the cost of leasing is apparently higher by 2%. However, this comparison is both simplistic and misleading. Since the lease requires

no upfront investment and leaves the tenant with no obligation at the end of the lease term, the correct debt metric to compare it to is the debt constant that fully amortizes the loan over the same period of time to a vacant residual sale. This in and of itself can reverse the conclusion. In addition, the decision to borrow and to continue to own exposes a company to the various risks of real estate ownership, including casualty, functional obsolescence and an unknown residual value.

A counter position involves applying **weighted average cost of capital (WACC)** to real estate investment decisions, which typically favors leasing as the WACC is generally significantly higher than the cost of debt. WACC is a calculation that blends the cost of equity (generally 10% or higher) and the cost of debt. The theory is that such decisions are longer term in nature and reflect investment decisions as opposed to financing decisions. For these companies, real estate ownership is viewed as a capital budgeting decision that should be measured against internal hurdle rates for core or new business activities. Companies that are growing organically or through acquisitions, and those with lower investment grade, or sub-investment grade debt ratings, may lean in this direction. Certain higher rated companies with liquidity may also favor leasing if there are better investment opportunities available within their core operations.

It is not uncommon to encounter situations in which finance executives differ in their perspective, such as a treasurer who advocates a cost of borrowing approach (prefers ownership), while a chief financial officer or chief operating officer believes the WACC is the appropriate metric. In these circumstances it is helpful to review a range of options, so the client can view the sensitivity to varying discount rates and make an informed decision.

Accounting and income tax considerations

Financial accounting and income tax considerations must also be closely evaluated. For accounting purposes, ownership requires recognizing depreciation and interest expense versus rent expense for leasing.

Another cost of ownership is the **opportunity cost of funds,** which may be measured as an alternative return on invested funds or additional interest cost incurred as a result of the use of funds. Applying an opportunity cost adds expense to the ownership scenario, even if it is not specifically attributed to the asset for reporting purposes. Also, for companies that consider EBITDA a more critical earnings metric than net income, ownership may be viewed more favorably since depreciation expense is added back to earnings in calculating EBITDA and lease expense is not.

Many companies prefer to keep real estate assets and related debt off their balance sheets to improve financial ratios, maintain borrowing capacity for other business activities, or simply for debt covenant compliance purposes. However, significant changes have been proposed to current lease accounting guidelines. It is likely that the current off balance sheet operating lease classification will cease to exist by 2018. Once this proposed accounting treatment becomes effective, all leases would be capitalized on the balance sheet and expensed through (a) amortization of an asset equal to the present value of the lease payments, and (b) financing expense recognized as if rent payments represent debt service on a fully amortizing capitalized lease obligation.

Income taxes come into play in preparing after-tax discounted cash flow comparisons. Leasing is fairly straightforward as rent is usually deductible in the year paid, while owned property is depreciated over 39 years, except for certain shorter-life components such as land improvements (15 years) and personal property (5 to 7 years). For companies favoring ownership, cost segregation studies can be strategically employed to substantiate shifting depreciation to shorter-life assets. For companies favoring lease transactions, tenant improvements should be carefully evaluated, as a significant portion may be considered real property and subject to 39 year depreciation.

Portfolio considerations

For established Fortune 500 companies and growing mid-cap companies with a substantial real estate footprint, portfolio rationalization greatly impacts the own versus lease decision. We see three primary factors as being the key areas of concern for users.

1 Flexibility

For homogenous locations within a portfolio, flexibility can be achieved through a combination of owned and leased assets with specified allocations to ownership, short-term leases, medium-term leases and long-term leases. This type of allocation ensures that at any point in the business or real estate cycle, users have options with respect to vacating sites with near-term lease expirations. Alternatively, some percentage of ownership acts as a hedge against exposure to increasing leasing costs in a growing market.

2 Capital allocation

In our experience, it is important to separate the real estate capitalization decision (ownership versus leasing) from the business unit site location decision. Often, business units are measured based on a financial reporting basis and skewed towards an ownership preference based on the lower expense profile associated with long depreciable life and low or no cost of capital charge. A more efficient approach is to charge business units a fair cost of capital on capital employed and apply a depreciable life reflective of the duration of the use requirement. Then, at a corporate level, the ownership versus leasing decision can be made based on the various factors referenced herein.

3 Match funding

Similar to the previous point, chief financial officers and treasurers manage the balance sheet by employing a strategy referred to as match funding. Match funding involves accessing financing with a similar weighted average life to the assets being financed. The benefit of this approach is a balance sheet where assets and the associated liabilities have a comparable duration. Organizations that have failed to apply this discipline end up in one of two problematic situations. When companies finance long-term assets with short-term financing, they are exposed to refinance risk which can be challenging based on either a deteriorating credit profile or an illiquid capital markets environment. Similarly, when companies make capital investment decisions based on an overestimate of the length of a facility's use requirement, asset values are overstated resulting in obsolescence and impairment charges.

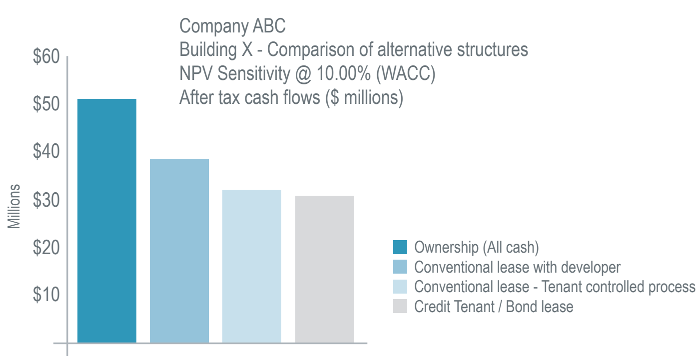
Proactive assessment for major requirements

For major real estate requirements, decisions regarding renewing or relocating and various associated transaction structures should be evaluated as early as three to four years in advance, depending on whether a build-to-suit is an alternative. Beyond the ownership and traditional lease criteria outlined above for existing buildings or build-to-suits, several creative structures should be explored to determine if the company's financial strength can be used to generate significant savings.

Tenant controlled development and financing – This type of transaction may be considered for a build-to-suit, with the objective of reducing the developer profit. By pre-negotiating lease terms and arranging for a third party investor to purchase the property upon completion, the developer's risk is reduced. The developer can reduce or eliminate their required equity contribution and therefore reduce the ultimate lease rate for the tenant.

Credit tenant lease (CTL) financing – This type of transaction has similar elements as the tenant controlled development and financing, but the tenant bears slightly more risk and plays an active role in securing long-term financing. CTL bond net leases generally include a "date certain" provision such that rent commences at a specified starting date. The savings may approximate a reduction in the rent factor of 25 to 100 basis points depending on tenant credit and lease structure. Additionally, this type of structure generally provides advantageous rent escalations, relative to the alternative indicated above, but requires an 20 to 25 year lease. The decision point for a credit tenant lease is typically the level of risk and ownership characteristics the tenant is willing to accept. Operating versus capital lease treatment under current accounting rules must also be closely examined with the company's auditors with respect to these risks.

The following chart depicts a comparison of the cost of ownership versus a traditional lease and these alternative structures for a recent client transaction, using a 10% WACC. The savings of an alternative structure was 15% to 20% on a pre-tax basis and 10% on an after-tax present value basis.



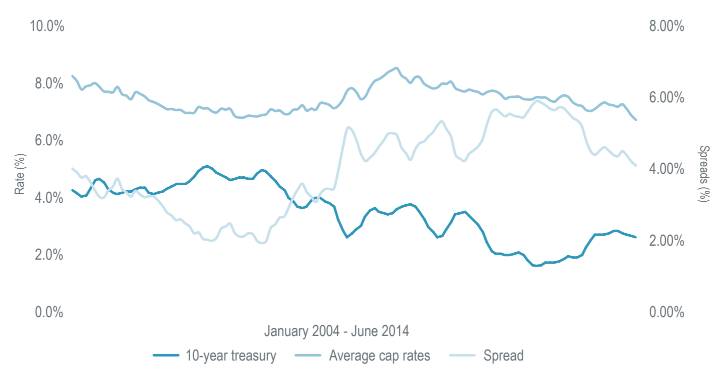
Synthetic lease – This off-balance sheet financing vehicle has generally had a negative stigma since the Enron events in 2002, but it is still employed by companies that prefer the positive earnings impact and are not deterred by the extensive footnote disclosures and the fact that analysts and rating agencies may re-characterize these leases as ownership. The aforementioned proposed changes in lease accounting would also apply to synthetic leases.

Through 2003, several companies renewed such existing leases on headquarters and other core facilities for a short term, pending further direction from management and an evaluation of a changing capital markets environment. Since 2004, an increasing trend has been sale-leasebacks or direct ownership of such facilities.

Popularity of sale-leaseback transactions

We are currently experiencing a well-popularized seller's market for quality commercial and industrial real estate throughout the U.S., with unprecedented low capitalization rates and high prices realized. Many high profile Class A CBD assets in major U.S. cities traded at capitalization rates in the 5% to 6% range during this period, with prices matching high historic values. Much of this activity is driven by low interest rates and increased allocations by institutions towards real estate, along with increased competition for product from private and public REIT's, pension funds and foreign investors, such as Middle-Eastern, Asian and European groups.

In 2008, a liquidity shortfall in the United States set off a financial crisis which led to the collapse of a number of financial institutions. Overall transaction volume fell dramatically as debt financing grew scarce and expensive, and as the pool of qualified buyers shrunk. Capitalization rates rose considerably, even for strong credit tenants, as there was limited investor appetite for vacancy or lease-up risk.



Corporate profits and equity markets started rebounding in 2010 and this has continued through 2014, which has propelled the real estate capital markets to new heights. Long-term net leased assets have emerged as the most desirable real estate investment alternative and pricing has recovered dramatically relative to late 2008 and early 2009. It has become clear that sale-leaseback transactions have gained broad market support with substantial market depth from private and institutional capital sources. While pricing does not reflect peak values for all markets, valuations and capitalization rates are very healthy by historic standards.

How does this capital markets environment translate to corporate real estate? Assets in the corporate portfolio should be reviewed using the same fundamental ownership versus leasing criteria to identify opportunities. In addition to the general characteristics favoring leasing decisions, the following drivers have spurred sale-leaseback activity by corporate America in the past few years.

> Take advantage of healthy investor appetite and resulting pricing
>
> Avoid future residual value or balloon risk
>
> Lock in a favorable long-term lease structure at a reasonable implied cost of capital
>
> Retire or reduce existing corporate credit facilities, thereby freeing up borrowing capacity
>
> Recoup capital expended on acquisitions (if the acquired company owns real estate)
>
> Raise capital for organic growth or future acquisitions
>
> Raise capital without additional financial covenants being imposed

Summary

We encourage corporate real estate directors to take an active role in collaborating with the senior finance and operation teams within their organization to develop a process for evaluating ownership versus leasing decisions, along with alternative structuring opportunities. A periodic review of the portfolio will facilitate keeping up with current trends in the real estate and capital markets, operating needs of the business units and the financial position of the company, and will result in optimal portfolio and individual property strategies.

Ownership vs. leasing decision criteria

Ownership characteristics

- Significant cash reserves/liquidity
- Investment grade profile
- Interest in property appreciation
- Favor control of property
- Decisions based on borrowing costs
- Low opportunity cost for ownership
- Established company with stable growth

Leasing characteristics

- Lower than investment grade profile
- Opposed to residual value risk
- Operational/exit strategy flexibility
- Staffing and production volatility
- Decisions based on WACC
- High opportunity cost for ownership
- Dynamic growth and acquisition orientation
- Potential for future obsolescence

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