CRIC2 FUNDS

Financing Alternatives for Corporate Real Estate

by Robert L. Nessen

Most real estate decisions by a corporation are, in reality, financial decisions. Once a company concludes it needs a particular piece of real estate in order to operate its business effectively, the real estate decision has been made. The next decision is strictly financial — how should the company pay for or finance the cost of the property?

In approaching this financial decision, the company should consider five basic alternatives:

- Purchasing the property for all cash.
- Purchasing the property but financing a substantial part of the cost through mortgage debt.
- Leasing the property under a traditional real estate lease.
- Leasing the property under a bond net lease.
- Leasing the property under a synthetic lease.

ALL-CASH ALTERNATIVE

If the corporation elects the all-cash alternative, it will be using up funds it could otherwise invest in its primary business. Consequently, if the company can earn 15% to 25% on the money (i.e., its investment opportunity rate), and decides to purchase a $10 million warehouse facility for all cash, the annual cost to the company of the warehouse is $1,500,000 (15% of $10 million).

Unlike most real estate calculations, there are, in this case, two absolutes. First, as long as the company's cost of borrowing is less than its investment opportunity rate, it should never invest all of its cash in real estate.

Second, if the company can get a higher rate of return by investing its cash in the real estate, then it should either get out of its current business and go into real estate, or it should fire the existing management.

DIRECT FINANCING ALTERNATIVE

Under this alternative, the company would purchase and own the real estate, and would finance most of the cost through mortgage debt.

Typically, the amount of the mortgage debt will not exceed 80% of the property value, or $8 million in the case of the $10 million property. The company must provide the $2 million balance in cash. Assume that the company's investment opportunity rate is 15%. In that case, the cost to the company for using its cash will be equal to its 15% investment opportunity rate. Therefore, if the company invests $2 million of its own funds, its annual expense under this alternative will be (a) $300,000 (15% of $2 million) plus (b) the cost of the mortgage debt.

This alternative has one decided advantage — ownership. At maturity, when the mortgage is fully paid off, the company will be the "free and clear" owner of the property. The value of ownership depends upon the company's estimate of what the property will be worth at the time the mortgage matures—for example, after twenty years. If the company projects the property will increase in value, this alternative becomes more attractive. If it projects a decline, then this alternative begins to lose its allure. In making a projection of future value, the company should keep two things in mind:

(1) Twenty years is a long time. In real estate it is often the equivalent of several lifetimes. (2) No matter what the estimated value is after twenty years, its current or present value is dramatically less. For example: $1.00 received in twenty years (assuming a 10% discount rate) is worth about $0.15.

This alternative has the following disadvantages:

1. Depending upon the actual value of the property after twenty years, the cost of funds to the company will probably be higher than under the leasing alternatives, particularly when the tax benefits of leasing versus owning are taken into account. I will elaborate on this in a moment.

2. The mortgage will be shown as long-term debt on the company's balance sheet.

3. To the extent the amount of the mortgage ($8 million in our example) is less than 100% of the cost of the property, the company will have to invest its own cash (or $2 million in our example).
4. Although the company will be able to deduct interest and depreciation for federal income tax purposes, the tax benefits arising from the rent reductions under the lease alternative will generally exceed those from interest and depreciation. Under the leasing alternative, 100% of the rent is deductible, including the amounts allocable to the land and to the return of "principal" of the owner's investment.

By contrast, under the mortgage alternative, any debt service payments made by the company and applied to the principal are not deductible, and depreciation can only be taken for the building and improvements and not for the land portion of the property.

TRADITIONAL REAL ESTATE LEASE ALTERNATIVE

Under this alternative, the company will lease the property rather than purchase it. The lessor will be an independent third party, and the term of the lease will usually be for the period over which the company requires the use of the real estate, whether ten, fifteen, or twenty-five years.

In the typical real estate leasing transaction, the lessor will be responsible for many, if not most, of the obligations of ownership. These obligations include maintenance and repair, real estate taxes, utilities, and insurance, although the company may be required to reimburse the lessor for some of these expenses. In the event of a minor casualty or condemnation, the rent will abate or be reduced. If there is a major casualty or condemnation, the company will ordinarily have the right to terminate the lease.

The advantages of this alternative are common to all leasing arrangements. In particular, for a properly structured transaction, the lease will be an off-balance sheet obligation of the company and will not have to be shown as debt or a long-term liability on its financial statements. The company will, for federal income tax purposes, be able to deduct the rent payments in full.

But there are several disadvantages to be considered:

1. As with most of the leasing alternatives, the company will not own the property at the end of the lease term. The third-party lessor will be the owner, even though the company's rent payments will have substantially repaid all of the lessor's investment with interest (including any debt financing that may have been obtained by the lessor).
2. As compared to the two other leasing alternatives to be discussed below, the rental cost will be high, and, frequently, materially higher than under a bond lease or synthetic lease arrangement. There are two reasons: (a)The lessor will be assuming material real estate risks, including casualty and condemnation. In return, it will demand compensation in the form of higher rents. (b)The lessor will be obtaining real estate mortgage financing. Unlike a bond net lease transaction, this type of financing will not be based upon the credit rating of the company. Therefore, the mortgage rate will ordinarily be higher than the bond rate. This higher cost will be passed on to the company through higher rents.
3. The company will be restricted in how it uses and operates the property. In particular, there will be serious constraints on any changes or improvements the company may want to make to the property. This alternative is rarely a sensible choice for the company. The rent cost is simply too high. The real estate risks being avoided are de minimus and can often be insured against at a relatively low cost. But, the cost to the company of passing these risks along to the lessor (as traditional as this practice may be in orthodox real estate circles) is prohibitively high and is not commensurate with the dangers being avoided or deflected by the company.

BOND NET LEASE ALTERNATIVE

Under this alternative, the company will have complete freedom of use of the property. In return, the company will assume all of the real estate risks and obligations of ownership. There will be no abatement of rent in the event of casualty or condemnation, with one exception: If there is a major casualty or condemnation, the company will have the option to terminate the lease. However, if the company does not exercise that option, and the insurance proceeds or condemnation award are not sufficient to pay off the balance of the lessor's investment with interest, then the company will be required to make a final payment to the lessor equal to the deficiency. The advantages of this alternative are the following:

1. The rents will reflect the credit standing of the company. In the case of an investment grade company, this will often result in below market rents.
2. The rent structure can be very flexible, including provisions for stepped rents, floating-rate rents, and a balloon rent.
3. The transaction can be structured as an "operating" lease, so that the lease will not appear as debt or other long-term obligation on the company's balance sheet.
4. The company will not have to put up any of its own capital to purchase the property. This alternative constitutes 100% financing.
5. In the case of an investment-grade corporate lessee, there will usually not be any financial covenants in the lease restricting the company's operations.
6. The company will be able to deduct, in full, all of the rent, including the rent attributable to the land portion of the property and to the repayment of the "principal" of the lessor's investment.

As discussed above, the major disadvantage, and frequently, the only disadvantage of this alternative, is the loss of ownership. The company will not own the property at the end of the lease term and will, accordingly, lose the value of the property in fifteen to twenty years.

SYNTHETIC LEASE ALTERNATIVE

The lease under this alternative is a bond net lease and will be treated by the company as an "operating" lease for accounting purposes. However, for federal income tax purposes, the company will be deemed to be the owner of the property. As a result, the company can deduct interest and depreciation, but cannot deduct rent. The major structural features of this type of transaction are as follows:

1. The lease term is usually for not more than five years. However, the company will have several options to renew so that it can continue to use the property for a period of time that is probably sufficient to satisfy its operation needs.
2. The lessor will finance close to 100% of the cost of the property through bond debt, with the interest rate floating over LIBOR or some comparable index. The debt will usually mature in not more than five years and typically, only interest will be payable (although some amortization may be required). At maturity, the debt will either be repaid or rolled over.
3. The lease will be in the form of a bond net lease, and the rent will reflect the floating interest rate payable on the debt. Consequently, the rent will not be fixed, and the company will be taking the interest rate risk.
4. At the end of the basic term of the lease (i.e., five years), the company will have the following options:
   a) To terminate the lease. In that case, the company must make a final payment that, together with the rents previously paid, has a present value of 89.9% of the cost of the property.

b) To purchase the property at a price at least equal to the then debt balance.

c) To have the property sold to a third party at fair market value. To the extent the sale price is less than the debt balance, the company must pay the deficiency. If the sale price is greater than the debt balance, the company can keep the excess.

d) Renew the lease, provided that the debt is refinanced or rolled-over.

The advantages to this alternative are: The company retains the residual ownership of the property, and the lease will be an "operating" lease.

The disadvantages of this alternative are as follows:

1. The transaction is, in substance, a short-term borrowing. Unlike the bond lease alternative, the rent cannot be fixed for a long-term period. This reduces the company's protection against inflation and subjects the company to interest rate risk (although the company can obtain a hedge against the interest rate increases, the company will have to pay the cost of the hedge, thereby increasing its effective cost funds. The hedge cost can be material, if the hedge contract is for more than six months).

2. The company can deduct interest and depreciation but not rent. If a significant amount of the financing has to be amortized, then the values of the interest and depreciation deductions will probably be less than the value the company would receive from rent deductions.

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3. There is a saying that if something is too good to be true, then it probably is. Although synthetic lease structure has thus far avoided being regulated away, it is under scrutiny by FASB and is vulnerable to attack by the SEC. Despite its form, the essence of the transaction is a financing, and we expect it eventually to be treated as such by the regulatory agencies.

4. This alternative cannot be used in a sale- and-leaseback arrangement. "Operating" lease treatment will not be allowed, if the company owns the property, sells it to third party and then leases it back under the synthetic lease arrangement.

In our view, the only serious alternatives among the five discussed above are mortgage debt financing and the bond lease. We do not believe the other alternatives bear up well when closely examined. As between the mortgage debt and bond lease alternatives, the decision will, in most cases, depend upon the answers to two questions:

First, which alternative is cheaper for the company after tax? Without considering the residual value, this is a calculation that can be made objectively and with fine precision.

Second, a far more difficult question is: How valuable is the long-term ownership of the property to the company? This, of course, is the classic issue in deciding between ownership and leasing. Unfortunately, this is not a question that can be answered by easy calculation—no matter how sophisticated our computer models may be. In grappling with this question, we are not dealing with a science. Guessing the future is pure speculation and, when successful, might even be considered an art. To the extent the company is satisfied that it has mastered the art form of guessing the future, mortgage financing and ownership may well be the better alternative. However, for those who may not be such good guessers, bond leasing is clearly the best game in town.

Robert L. Nessen, the Chairman of CRIC$_2$ Funds, LLC, hasspecialized in corporate and net lease financing since beginninghis career in 1958. He isnationally-recognized for the work he has done in creating and implementing new financing techniques for real estate.