

Synthetic Leases – A Financing Tool for a Better Balance Sheet for Your Client

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Today many companies are seeking to finance their acquisitions of equipment and real estate (such as offices and manufacturing facilities) by “off-balance sheet” lease financing known as “synthetic leases”. This financing technique keeps the leased assets and related liabilities off the balance sheet for accounting purposes. At the same time the user continues to depreciate the assets for income tax purposes. The synthetic lease structure accomplishes both these goals by qualifying as an operating lease for financial accounting purposes and a financial transaction for income tax purposes. (As an example, the user remains the owner of the assets for income tax purposes.) This structure opens up a wide range of funding sources: bank debt, capital markets, Rule 144A private placements and commercial paper.

Some possible significant benefits of a synthetic lease are:

1. Conventional financing and capital leases must be shown as assets and liabilities on the balance sheet; thereby effecting debt-equity, interest coverage and other ratios. On the other hand, the synthetic lease is an operating lease for financial accounting purposes and requires only a footnote and will not ap-

pear on the balance sheet as a liability or asset. Consequently, the financing should not affect the company ratios, credit rating, cost of funds and stock price.

2. The synthetic lease may avoid triggering bank covenants that limit additional indebtedness.
3. Since the synthetic lease contains a fixed-price, purchase price option, the company can retain the benefit of future appreciation in the property.
4. The synthetic lease provides an additional source of project capital with no direct impact on the balance sheet, thereby providing flexibility to the company’s capital program.
5. A properly structured synthetic lease will avoid being treated as a “true lease” for income tax purposes.

A synthetic lease of land and improvements must quantify as an operating lease for accounting purposes. To meet this test the following must be true:

- The ownership of the property must not transfer to the lessee at the expiration of the lease term or have a “bargain price” purchase option. Usually, the synthetic lease will give the lessee company an option to purchase

the property at the lease’s term of expiration. The purchase price is fixed at the commencement, but not at a “bargain price”. An example may be a purchase price equal to the appraised value of the property at the option date or equal to the unamortized principal and interest on the debt outstanding. Typically the lease contains conditions, which encourage the user to exercise the purchase option.

- The lease term is equal to 75% or more of the estimated economic useable life of the property
- The present value of the lease minimum rent payments, excluding operating expenses equals or exceeds 90% of the leased property’s fair market value.

As a practical matter, the synthetic lease is generally implemented only before the user acquires the real property. Because the lease structures may vary and the risks and benefits of ownership of the leased property vary with each synthetic lease structure, your client should work closely with their legal, tax, accounting and valuation advisors to

ensure that the chosen structures meet their individual needs and requirements. Since synthetic lease financing is typically for amounts equal to the asset's market value, an independent appraisal is required.

When a participant (either as secured lender or equity investor) in a real estate synthetic lease is a federally guaranteed financial institution Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), requires that institution to have the property appraised. This appraisal must be either under that institution's appraisal guidelines or under the Uniform Standards of Professional Appraisal Practice ("USPAP"). Marshall & Stevens is completely familiar with FIRREA and the USPAP guidelines, as will as the traditional non-regulatory concerns of lenders, investors and lessees in these transactions. We have served as the independent appraiser and consultant for lessors, lessees, advisors and property owners for over 65 years.

If your client is entering into this type of transaction there are several factors that may effect the final appraised value of the property that the client should be aware of. Some of these include:

- The cost of construction may exceed the "market value" of the property when completed. This may be the case for a corporate headquarters property, for which the construction cost could exceed the value of the property if occupied by another tenant or tenants at prevailing market rents.
- The lender may require an additional appraisal or update when the property is completed and the markets have changed since the original analysis.
- Extraordinary costs such as site remediation, assemblage costs

and infrastructure improvements frequently are not reflected in the "market value".

All of these factors may impact the ultimate decision to go forward with a synthetic lease transaction. Synthetic lease investors will not generally fund a transaction in excess of the appraised value.

An important part of the synthetic lease transaction is the residual value estimate at the end of the proposed primary lease term. Frequently the parties of the transaction are so focused on the market value of the proposed lease property that the residual value estimate is of secondary concern. Here the appraiser provides a significant contribution to the lease transaction. A reasonable estimate of the residual value is needed to satisfy accounting rule FASB 13, which prohibits "bargain purchase" options. Furthermore, debt and equity investors in these transactions, who typically are not compensated with premium returns for assuming significant residual risks, require a significant residual "cushion". That is the residual value of the leased property should be well above the unguaranteed asset risk in a transaction. The valuation consultant should not only be able to estimate market value and project the residual value, but also be able to advise the investor (s) if the highest and best use of a property at the end of the lease will differ from the original use by the lessee. In such a case, the investor will need to know that the expected reduction in residual value reflects the required modifications for the new use and the anticipated lease up time so that it may be reflected in the end-of-term notification and return provisions of the lease.

The synthetic lease is another tool in the commercial and industrial brokers tool chest to enable them to

provide a better service to their clients. Part of this tool package is to have discussions with a valuation consulting firm like Marshall & Stevens, which has both the experience and knowledge in the arena, early in the negotiations in order to prevent value related surprises and aid in the implementation of the synthetic lease program.

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