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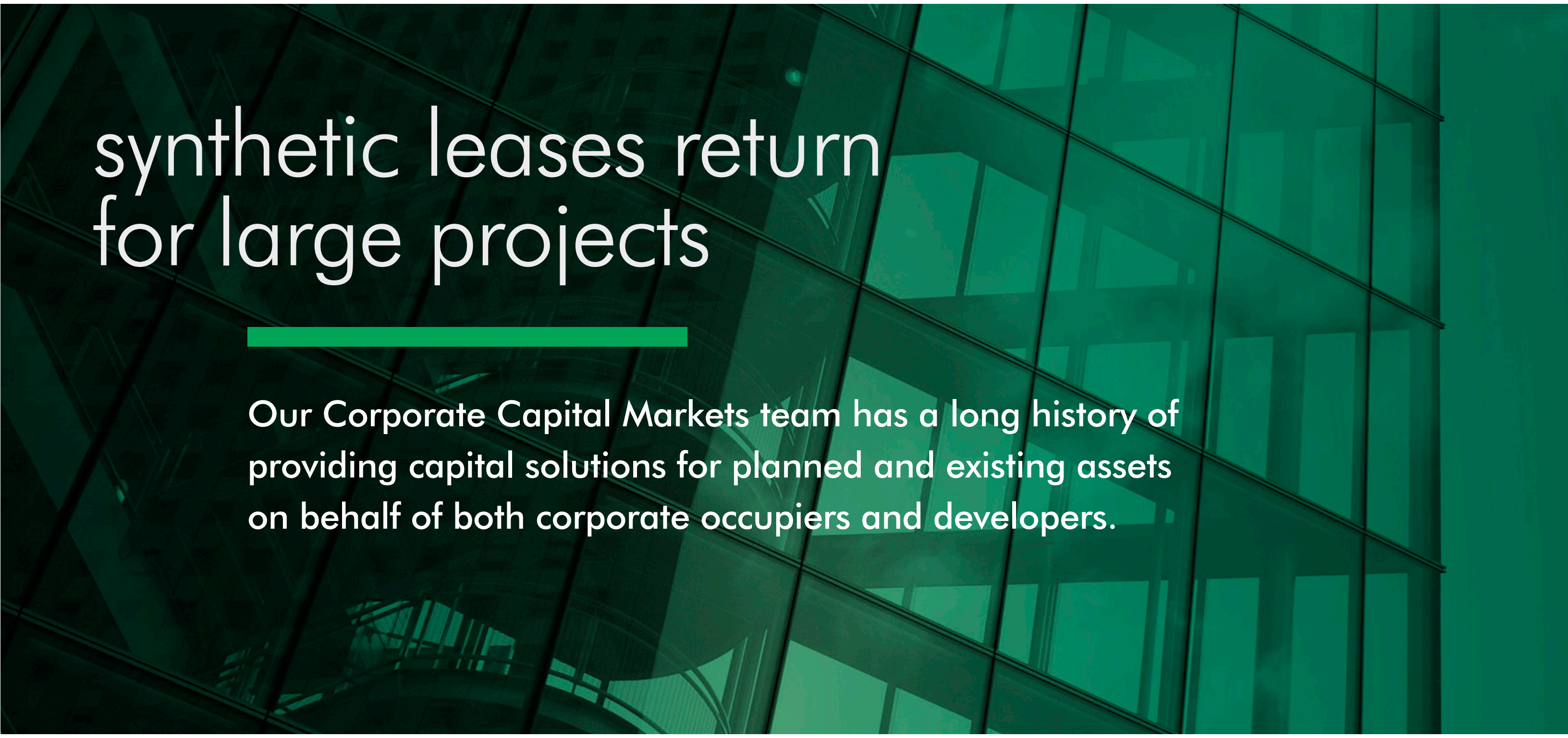
syntheticleases



synthetic leases return for large projects

Our Corporate Capital Markets team has a long history of providing capital solutions for planned and existing assets on behalf of both corporate occupiers and developers.

Securing capital on behalf of corporate occupiers can create great complexities for some structures, and we have developed expertise in lease accounting to support this activity. This has made us aware of a trend, in many ways, is counter intuitive considering the issuance of the new lease accounting standard (Accounting Standards Codification (ASC) 842): the reemergence of the synthetic lease.

The changes to lease accounting will alter many aspects of how companies view core properties. These changes may also create interesting opportunities for the credit-based financing structure called a synthetic lease. The application is best suited for investment-grade companies planning to occupy larger properties. Recently we completed a $162 million synthetic lease for a new HQ in Portland, Oregon for a corporate client. The synthetic was selected by the client after review of a dozen or more financing solutions. We also helped another corporate client cut occupancy costs by 80% using a $277 million synthetic lease on a new downtown HQ. Currently, we are working with a corporate client on a $380 million synthetic lease for a new build-to-suit HQ. This alternative was selected for its low rate of construction financing, as well as its optionality post-construction. There are recent real estate projects ranging from $75 million to $675 million in the market for synthetic leases. In short, there is a mini-boom in synthetic lease activity today that is likely to grow.

Briefly, a synthetic lease is a credit-based financing structure that, pursuant to current (ASC 840) and future (ASC 842) lease accounting guidance, is an operating lease for accounting purposes, but treated like ownership for tax purposes. In simple terms, a synthetic lease is similar in structure to a corporate credit facility: it is an interest-only financing based on short-term rates, usually LIBOR or commercial paper, that offers either floating or, via a swap, fixed rates. At the end of the lease term the company must either renew the synthetic, purchase the asset (or roll its right to purchase into something else) at the original principal amount, or must arrange a sale to a third party on behalf of the lessor (typically a bank-related entity) if it no longer needs the asset. To achieve operating lease treatment, the corporate lessee can only be responsible, via a guarantee, for approximately 85% of the loss if the sale to a third party does not cover the principal amount. However, the lessee receives all the upside if the asset is sold for a price above the principal basis.

Four reasons **synthetic lease activity** is on the rise

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REASON 1: ASC 842 The new lease accounting standard
This is the most important reason of all. The new guidance will capitalize real estate leases onto the balance sheet of the lessee at the PV of the lease payments over its term. With a synthetic, according to leasing experts within the Big Four accounting firms, the initial capitalized value will be the PV of the lease payments plus the guaranteed amount the lessee deems it will likely have to cover. In most cases, it is unlikely that a lessee will owe any of the guaranteed residual value at the end of the lease term, therefore, none of it is required to be capitalized. The benefits in terms of reduced impact to the balance sheet are striking, as illustrated in the following table comparing three different structures:

$200 Million Project | Day-1 Balance Sheet Impact

	Asset	Liability
Own w/ Financing	$200,000,000	$200,000,000
15-Yr Lease[1]	$152,799,538	$152,799,538
5- Yr Synthetic Lease[2]	$32,493,330	$32,493,330

1 6.50% Yr 1 lease constant w/ 2% increases per year, discounted at 5.0%.
2 L+150 bps (3.61%) constant over term, discounted at 3.61%. FMV equals cost.

The above shows that any company interested in minimizing balance sheet display associated with a new real estate asset will find synthetic leases to be an attractive option.

REASON 2: Low-cost financing for quality credits
Synthetic leases offer very low costs of capital compared to other forms of financing. This is especially apparent when used for a build-to-suit. A synthetic can offer 100% construction financing at extremely low rates and, under both current and future leases standards, do so in an off-balance sheet structure. In today's market, major projects with lengthy construction schedules are difficult and expensive to finance as the following table highlights:

$200 Million Project | 30-Month Delivery Schedule

	Capitalized Interest Expense[1]
Traditional Lease[2]	$12,812,500
CTL Lease[3]	$23,100,000
Synthetic Lease[4]	$9,023,750

1 assumes average outstanding draw schedule at 50% of cost.
2 assumes 75% loan at 3.50% and equity at 10% contributed pari passu.
3 assumes 4.62% rate on A credit fully funding up front and used for construction.
4 assumes 3.61% rate for A credit.

Synthetic leases provide low-cost 100% financing solutions that can significantly reduce the overall cost of a new project or allow more money for investment into the project.

REASON 3: Operating lease treatment
Pursuant to ASC 842, which will go into effect in 2019, Synthetic Leases will still be afforded Operating Lease treatment. Even though the PV of the lease payments must be placed on the balance sheet, the liability will be considered an Other Asset, rather than the Other Debt classification required by Capital or Finance Leases. During construction, a build-to-suit project will continue to receive off-balance treatment.

REASON 4: Flexibility
Synthetic leases allow the lessee to purchase the asset at any point in time after lease commencement. For some companies, the low-cost financing for build-to-suits, with the ability to roll into another structure offers the powerful advantages of efficiency and optionality. The purchase option in a Synthetic is for the original cost of the project, regardless of changes to market values. Additionally, a company may choose to sell a property subject to a long-term lease, and retain any proceeds over the original cost.

Synthetic leases will not be the best solution for all applications, but should be considered for strong-credit companies planning to build or lease major real estate projects. Evaluating the benefits and the risks of synthetic leases should be part of a thorough review of capital alternatives to own or lease a new corporate facility.

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