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synthetic leases

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 off-balance sheet structures, and we have developed expertise in lease accounting in order to support this activity. This has made us aware of a trend in the making that, in many ways, is counterintuitive 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 $150 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 on- and off-balance sheet financing solutions. We also helped another corporate client cut occupancy costs by 80% through the use of a $277 million synthetic lease on a new downtown HQ. 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 lease guidance (ASC 840), 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 revolving 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 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 80% to 86% of the loss if the sale to a 3rd party does not cover the principal amount. However, the lessee receives all of 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 difference between the fair market value of the asset and the guaranteed amount. 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 Display

	Asset	Liability
Own w/ 100% Corporate Debt	$200,000,000	($200,000,000)
15-Yr Lease[1]	$152,799,538	($152,799,538)
5-Yr Synthetic Lease[2]	$14,622,054	($14,622,054)

[1] 6.5% Yr 1 lease constant w/ 2% increases per year, discount at 5.0%
[2] L + 110 bps (1.53%) constant over term, discounted at 1.53%. 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 the current leases standard, 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]	$10,937,500
CTL Lease[3]	$22,500,000
Synthetic Lease[4]	$3,825,000

[1] Assumes average outstanding draw schedule at 50% of cost.
[2] Assumes 75% loan at 2.5% and equity at 10% contributed pari passu.
[3] Assumes 4.5% rate on an "A" credit fully funding up front and used for construction.
[4] Assumes 1.53% rate for an "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.

CBRE Corporate Capital Markets provides capital markets advisory and execution expertise for planned or existing single-tenant assets on behalf of corporate occupiers, developers and owners.

REASON 3 ASC-840-Current lease accounting

Pursuant to current accounting, a properly structured synthetic lease used for a build-to-suit will receive off-balance treatment during construction. During the term of lease all synthetics receive off-balance sheet treatment, which means no asset or liability will be reflected on the balance sheet of the company. A synthetic lease appears in the footnotes to a company's financial statements, and is limited to information about the lease payments and guarantee.

This will change with the implementation of ASC 842; all leases will be capitalized onto the balance sheet beginning in 2019. Today's off-balance sheet display is a preferred option for most companies.

REASON 4 Flexibility

Synthetic leases allow the lessee to purchase the asset at any point in time. For some companies, the ability to have off-balance sheet treatment now and either stay in the synthetic lease or easily roll into a new structure when the lease accounting changes are implemented offers the powerful advantages of efficiency and optionality. As discussed earlier, the corporate lessee has the right to purchase the asset at any time for the original cost of the project, regardless of changes to market values.

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.

FOR MORE INFORMATION CONTACT:

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