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Awaiting a Financial Windfall

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A federal crackdown on off-balance-sheet financing in the wake of Enron and other corporate accounting scandals was expected to be a boon to the sale-leaseback market. But the much-anticipated surge in deal volume hasn't materialized. Why? For starters, the changes governing synthetic leases and the rules of enforcement are still evolving, resulting in much confusion in the marketplace. Experts also cite low interest rates and a choppy economic recovery as the chief reasons for unrealized expectations.

Much is at stake for the net-lease industry. Synthetic lease transactions represent a $100 billion annual industry, and net-lease players were hoping some of those deals would end up in the sale-leaseback market.

“What we expected to see with Enronitis was a change in general leasing of corporate facilities,” says David Sickle, a partner in the real estate practice in the Chicago office of national law firm Piper Rudnick. But the shift from synthetic leases to sale-leasebacks hasn't occurred. “There is not a lot of consumption in new facilities,” Sickle says. “That is not so much driven by the new regulations. The demand is not there.”

In a synthetic lease, the owner takes out a lease from its own special purpose entity, which allows the firm to remove the debt involved in the acquisition from its balance sheet while deducting leasing payments for tax purposes. In January 2003, the Financial Accounting Standards Board issued Financial Interpretation Number 46 (FIN 46), which introduced tighter regulations regarding the use of those special purpose entities.

However, there has been confusion regarding how the new regulations will be enforced. In addition, FASB issued a comprehensive revision of FIN46 in October that added to the confusion. Although the enforcement date was moved from June to December, it will likely be several months before the impact becomes clear, says Ethan Nessen, a principal at CRIC Capital in Boston.

The speculation that FASB might return to the drawing board to further revise the guidelines has only fueled uncertainty, says Nessen.

Still, many are optimistic that net-lease financing will benefit from the stricter requirements. “In the third quarter, we saw an increase in activity, which is partially a function of getting some comfort with the new accounting regulations,” Nessen says.

Indeed, deal flow at CRIC Capital has picked up by 50% in the second half of the year compared with first-half activity. Nessen attributes some of the increase to pent-up demand. Companies can only stand on the sidelines so long before they have to make a decision.