Shopping Center World

Scrutinizing synthetic LEASES

By Steve Bergsman

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By acting quickly last year, PETsMART Inc. avoided a dicey situation that could have landed the company in a financial doghouse. With the synthetic lease on a number of its properties — including its large distribution facility for the western United States — coming to a close this year, the Phoenix-based pet supplies retailer faced four possible considerations: purchase the property, refinance, sell to a third party, or walk away with a financial penalty.

Deciding not to wait until the very end of the synthetic lease, PETsMART turned to W.P. Carey & Co. LLC, which acquired the distribution facility and 12 stores and then leased the properties back to the company in a $71 million deal. Under the terms of the agreement, the facilities will be leased to PETsMART for 20 years. “The lease was due in the next 12 months and they had originally planned to sell the portfolio of 12 retail sites one-by-one,” says Benjamin Harris, a W.P. Carey director. “We were able to go in there and create a package for them.”

In this post-Enron world, the future of synthetic leases, which use an off-balance-sheet “special purpose entity” or SPE, looks dubious at best. Even if the Financial Accounting Standards Board (FASB) doesn't kill it off altogether, it may initiate new regulations so restrictive as to make the synthetic lease untenable.

In February, the Securities & Exchange Commission made a number of proposals in regard to changing SPEs and FASB says it will issue new guidelines later this year. It's not expected that SPEs will be totally eliminated. However, a small, key change involving minimum equity contribution from the investor to the SPE from 3% to 10% could be the deathknell for most deals.

As represented by the PETsMART transaction, the change from synthetic leases coming to fruition is supposed to be a boon to companies that specialize in sale/leasebacks, an alternative form of financing where an investor buys a property and then leases it back to the corporation on a long-term basis.

Going back to last year, executives at companies that specialize in sale/leasebacks were predicting a boom year in 2002. Gary Ralston, president of Orlando-based Commercial Net Lease Realty Inc., for example, exclaimed there would be a “tsunami” of sale/leaseback transactions. Although business was much slower than expected in the first quarter for such deals, company executives still predict a very busy second half of 2002.

“For the first quarter volume was down because of lack of product,” notes Brian Tracy, a managing partner with Net Lease Properties LLC in Manhattan Beach, Calif. “We don't give out figures, but we are down in the 15% range from past years.”

It's not for lack of trying. “There's lots of cash out there,” Tracey adds.

In a synthetic lease, an off-balance sheet SPE is created to own the property (or properties), with the financing entity usually a bank. It is short-term in nature, usually three to five years. At the end of the lease, there's a balloon payment to the lender.

In the 1990s, synthetic leasing was an extremely popular form of real estate financing because it kept debt and risk out of a company's day-to-day operations, limited the tax burdens and was much cheaper financing than a sale/leaseback.

Young high-tech companies gravitated to synthetic leases, because it allowed them to present a cleaner balance sheet, plus it was an easier form of loan to ascertain. Retailers were also big users of synthetic leases.

Today, CRIC Capital LLC, a Boston-based joint venture of CRIC and Prudential Real Estate Investors, estimates the size of the synthetic lease market at $6 billion to $8 billion per year.

Not all of that will roll over into a sale/leaseback, but even a small amount of change will mean a tremendous boost for companies in that sector. “The magnitude of the synthetic lease market is so immense, that if just a small portion of it moves into sale/leasebacks it will have a big impact,” says Ralston. “Supposing the synthetic lease market was just $100 billion, if 10% rolls into net lease that is big.” Meanwhile, in anticipation of change, the market waits.

“The volume isn't what most people anticipated,” observes Richard Ader, chairman of New York-based U.S. Realty Advisors LLC. “There is a tremendous amount of talk going on in the marketplace. Just with the things that are up in the air, we are dealing with a multitude of two or three times what we historically have seen. But, there are few deals right now as everyone waits to see what the structure of the synthetic lease is going to be.”

Through the first quarter, U.S. Realty Advisors' deal volume ran about $100 million, which was a little more than the comparable quarter 2001. Last year, the company's total volume of business was about $1 billion. When asked if this year was going to be better than last, Ader obliquely referred to a transaction in progress that could mean $1.5 billion in business.

“There hasn't been a whole lot of activity,” reiterates CNL's Ralston, “but people are positioning themselves in the sale/leaseback space so they can participate starting in the second half of the year.”

CNL experienced what Ralston calls a “fairly modest” first quarter with deal volume at $50 million, about equal to last year's first quarter. Still, CNL boasted a record year in 2001, adding $300 million in assets. Depending on what happens with synthetic leases, Ralston says volume this year could end up anywhere from a tired $150 million all the way to $500 million.

It's important to remember that most of the synthetic lease deals that were done in the past decade were in compliance with existing regulations. That being said, part of the synthetic lease beauty for some companies was that SPE risk and losses weren't recorded on the balance sheet and could be hidden from investors.

After Enron, SPEs have come under such intense scrutiny from regulators and the media that companies considering such financing vehicles have had to relent. After intense criticism by investors and the financial press, Krispy Kreme Doughnuts Inc. earlier this year backed away from its intention to do a synthetic lease on a new manufacturing and distribution center in Illinois.

“It would be a good thing for the sale/leaseback industry for companies to be scrutinized,” says Fred Berliner, a senior vice president with Miami-based United Trust Fund. “Those companies will be looking for new forms of finance to take out the old forms such as synthetic leases, and the sale/leaseback will be one of the alternatives.”

Last year, UTF deal volume totaled $160 million. “The year started off a little slow, but now is picking up,” says Berliner. “2002 will be better than 2001 and 2003 looks even better.”

W.P. Carey was one of the few sale/leaseback companies reporting excellent volume in the first quarter, $117 million vs. $44 million the year before. The company expects its good times to keep rolling and is looking to top last year's $400 million total.

One of the reasons it has been doing well is that it has been aggressively going after synthetic lease deals, not waiting for the existing contracts to expire.

Also making a quick adjustment to the new marketplace is Boston-based CRIC Capital LLC, which claims to have developed a proprietary sale/leaseback that has the look and feel of a synthetic lease. “There are many corporations that need to have facilities built and they need to have them kept off balance sheet,” says Leo Schwartz, executive director of acquisitions, “we are able to provide a structure that allows the economic attributes that their former synthetic lease had.”

Like W.P. Carey, CRIC can boast a very busy first quarter, with volume around the $100 million range. Considering last year the company only did about $200 million worth of business, that's a lot of dealmaking. Schwartz predicts a record year, perhaps $400 million, in 2002.

One reason for CRIC's early success this year is the fact that it formed a joint venture with Prudential Real Estate Investors out of Parsippany, N.J. The joint venture gets CRIC better access to capital. Two years ago, GE Capital Real Estate and U.S. Realty Advisors formed a similar alliance, which proved beneficial to the latter — as witnessed by its deal flow.

“One of things that is driving deals to us at this point is our new venture partner, Prudential,” says Schwartz.

CNL's Ralston predicts more partnerships will be formed with sale/leaseback specialists because of the amount of potential business if FASB turns the screws on synthetic leases.