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FOCUS ON: Corporate Leases

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Shift from synthetics

New accounting rules mean new opportunities for you.

During the booming mid-1990s, off-balance-sheet property transactions called synthetic leases were a popular option for fast-growth companies that needed to keep cash on hand. That technique gave commercial real estate practitioners a potent vehicle for structuring transactions to meet their clients' needs.

But recent changes to federal accounting standards resulting from accounting scandals at major corporations such as Enron and Adelphi have impacted the technique. So, many companies with synthetic leases will be looking to restructure their ownership arrangements. That opens a window of opportunity for you.

Estimates vary, but upwards of $120 billion worth of the off-balance-sheet contracts have been put in place, mostly for large corporations with offices around the country.

Initially used in leases for heavy construction equipment and aircraft, synthetic leases came into vogue in real estate among high-tech and other fast-growth companies about 10 years ago. The leases allow companies to plow their capital into their core business activities rather than real estate operations.

Under a synthetic lease, a company seeking office, warehouse, retail, or other commercial space establishes a third-party entity to contribute a certain percentage in equity toward the property purchase. The company borrows the balance from a bank or commercial lender. Then, the company executes an agreement to lease the space from the third-party entity, which pays the mortgage. But the company, now the lessee, also guarantees the debt, generally structured at a short-term floating rate for five years.

As the guarantor of the debt, the company receives some benefits of property ownership, including depreciation. In addition, the company doesn't have to show development or acquisition costs on its balance

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sheet as a liability.

Under the accounting standards changes, promulgated by the Financial Accounting Standards Board, companies are subject to stricter disclosure and new structuring requirements, and the third-party entities must up their equity contribution from 3 percent to 10 percent.

The new requirements include some changes to lease guarantee disclosures. For instance, lessees are required to show the guarantees at their fair value as liabilities on their balance sheets.

In other changes, the company that has the controlling financial interest in the assets, liabilities, and activities of the third-party entity generally will have to consolidate the finances of that third-party entity onto its balance sheet. In most synthetic lease arrangements, the company with the controlling interest would be the lessee.

Companies in existing synthetic leases have until June 2003 to "unwind" or reorganize their leases to comply with the changes. The regulations allow existing third-party entities up to six months, from March 15, to comply with applicable changes including the higher equity requirement. For new synthetic lease transactions, the new standards became applicable generally at the end of 2002.

Without a doubt, the higher equity amount and more stringent reporting rules will reduce the attractiveness of synthetic leases to some companies. That will likely create opportunities for commercial brokers in advising clients on the options available to them. At my company, for example, we've seen a slight escalation in proposals to do sale leasebacks, an alternative to synthetic leases, and expect to see more in the coming months.

How can you tap the market opportunity? Remember that the synthetic lease structure is primarily a tool for large corporations with significant real estate portfolios. Thus, the decision of what to do with these properties will usually fall to the companies' finance department. If you know executives in that department, start with them.

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