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Synthetic leases fade in popularity

CORPORATIONS PREFER TRADITIONAL LEASES

Contributing Writer

The fallout from the accounting scandals surrounding Enron Corp., WorldCom Inc. and other U.S. companies has greatly reduced interest in synthetic leases, a lease that moves real estate from the balance sheet to the income statement.

"Wall Street is watching off-balance sheet financing more closely," says Jeff LaFavre, vice president at United Properties.

Synthetic leases gained popularity during the technology boom, particularly on the West Coast where dot-coms and software firms thrived. Companies that were growing quickly wanted to reinvest finances into the business rather than into real estate, LaFavre says.

The strategy also was used to some extent in the Twin Cities, says Mark Hamel, a partner and chair of the real estate department at the law firm Dorsey & Whitney LLP. He participated in five synthetic lease transactions with Twin Cities clients: four with local real estate and the fifth with property in various locations around the country.

"I'm not aware of anyone doing synthetic leases right now," Hamel says.

How it works

A synthetic lease allows a corporation to keep its real estate off the balance sheet. Instead of recording the lease as a liability, the company records it as an expense on the income statement.

"The theory is that you never really own the asset or have the debt," says Darwin Voltin, a CPA with McGladrey & Pullen LLP in Minneapolis.

A special purpose entity (SPE) is set up by someone with a relationship to the corporation. The SPE must retain a 3 percent ownership in the property under the old rules; the percentage recently changed to 10 percent effective retroactively as of Sept. 30, 2003. The remaining value of the property is borrowed from a bank or other lender.

The tenant of the property makes payments to the SPE, who then pays the bank. At the end of the lease term, the tenant may have the option of buying the property for the same price the SPE paid at the beginning of the lease. The tenant also may renew the lease or ask the SPE to sell the property.

"If the property went up in value, you reap the benefits," Voltin says. "If it goes down, you have to reimburse the SPE."

Companies created synthetic leases when they wanted to keep assets and related debt off the balance sheet but still wanted to control the property, Voltin says. The tenant gets the tax benefits of depreciation without actually owning the building.

Changing perspectives

Although synthetic leases are perfectly legitimate, companies are avoiding anything defined as off-balance sheet accounting, LaFavre says.

"What happened in a lot of off-balance sheet accounting was there was an intent to deceive," he says.

"Even though there may be nothing wrong with them, there's been so much negative feedback from Wall Street that companies are biting the bullet and getting rid of (synthetic leases)," Hamel says.

He calls it a "guilt by association" situation. As long as Enron is fresh in people's minds, anything off the balance sheet will receive greater scrutiny.

"The new standard is to be forthright," says Dave Jellison, vice president and Minneapolis city manager for Liberty Property Trust.

Jellison is working on a deal to buy 12501-07 Whitewater Drive in Minnetonka. ADC Telecommunications Inc. has a synthetic lease on the two linked buildings, but that lease will terminate when the 200,000 square foot complex sells.

ADC has four or five synthetic leases, says Clint Baer, director of corporate real estate for the communications infrastructure company.

"The synthetic lease strategy is one that is perfectly acceptable and legal," Baer says. "It's attractive because you get very advantageous interest rates and it allows for some tax and depreciation benefits. My own philosophy was to go forward and use them and, in the context of our company's philosophy, simply disclose the use of that financing technique."

When Wall Street began criticizing off-balance sheet accounting, ADC disclosed its synthetic leases in its Securities and Exchange Commission documents.

Additional synthetic leases are not an issue for ADC. The company is reducing its real estate portfolio from 8.3 million square feet two years ago to approximately 3 million square feet.

Are synthetic leases gone for good? Fewer companies will participate in synthetic leases in the future, particularly larger deals, says Terry Kingston, a principal with Northstar Partners in Minneapolis.

"Companies with liquidity that are not strapped for cash will continue to own their real estate as opposed to putting it in SPEs and doing off-balance sheet deals," Kingston says. "Companies that are capital-constrained will do a sale/ leaseback or a conventional mortgage."

Businesses also want to wait for the dust to settle around the accounting scandals in case any new regulations come out of Washington, Kingston says.

Corporations struggle between a desire to keep assets off the balance sheet and a desire to maintain control, Voltin says. But the question is moot in a market where real estate values remain uncertain.

"If building values are stagnant, does it matter whether you share in zero percent increases or not?" Voltin says.

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