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## HOW TO... GET MORE VALUE OUT OF A REAL ESTATE LEASE

Structured lease financings — once-popular vehicles to keep leases off balance sheets but still maintain tax benefits — are seeing a revival due to market conditions and economic benefits, such as 100 percent financing at a very low interest rate.

Two popular variations of structured leases are the synthetic lease, in which a company enters into a short-term lease with a bank-lessee, who requires periodic interest-only payments with a balloon purchase option at the end of the term.

The other is a credit-tenant lease, where a lender, most often a life insurance company, makes a loan to a company supported by the long-term lease obligations of an investment-grade user-lessee.

Both synthetic and credit-tenant leases are triple-net leases in which substantially all real estate duties are the responsibility of the user-lessee, including the obligation to make capital repairs or to rebuild in the event of a casualty. Unlike traditional real estate financings, the lender relies on the credit of the user-lessee rather than the value of mortgaged property.

Properly documented synthetic leases are treated as operating leases for accounting purposes and, therefore, do not go on the user-lessee's balance sheet. However, they are treated as a financing instrument under tax rules, so the user-lessee retains the benefits of being considered the owner of the property.

Most important to the user-lessee is the ability to realize the appreciation of the property through a fixed-purchase option, plus the ability to take tax deductions for depreciation and interest expense. To qualify for the off-balance sheet/operating lease treatment, the user-lessee must have the option of turning the property back to the lender-lessee at the end of the lease term. However, the lease documents are structured such that no commercially reasonable user-lessee would choose such an option because of the required payments and obligations.

To take full advantage of the benefits of a synthetic lease, a user-lessee must not be in

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the chain of title of the property. This requires the lender-lessee to purchase the property from the existing owner. Additionally, accounting rules dictate user-lessees not take on substantial construction-period risk and maintain lessee status. This means the lender-lessee actually enters into virtually all construction contracts related to development.

Before 2003, the lessor that had record title to the project was typically a minimally capitalized special purpose entity primarily owned and controlled by the user-lessee. Critics argued that companies like Enron were taking advantage of the accounting rules and using these structures to avoid reporting assets and liabilities.

To counteract this, a new regulation was passed in late 2003 in which most special purpose entity-lessors would be considered variable interest entities and would be consolidated with the user-lessee, relieving the user-lessee of the benefits of a synthetic lease. Of the five factors to determine whether an owner-lessee is a VIE, the most critical one is whether the equity investment at risk is sufficient to finance the activities of the entity. The at-risk equity of the owner-lessee generally must be at least 10 percent of the total assets.

To purchase or develop the property, the owner-lessee invests a modest amount of equity, often as low as 3 to 5 percent, and obtains nonrecourse financing private placement mortgage bonds for the balance, based on the user-lessee's (or guarantor's) credit rating.

This detail typically limits the universe of eligible owner-lessors to investment-grade entities. The user-lessee's rental obligation under a CTL will correspond directly to the amounts owed under such loan. Under National Association of Insurance Companies rules, which govern typical CTL investors, the loan is classified as a bond rather than a mortgage loan. This classification gives the lender advantageous regulatory accounting treatment.

Thus, the owner-lessee will not realize any return on its investment until the end of the lease term (other than certain tax and accounting benefits, which are often off-set by phantom-income obligations), but will retain ownership of the asset, free and clear, at the end of the lease term.

While synthetic leases usually have a term of two to seven years, CTLs can last up to 25 years, and the user-lessee has no right to terminate prior to the end of the term except under limited circumstances. From the user-lessee's perspective, the CTL is advantageous because it provides permanent, fixed financing at a low interest rate for a long period of time. Lenders under a CTL often require a debt-service-coverage ratio as low as 1 percent.

With 100 percent financing and other favorable terms often available, many user-lessees with investment-grade credit are once again entering into structured lease financings to capitalize real estate assets.

However, it is important to note that accounting changes related to lease classification have been and continue to be reviewed and analyzed by the Financing Accounting Standards Board and the International Accounting Standards Board, which will directly impact the lease structures discussed in this article.

While it is unclear when these changes will go into effect, analysts have speculated that changes may occur as soon next year.

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