“Should we lease or own?”

- A six point guide to help you answer this question

Your Fortune 500 corporation just made an acquisition, doubling your headcount in a major city, but you are now spread out among 10+ facilities with redundancies and inefficiencies, not to mention multiple trailing lease obligations. Your bio-tech company is ramping up a new product for RDA approval that may (or may not) require a 200,000 SF manufacturing facility with specialized improvements at over $600 per square foot. Your company just went public which will cause major headcount growth, and your building and neighboring land are available for sale. Do you buy, lease, renovate, build, bank land, borrow or design a campus?

OWNERSHIP VS. LEASING – QUESTIONING HISTORIC STRATEGIES

Over the past few years, corporate real estate directors have constantly been challenged to balance the opportunities in today's dynamic capital markets environment with the operational and financial goals of their company.

While certain companies have stayed the course and continued with an ownership or leasing strategy driven by long standing financial policies, others are implemented new strategies for selected properties, such as sale-leaseback transactions to take advantage of aggressive capitalization rates and unprecedented values to raise capital, or shifting to an ownership position based on a perception of the company's cost of capital.

Many of these financial decisions have historically been driven by chief financial officers and treasurers, yet we find corporate real estate directors are often taking a more proactive approach to understanding the various economic, financial accounting and tax consequences in order to recommend structures that best match up with the company's operating and financial strategies.

Within this article we will focus on the spectrum of decision criteria for evaluating ownership versus lease decisions for both portfolios and individual property transactions, and the potential benefits of alternative leasing structure an sale-leaseback transactions.

RANKING THE CRITICAL CRITERIA

It is essential for corporate real estate directors to clearly understand the philosophies and objectives of the senior financial team within the organization, in addition to the operational objectives of the company as a whole and its different business units. Guidelines are commonly established for ownership versus leasing decisions, but operations and financial may have differing viewpoints as to the most critical criteria. The following are the primary considerations that should be addressed in a collective manner by the organization to establish its guidelines an seek an efficient process for making decisions.

Operations – Factors such as providing flexibility for a growing workforce or potential contraction in the future should be considered for any real estate decision. Although a company policy may favor ownership certain locations warrant consideration for leasing if the particular business unit has volatility in staffing or production, or if there are indications of declining real estate market conditions or potential obsolescence.

Cost of Capital – For any company, determining the appropriate cost of capital in preparing discounted cash flow/net present value comparisons for ownership versus leasing decisions is a critical variable. In general there are two schools of thought:

- Companies with large reserves of cash and short-term investments, plus a high investment grade debt rating may lean towards ownership. The utilization of cash is viewed as merely a reduction of invested funds

- earning nominal returns or the use of a low-cost corporate debt facility, compared to the rent factor on a lease. If a company can borrow at 6.00%, interest only, under an existing credit facility and the initial rent factor on a new building is 8.00% of project cost, the cost of leasing is higher by 2% of project cost. Certain companies with a less favorable financial profile may still favor ownership, if they perceive an opportunity for property appreciation and prefer the control elements of ownership.
- A counter position to this approach is applying weighted average cost of capital (WACC) to such decisions, which typically favors leasing if the cost of capital for ownership exceeds the rent factor. WACC is a calculation that blends the cost of equity (stock) and the cost of debt. The theory is that such decisions are longer term in nature and impact the entire capital structure of the company. In addition, ownership is viewed as an investment and should be measured against internal hurdle rates for core and new business activities. Companies that are growing organically or through acquisitions, and those with lower investment grade, or sub-investment grade debt ratings may lean in this direction. Certain higher rated companies with liquidity may also favor leasing, for reason such s operational flexibility and to avoid residual value risk.

It is not uncommon to encounter situations in which finance executives differ in their perspectives, such as a treasurer who advocates a cost of borrowing approach (versus ownership), while a chief financial officer or chief operating officer believes the WACC is the appropriate metric. In these circumstances it is helpful to review a range of options, so the client can view the sensitivity to varying discount rates and make an informed decision.

ACCOUNTING AND INCOME TAX CONSIDERATIONS

Financial accounting and income tax considerations must also be closely evaluated. For accounting purposes, ownership requires recognizing depreciation expense versus rent expense for leasing.

Another cost of ownership is the opportunity cost of funds, which may be measured as an alternative return on invested funds or additional interest cost incurred as a result of the use of funds. Applying an opportunity cost adds cost to the ownership scenario, even if it is not recognized for accounting purposes. Also, for companies that consider EBITDA a more critical earnings metric than net income, ownership may be viewed more favorably since depreciation expense is added back to earnings in calculating EBITDA and lease expense is not

Many companies prefer to keep real estate assets and related debt off their balance sheets to improve financial ratios, maintain borrowing capacity for other business activities, or simply for debt covenant compliance purposes.

Income taxes come into play in preparing after-tax discounted cash flow comparisons. Leasing is fairly straightforward as rent is usually deductible in the year paid, while owned property is depreciated over 39 years, except for certain, shorter-life components such as land improvements (15 years) and personal property (5 to 7 years). For companies favoring ownership, cost segregation studies can be strategically employed to substantiate shifting depreciation to short-life assets. For companies favoring lease transactions, tenant improvements should be carefully evaluated, as a significant portion may be considered real property and subject to 39 year depreciation. It is important to note that qualifying leasehold improvements may currently be depreciated over 15 years, rather than 39 years since Congress recently extended this favorable provision for improvements placed in service through 2007.

PROACTIVE ASSESSMENT FOR MAJOR REQUIREMENTS

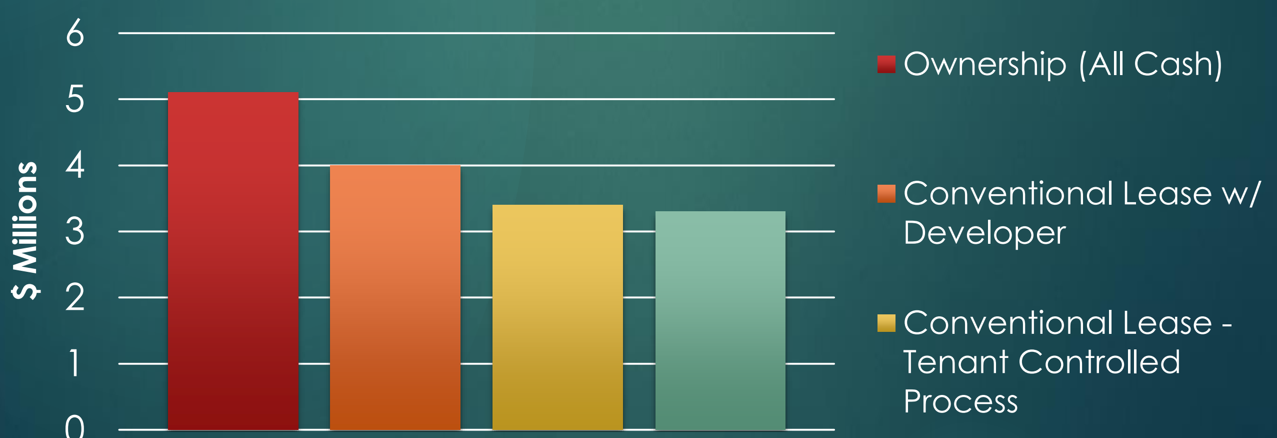
For major real estate requirements, decisions regarding renewing or relocating and various associated transaction structures should be evaluated as early as three to four years in advance, depending on whether a build-to-suit is an alternative. Beyond the ownership and traditional lease criteria outlined above for exiting buildings or build-to-suits, several creative structures should be explored to determine if the company's financial strength can be used to generate significant savings.

Tenant Controlled Development and Financing – This type of transaction may be considered for a build-to-suit, with the objective of reducing the developer profit. By pre-negotiating lease terms and arranging for a third party investor to purchase the property upon completion, the developer's risk is reduced. The developer can obtain 100% construction financing and the ultimate lease rate is significantly lower for the tenant.

Credit Tenant / Bond Lease – This type of transaction has similar elements as the tenant controlled development and financing, but the tenant bears more risk. Lease provisions include paying rent at a specified starting date (beyond normal construction delays), and in the event of major casualty and condemnation, as well as potentially taking on environmental risk. The savings may approximate a reduction in the rent factor of 0.25% relative to the structure described above and with more advantageous rent escalations, while requiring a 15 to 20 year lease. The decision point for a credit tenant lease is typically the level of risk and ownership characteristics the tenant is willing to accept. Operating versus capital lease treatment must also be closely examined with the company's auditors with respect to these risks.

The following chart depicts a comparison of the cost of ownership versus a traditional lease and these alternative structures for a recent client transaction, using a 10% WACC. The savings of an alternative structure was 15% to 20% on a pre-tax basis and 10% on an after-tax present value basis.

Company ABC
Building X – Comparison of Alternative Structures
NPV Sensitivity @ 10.00% (WACC)
After Tax Cash Flows ($ Millions)



Synthetic Lease – This off-balance sheet financing vehicle has generally had a negative stigma since Enron, but it is still employed by companies that prefer the positive earnings impact and are not deterred by the extensive footnote disclosures and the fact that analysts and rating agencies may re-characterize these leases as ownership.

Through 2003, several companies renewed such existing leases on headquarters and other core facilities for a short term, pending further direction from management and an evaluation of a changing capital markets environment. Since 2004, an increasing trend has been sale-leasebacks of such facilities, to take advantage of aggressive capitalization rates and unprecedented asset values exceeding the underlying debt payoff and to lock in a favorable long-term operating lease structure with minimal disclosure requirements compared to a synthetic lease.

GROWING POPULARITY OF SALE-LEASEBACK TRANSACTIONS

We have experienced a well-publicized seller's market for quality commercial and industrial real estate throughout the U.S. from 2004 to 2006, with unprecedented low capitalization rates and high prices realized. Many high profile, Class A, CBD assets in major U.S. cities have traded at capitalization rates in the 5% - 6% range during this period, with prices exceeding historic values. Much of this activity has been driven by low interest rates and increased allocations by institutions towards real estate, along with increased competition for product from private and public REIT's, tenant-in-common (TIC) syndications and foreign investors, such as Australian and European groups.

Many ask when this feverish demand will slow down. The volume of transactions has slowed some, but capitalization rates and prices per square foot remain very aggressive for high quality product. Statistics seem to indicate that the compression in pricing is inevitable, as the spread between capitalization rates and interest rates reached a dramatic low point earlier this year. The following illustration shows a spread in the 4.00% to 5.00% range during 2001 to 2003 for CBD properties nationally, and a steady decline towards 2.00% in 2006. We expect slightly more conservative underwriting during 2007, with the spread increasing to the 2.50% range, while demand remains strong.

Office – CBD Cap Rates vs.
10 Year Treasury Graph

How does this capital markets environment translate to corporate real estate? Assets in the corporate portfolio should be reviewed using the same fundamental ownership vs. leasing criteria to identify opportunities. In addition to the general characteristics favoring leasing decisions, the following drivers have spurred sale-leaseback activity by corporate America in the past few years.

- Take advantage of potential "top of the market" pricing and avoid future residual value risk
- Lock in a favorable long-term lease structure at the low rent constant, with favorable escalations
- Retire or reduce existing corporate credit facilities, thereby freeing up borrowing capacity
- Recoup capital expended on acquisitions (if the acquired company owns real estate)
- Raise capital for organic growth or future acquisitions
- Dispose of assets 3 to 5 years prior to a potential relocation or obsolescence, especially for properties that are prime candidates for redevelopment

Traditional buyers of corporate real estate under sale-leaseback transactions have been the institutional backed net lease investors. However, there is increasing interest among public and private REIT's, regional investors, 1031 exchange buyers (including TIC's) and foreign investors, due to the challenge in securing transactions in the competitive environment for multi-tenant properties.

SUMMARY

We encourage corporate real estate directors to take an active role in collaborating with the senior finance and operation teams within their organization to develop a process for evaluating ownership versus leasing decisions, along with alternative structuring opportunities. A periodic review of the portfolio will facilitate keeping up with current trends in the real estate and capital markets, operating needs of the business units and the financial position of the company, and will result in optimal portfolio and individual property strategies.

Ownership vs. Leasing Decision Criteria

Ownership Characteristics	Leasing Characteristics
Significant cash reserves / liquidity	Lower than investment grade profile
Investment grade profile	Opposed to residual value risk
Interest in property appreciation	Operational / exit strategy flexibility
Favor control of property	Staffing and production volatility
Decisions based on borrowing cost	Decisions based on WACC
Low opportunity cost for ownership	High opportunity cost for ownership
Established company with stable growth	Dynamic growth and acquisitions orientation
	Potential for future obsolescence