

Ownership Versus Leasing Decisions

Corporate real estate directors are constantly challenged to balance the opportunities in a dynamic capital markets environment with the operational and financial goals of their company. A prominent consideration for many companies is the decision to own or lease its real estate, which has been magnified as the economy and commercial real estate market continues to recover from one of the most significant downturns in history. In addition to general economic and real estate market conditions, factors such as uncertainty over staffing and related space requirements, optimizing occupancy costs, maintaining sufficient liquidity, and planning for anticipated changes to lease accounting, have made such decisions even more complex.

While certain companies have stayed the course and continued with an ownership or leasing strategy driven by long standing financial policies, others have implemented proactive strategies for selected properties, such as sale-leasebacks of owned assets, acquisitions of leased facilities with upcoming lease expirations where landlords risk losing the assets, or targeting existing distressed properties to acquire.

Many of these financial decisions have historically been driven by chief financial officers and treasurers. However, the dynamics of the major run up in values from 2005 through mid-2008, followed by the significant downturn in 2009 and 2010, and an uncertain recovery period for many aspects of the industry, have been an impetus for corporate real estate directors taking a more active role.

More emphasis is being placed on proactive surfacing of opportunities and evaluating 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.

This white paper is designed to provide a useful guide for corporate real estate directors, chief financial officers

and other members of senior management, with the entire spectrum of decision criteria for evaluating ownership versus leasing decisions addressed. Also included is an overview of the potential benefits of alternative leasing structures for major requirements and sale-leaseback transactions.

Identifying the Critical Criteria

It is essential for corporate real estate directors to clearly understand the philosophies and objectives of the senior finance 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 finance 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 and seek an efficient process for making decisions.

Operations – Factors such as providing flexibility for a growing or contracting workforce 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. Alternatively, locations requiring significant capital investment in equipment and infrastructure may favor ownership due to the relocation constraints created by such investment.

Cost of Capital / Net Present Value Comparisons – 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 a rent factor on a lease. If a company can borrow at 6.0% interest only under an existing credit facility and the initial rent factor on a new building is 8.0% of the project cost, the cost of leasing is apparently higher by 2.0%. However, this comparison is somewhat simplistic. Since the lease leaves the tenant with no obligation at the end of the lease term, ownership scenarios should also consider debt principal amortization and amounts due at maturity over an appropriate holding period, along with an estimate of residual value, all on an after-tax basis. In addition, the decision to borrow and continue to own exposes a company to the various risks of real estate ownership, including casualty, functional obsolescence and an unknown residual value. Certain companies with a less favorable financial profile will still favor ownership if they perceive an opportunity for property appreciation and prefer the control elements.

A counter position involves applying weighted average cost of capital (WACC) to real estate investment decisions, which typically favors leasing as the WACC is generally significantly higher than the cost of debt. WACC is a calculation that blends the cost of equity (generally 10% or higher) and the cost of debt. The theory is that such decisions are longer term in nature and reflect investment decisions as opposed to financing decisions. For these companies, real estate ownership is viewed as a capital budgeting decision that should be measured against internal hurdle rates for core or 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 if there are better investment opportunities available within their core operations, or for other reasons such as operational flexibility and avoiding residual value risk.

It is not uncommon to encounter situations in which finance and operations executives differ in their perspective, such as a treasurer who advocates a cost of borrowing approach (prefers 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 in order to view the sensitivity to varying discount rates and make an informed decision.

Ownership vs. Leasing Decision Criteria	
Ownership Characteristics	Leasing Characteristics
<ul style="list-style-type: none"> • Investment grade profile • Interested in property control and appreciation • Significant cash reserves / liquidity • Core property with a long-term hold strategy • Decisions based on the cost of borrowing • Low opportunity cost for ownership • Established company with a stable growth profile • Significant property capital improvements 	<ul style="list-style-type: none"> • Sub-investment grade profile • Opposed to residual value risk • Operational / exit strategy flexibility • Staffing and production volatility • Decisions based on WACC • High opportunity cost for ownership • Dynamic growth and M&A activity • Potential for future obsolescence

Real Estate Market Conditions

Since 2009 there has been a significant increase in users seeking to acquire properties for strategic assets in order to take advantage of declining values. Much of this is driven by heightened awareness of senior management and Boards of Directors for public companies and more entrepreneurial private companies seeking to be opportunistic. The best opportunities for such acquisitions exist: (1) when the tenant occupies a majority of a building and has 4 years or less remaining on its lease, thereby minimizing risk to the landlord in the event of a relocation, and (2) identifying relocation opportunities for distressed properties. For companies evaluating a strategy primarily driven by opportunistic market conditions, the fundamentals outlined above should still be considered, in addition to evaluating factors such as the maximum level of lease-up risk if not a right-sized facility and the ability to fund tenant improvements and commissions for leasing up excess space.

Mergers and Acquisitions

Merger and acquisition (“M&A”) activity may result in diverging viewpoints of whether existing real estate of the target company should be owned or leased. Many factors can come into play, such as potential consolidation or

abandonment of facilities. In addition, acquiring companies often times evaluate sale-leasebacks of target company real estate in order to raise capital to offset the acquisition cost. Corporate real estate directors should work with the M&A transaction team to surface such matters early in the process, as certain aspects may have a significant impact on valuations, real estate strategy, and the overall transaction structure.

Portfolio Considerations

For companies with a substantial real estate portfolio, the following primary factors should also be evaluated in establishing an overall portfolio strategy for ownership versus leasing decisions.

Flexibility – For homogenous locations within a portfolio, flexibility can be achieved through a combination of owned and leased assets with specified allocations to ownership, short-term leases, medium-term leases and long-term leases. This type of allocation ensures that at any point in the business or real estate cycle, users have options with respect to vacating sites with near-term lease expirations. Alternatively, some percentage of ownership acts as a hedge against exposure to increasing leasing costs in a growing market.

Capital Allocation – It is important to separate the real estate capitalization decision (ownership versus leasing) from the business unit site location decision. Often times, business units are measured based on a profit and loss metric, and skewed towards an ownership preference based on the lower expense profile associated with a long depreciable life and low or no cost of capital charge. A more efficient approach is to charge an appropriate cost of capital to the business unit based on capital employed, plus a depreciation charge accurately reflecting the duration of the use requirement. Then, at a corporate level, ownership versus leasing decisions can be made based on the various factors referenced herein.

Accounting and Income Tax Considerations

Financial accounting and income tax considerations must also be closely evaluated. For accounting purposes, ownership requires recognizing depreciation and interest expense versus rent expense for leasing. Another cost of ownership is the opportunity cost on equity invested, 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 expense to the ownership scenario, even if it is not

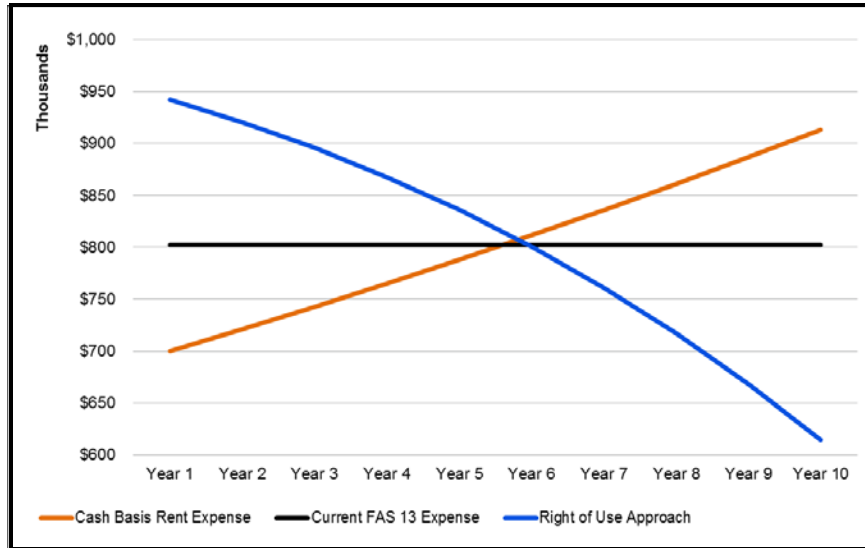
specifically attributed to the asset for reporting purposes. Also, for companies that consider EBITDA a more critical earnings metric than net income, ownership may be viewed more favorably since interest and depreciation expense are added back to earnings in calculating EBITDA, and lease expense is 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. However, significant changes in lease accounting rules are being developed through a joint FASB / IASB effort, with a new standard anticipated to be released in the fourth quarter of 2011. It is likely that the current off balance sheet operating lease classification will cease to exist for tenants effective January 1, 2015. Therefore, public companies required to report comparative results for three years need to maintain two sets of books for 2013 and 2014, in order to be prepared for 2015 reporting.

Once new lease accounting guidelines becomes effective, a “right of use approach” will be required whereby all leases would be capitalized on the balance sheet and expensed through (a) amortization of an asset equal to the present value of the lease payments, plus (b) interest expense recognized as if rent payments represent debt service on a fully amortizing capitalized lease obligation. In general, this will cause front loading of expense relative to current accounting rules whereby rent is generally straight-lined during the term, since interest is higher in earlier years of a loan and declines annually (see the line graph on the next page). Such changes in lease accounting will certainly add another dynamic to ownership versus leasing decisions, since certain perceived financial accounting benefits of leasing will no longer exist.

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 shorter-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.

Pending Changes to Lease Accounting Annual Impact on Occupancy Costs - 10 Year Lease



Proactive Approach 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 existing 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 reduce or eliminate its required equity contribution and therefore reduce the ultimate lease rate for the tenant. If the tenant can identify and control the property, the developer can be placed in a fee developer role, and, depending on the credit profile, certain net lease investors will fund the construction and own upon completion, creating a more efficient structure and overall cost of capital / rent factor.

Credit Tenant Lease (CTL) Financing – This structure requires a certain credit profile, and has similar elements as the tenant controlled development and financing approach. However, the tenant bears slightly more risk and plays an active role in securing long-term financing. CTL / bond net leases generally include a "date certain"

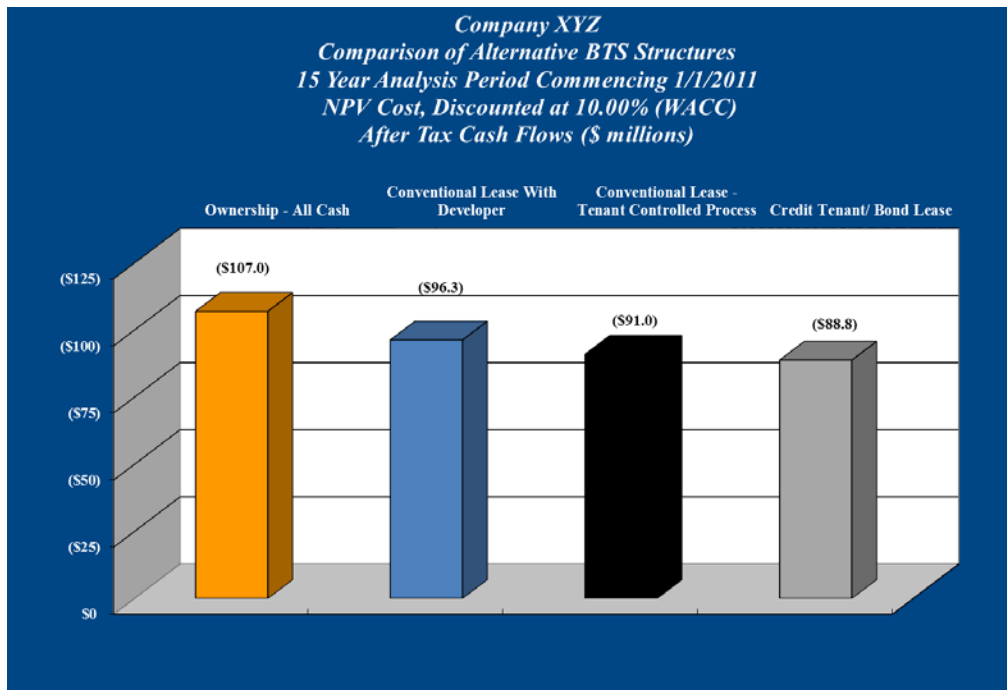
provision such that rent commences at a specified starting date. The savings may approximate a reduction in the rent factor of 25 to 100 basis points depending on tenant credit and lease structure.

Additionally, this type of structure generally provides advantageous rent escalations, relative to the alternative indicated above, but requires a 15 to 25 year lease in order to be compelling. 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 under current accounting rules must also be closely examined with the company's auditors with respect to these risks.

Synthetic Leases – This off-balance sheet financing vehicle has generally had a negative stigma since the Enron events in 2002, 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. A very limited number of synthetic leases have been initiated in the past five years, and many previous ones have been eliminated through acquisitions and refinancing by lessees, sale-leasebacks, and outright dispositions. The aforementioned proposed changes in lease accounting will also apply to synthetic leases, so the advantages of this structure will effectively be eliminated by 2015.

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 10% to 17% on an after-tax present value basis.



Potential Advantages of Sale-Leaseback Transactions

A well-documented seller’s market existed for quality commercial and industrial real estate throughout the U.S. from 2004 through early 2008, with unprecedented low capitalization rates and high prices realized. Many high profile Class A CBD assets in major U.S. cities traded at capitalization rates in the 5% to 6% range during this period, with prices significantly exceeding historic values. Much of this activity was 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.

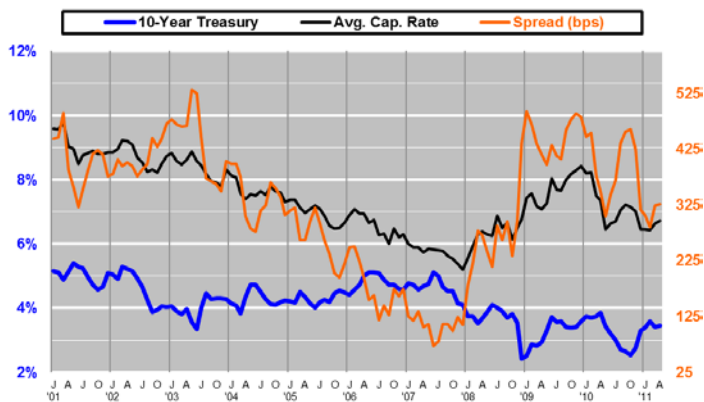
In the second half of 2008, a liquidity shortfall in the United States set off a financial crisis which led to the collapse of a number of financial institutions. Overall transaction volume fell dramatically as debt financing grew scarce and expensive, and as the pool of qualified buyers shrunk. Capitalization rates rose considerably, even for strong credit tenants, as there was limited investor appetite for vacancy or lease-up risk.

Corporate profits and equity markets started rebounding in 2010 and real estate capital markets have begun to stabilize, with a continued increase in transaction activity to date in 2011. Long-term net leased assets have emerged as the most desirable real estate investment alternative and pricing has recovered dramatically relative to late 2008 and 2009. It has become clear that sale-leaseback transactions have gained broad market support with substantial market depth from institutional capital sources. While pricing does not reflect peak market bubble levels, valuations and capitalization rates are very healthy by historic standards.

How does this capital markets environment translate to corporate real estate? Assets in the corporate portfolio should be reviewed using the same fundamental ownership versus 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 healthy investor appetite for quality projects and a strong credit profile
- Avoid future residual value or balloon refinancing risk
- Lock in a favorable long-term lease structure at a reasonable implied cost of capital
- 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
- Raise capital to manage financial covenants

The following line graph depicts the spread, or relationship, between the 10-year treasury rate and average U.S. CBD office capitalization rates over the past 10 years. Notable trends for sale-leasebacks and other investment sale activity include: (a) a sharp decrease in the spread from 2005–2007 correlating to increased values and activity; (b) a dramatic increase in the spread during 2008-2009 when the market declined; and (c) in 2010-2011, a return to a spread more representative of an average over the past 10 years, with low interest rates resulting in favorable capitalization rates for sellers.



January 2001 - April 2011

Source: Real Capital Analytics

Summary

Corporate real estate directors are encouraged 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, resulting in optimal portfolio and individual property strategies.

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Company Profile

Freeman Realty Company was formed in 2011 to provide commercial real estate services to corporate and other occupiers, investors and developers.

Grant Freeman, principal, has worked for premier companies in the industry for almost three decades, developing comprehensive experience in investment sales, leasing, project financing, asset management, corporate finance, financial accounting and income tax.

He is recognized in the industry as an expert in working with clients on making ownership versus leasing decisions for major requirements, and has completed over two million square feet of corporate acquisitions, sale-leasebacks, sales of excess corporate real estate, build-to-suits, development advisory and other tenant representation transactions over the past three years.

Please contact us to determine how we can work with your company to evaluate ownership versus leasing decisions, and provide related transaction services designed to optimize the value of your real estate portfolio and related occupancy costs.

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