March 2016

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 experienced a recovery the past five years after one of the most significant downturns in history, and uncertainty as to when the next negative turn in the cycle will occur (many believe it will start in 2017, but not be as significant as 2008–2010). 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 changes to accounting for leases starting calendar year 2019, 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 vacant or under-utilized properties to acquire.

Many of these financial decisions have historically been driven by chief financial officers and treasurers. However, the dynamics of the cyclical nature of commercial real estate values has 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 making 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 a fixed interest rate of 5.0% and the initial rent factor on a new building is 7.5% of the project cost, the cost of leasing is apparently higher by 2.5%. However, this comparison is too 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 the reversion 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 reversion 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 after-tax cost of debt. WACC is a calculation that blends the cost of equity (typically 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
• Investment grade profile	• Sub-investment grade profile
• Interested in property control and appreciation	• Opposed to residual value risk
• Significant cash reserves / liquidity	• Operational / exit strategy flexibility
• Core property with a long-term hold strategy	• Staffing and production volatility
• Decisions based on the cost of borrowing	• Decisions based on WACC
• Low opportunity cost for ownership	• High opportunity cost for ownership
• Established company with a stable growth profile	• Dynamic growth and M&A activity
• Significant property capital improvements	• Potential for future obsolescence

Real Estate Market Conditions

From 2010-2013 there was a significant increase in users acquiring properties for strategic assets in order to take advantage of decreased values from 2008-2010. This was largely driven by heightened awareness of senior management and Boards of Directors for public companies and entrepreneurial private companies being opportunistic. Such activity has declined during 2014-2016 due to increased values making ownership less compelling, despite corresponding increases in rental rates. The best opportunities for such acquisitions exist: (1) when the tenant occupies a majority of a building and has 3 years or less remaining on its lease, thereby minimizing risk to the landlord in the event of a relocation, and (2) identifying relocation opportunities in a declining market. For companies primarily driven by being opportunistic, the fundamentals outlined above should still be considered, in addition to evaluating the maximum level of lease-up risk if not a right-sized facility, and the ability to fund tenant improvements and commissions to lease up excess space.

Mergers and Acquisitions

Mergers and acquisitions ("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.

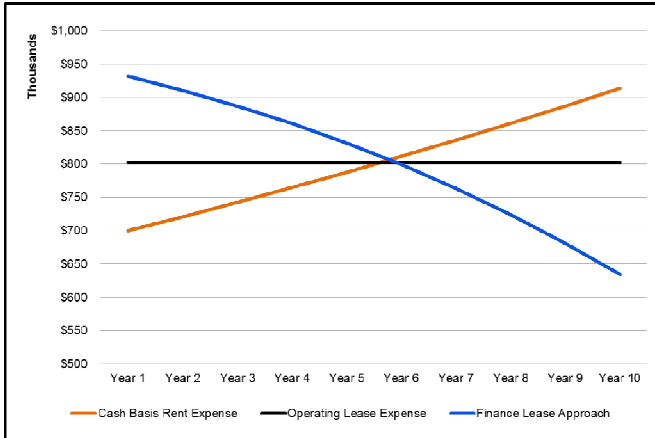
Many companies prefer to keep real estate assets and related debt off their balance sheets to improve financial ratios, maintain borrowing capacity for other business activities, or simply for debt covenant compliance purposes. However, significant changes in lease accounting have recently been finalized after a 10 year joint effort between the FASB and IASB, with the new "ASC 842" being issued by the FASB in February 2016. The current off balance sheet operating lease classification will cease to exist for public companies in 2019 and other entities in 2020, with early adoption permitted. Also, companies required to report comparative results for three years will need to maintain two sets of books for 2017 and 2018, in order to be prepared for 2019 financial reporting.

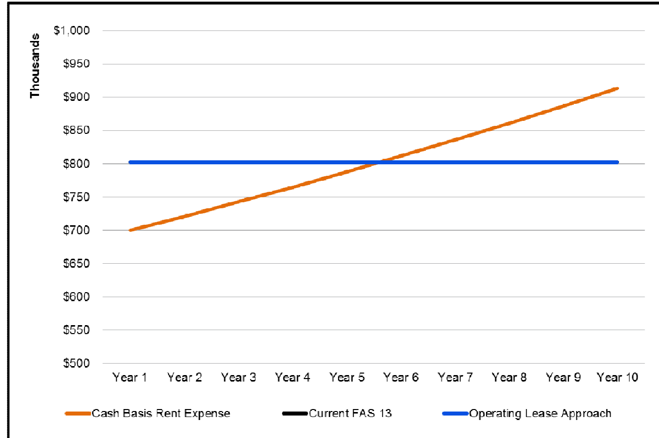
A "right of use approach" will be required whereby all leases will be capitalized on the balance sheet as a Right of Use Asset, with a corresponding Lease Liability. There will be two methods used to measure the P&L impact. For most real estate leases there will be a straight line expense similar to today's "Operating Leases." For leases with similar characteristics as today's "capital leases" there will be a front loaded interest and amortization approach (Finance Lease"). ***For an illustration of the differences, please refer to the graphs on the next page***. Given these changes, existing and pending leases will need to be reviewed to ensure proper classification and reporting, with ASC 842 also providing guidance on the accounting transition for existing leases. Such changes will certainly add new dynamics to ownership versus leasing decisions, especially for major requirements.

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.

Upcoming Changes to Lease Accounting – ASC 842
Annual Impact on Occupancy Costs – 10 Year Lease With 3% Annual Rent Increases

Finance Lease Approach - There is a front loaded expense profile relative to the operating lease approach. This treatment will be applied to leases with similar characteristics as today's "capital leases" (see the blue line below).	Operating Lease Approach – There is a straight line expense profile similar to today's operating leases. The only difference from the current standard is accounted for such leases on the balance sheet (see the blue line below).





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.

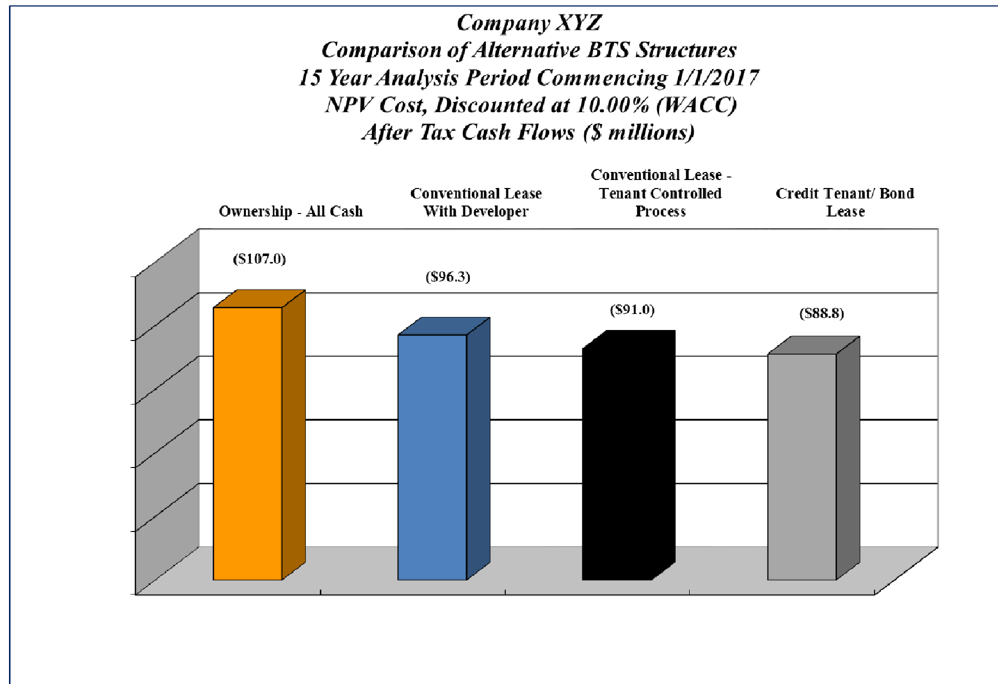
Credit Tenant Lease (CTL) Financing – This structure requires a certain credit profile, and has similar elements as the tenant controlled development and financing approach. However, the tenant bears slightly more risk and plays an active role in securing long-term financing. CTL / bond net leases generally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

Impact of ASC 842 (new lease accounting standard) – The new lease accounting rules effective calendar year 2019 for public companies (see discussion on page 3) also incorporate updated guidance regarding lessee involvement in asset construction for build-to-suit transactions. The new standard stipulates that an asset controlled by a lessee during the construction period would be subject to sale-leaseback accounting upon completion. There is also new guidance for costs incurred by the lessee during construction if it does not control the asset. These provisions are relatively complex, so companies should consult with its auditors during the negotiation process to ensure no unexpected accounting consequences arise.

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-Leasebacks

A very compelling 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.

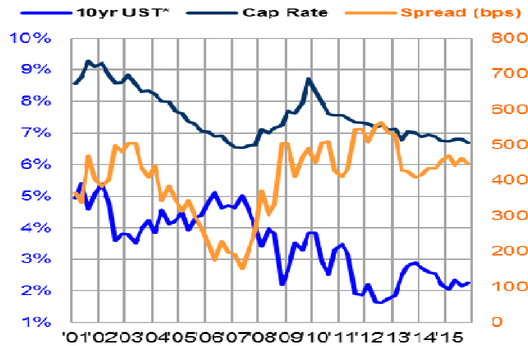
In the second half of 2008, a liquidity shortfall in the United States set off a financial crisis which led to the collapse of a number of financial institutions. Overall transaction volume fell dramatically as debt financing grew scarce and expensive, and as the pool of qualified buyers shrunk. Capitalization 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 began to stabilize, with a steady increase in transaction activity and values during 2011-2016. Long-term net leased office and industrial assets with credit tenants have remained a highly sought after real estate investment alternative for institutional and other primary investor categories, with a low supply of high quality properties being brought to market in recent years. Capitalization rates and pricing for such assets are now at or above peak levels from 2006-2007, depending on the property and local market conditions. With the upcoming 2016 presidential election and increasing concern about the timing and extent of the next downward cycle, more companies are re-evaluating their portfolios for sale-leaseback opportunities while interest rates and associated capitalization rates remain at historically low levels (a downward cycle will likely start in 2017 or 2018, but should not be as significant as 2008-2010).

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 traditionally spurred sale-leaseback activity by corporate America.

- Take advantage of healthy investor appetite for quality projects and a strong credit profile
- Avoid future reversion 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 graph depicts the spread, or relationship, between the 10-year treasury rate and average U.S. CBD office capitalization rates since 2001 (please see the orange line). Notable trends for sale-leasebacks and other investment sales 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; (c) from 2010 - Q2 2011, a return to a spread closer to the average over the previous 10 years, with low interest rates and cap rates helping the recovery; (d) for Q3 2011 – Q1 2013, a spread approximating 500 bps due to record low treasury rates; and (e) for the balance of 2013 and through 2015, a spread closer to 400 bps due to treasury rates settling in the 2.00% to 3.00% range. Please note that Class "A" CBD assets and long-term sale-leasebacks with strong credit generally trade at lower spreads than the average.



January 2001 – December 2015 (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 over thirty years, 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 three million square feet of corporate acquisitions, sale-leasebacks, sales of excess corporate real estate, build-to-suits, development advisory and other tenant representation transactions during his career.

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.

Freeman Realty Company, Inc.

23 Corporate Plaza Drive, Suite 150
Newport Beach, California 92660

Office: 949.629.2491
Mobile: 949.230.4477

grant@freemanrealtyco.com
www.freemanrealtyco.com

California Real Estate Broker Licenses:
Grant M. Freeman: 01321446
Freeman Realty Company, Inc.: 01897018