

Changes to Lease Accounting:

Will sale/leasebacks still make sense?

Sale/leasebacks are an established form of asset monetization offering many benefits to corporate owner/occupiers. Sale/leasebacks liberate capital locked up in real estate in exchange for lease obligations, potentially yielding an array of advantages for businesses. However, the proposed new lease accounting standard will eliminate off-balance sheet treatment favored by many companies. Will this change overshadow other benefits and effectively kill the sale/leaseback? Let's start the discussion by examining the changes to lease accounting as currently proposed and how they apply to sale/leasebacks.

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eliminating the potential benefit of off-balance sheet treatment.

Under the current FAS 13, a lease can be classified in one of two ways: a capital or finance lease, which is included on the balance sheet, or as an operating lease, in which payments associated with the leaseback are kept off

the balance sheet. The proposed new accounting model would eliminate operating lease treatment altogether and put real estate lease obligations on the balance sheet as both an asset under a right-of-use approach and as a liability associated with

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lease payment obligations. In other words, virtually all lease obligations will show up on the balance sheet.

Background on Changes to Lease Accounting

In 2002, the Financial Accounting Standards Board (FASB) and its London-based European counterpart, the International Accounting Standards Board (IASB) agreed to work toward reducing differences between their two sets of standards. The convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) would, among other things, change the way real estate leases have been reported since 1976, when the current U.S. lease accounting standard known as FAS 13 came into existence.

The FASB and IASB jointly released an Exposure Draft in August 2010 outlining details of the new lease accounting as it would affect both lessees and lessors and provided for a comment period extending through December 15, 2010. In February 2011, the Boards addressed tentative changes in response to criticism received by industry that the proposed model was too complex and costly to implement. Although finalization isn't expected until at least summer 2011, one basic element is clear: The new standard will require all real estate leases to be recognized on the balance sheets of lessees, thereby

The Impact on Sale/Leasebacks

So, will companies still be interested in sale/leasebacks when off-balance sheet treatment can no longer be achieved? The answer will vary from company to company and will be determined by motivations and priorities behind why a particular company might enter into this type of transaction.

Specific objectives supporting the decision to pursue a real estate sale/leaseback are numerous and vary from company to company. The most frequent reasons include:

- Improves financial performance;
- Transfers obsolescence and residual risk of ownership;
- Maintains long-term control of property as needed;
- Unlocks illiquid capital for growth and operations;
- Raises capital via non-traditional sources;
- Accesses potentially favorable cost of long-term financing;
- Avoids debt covenants and restrictions typical of most corporate finance instruments.

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Of the reasons cited above, only “improves financial performance” relates to achieving operating lease classification for reporting purposes. Structuring a sale/leaseback to achieve off-balance sheet treatment can improve financial ratios (debt-to-equity, interest coverage, etc.) and enhance performance metrics such as ROE and ROA, and the removal of depreciation expense can increase earnings per share. But is off-balance-sheet treatment the main reason companies choose these structures?

In our experience, the number one reason companies pursue sale/leasebacks is not to improve balance sheet display, but to raise cash. Although capital and credit markets have largely recovered from the near collapse that occurred in the fall of 2008, credit is still tight for many companies. Investment-grade and large non-investment grade companies have been embraced by the credit markets, with rates near historic lows and issuance near record highs. These companies have access to abundant and cheap financing, and many are sitting on historic amounts of cash. The problem these companies have is not accessing capital, but rather employing capital in today’s business environment.

Not every company is strong enough or large enough to access the bond, high-yield, leverage loan, or other active segment of the credit markets. Many businesses rely on banks as their primary source of credit. Smaller and financially weaker companies in particular find that obtaining credit today is a challenge, as banks continue to ration credit to those needing it most. This concern will increase as the economy continues to improve and businesses need capital for investment.

Quality real estate assets are prized in today’s real estate capital markets, and a sale/leaseback can offer a corporate occupier many advantages as an alternative source of capital. Even smaller or weaker companies can find willing and aggressive sources of capital when a good real estate asset is in-

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volved. Plus, real estate investors and their lenders are new sources of financing that do not typically require cove-

nants or restrictions found in most corporate debt instruments. Accessing these new capital sources via a sale/leaseback can be an effective solution for funding business needs while traditional sources for corporate finance remain constrained.

Will changes to lease accounting kill sale/leaseback transactions? For most companies, the answer is probably not, as needs for capital will trump accounting treatment. In fact, if the final new standard is similar to current IFRS treatment, then gains will be able to be recognized in their entirety in the reporting year of the event, instead of spread across the period of leaseback as is typically the case with current U.S. GAAP.

This could make sale/leasebacks more attractive for a company trying to manage its earnings.

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Proposed new accounting could result in changes to terms and conditions of sale/leasebacks. For example, current accounting guidance disallows the corporate seller/lessee from achieving operating lease treatment if the leaseback contains fixed-priced purchase options. Since all new leases under the new standard will be capitalized onto the balance sheet, companies

may wish to negotiate future purchase rights.

Sale/leasebacks may evolve as a result of lease accounting changes, but the need for companies to raise cash will maintain their spot as a strong monetization option.



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