

Synthetic Leasing:  
A Viable Alternative for the Corporate User?

by

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## ABSTRACT

Synthetic leasing is a method used to provide off-balance sheet financing to a corporate entity for the acquisition and development of a commercial real estate asset. Recently, off-balance sheet transactions, specifically synthetic leases, have proliferated in connection with corporate acquisitions and with construction and development of corporate real estate facilities. Under synthetic leasing, the lease is treated as an operating lease for accounting purposes; however, for federal income tax purposes, the company will be deemed the owner of the property, thus offering the corporate user what appears to be the best of both leasing and ownership.

Are synthetic leases all that they claim to be? Do they offer the user an advantageous hybrid of the ownership versus leasing options? And what are the risks and potential drawbacks of these lease types? This thesis examines each of these questions as part of the overall analysis of synthetic leases and their use within the corporate real estate setting.

Research material is derived from two sources; existing research and writings of the topic, and personal interviews and case examples from three US corporations using synthetic leases.

The conclusion that the work leads to is that synthetic leases are indeed an authentic means of structuring real estate to derive cost savings, improved financial ratios and preservation of company resources. However, the benefits are very situation- dependent and must be used after a thorough evaluation of all of the other transaction options.

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## **I. Introduction**

For corporations, owning and leasing real estate is expensive. For most companies, real estate costs are second only to those for personnel. A corporation's real estate has financial and non-financial implications for the corporation and because it involves so much of a company's expenses, it is essential that a company incorporate their real estate holdings into the overall strategy and planning process of the firm.

In today's business climate of intense scrutiny of a company's financial ratios and conditions, the focus of a company's real estate holdings moves into a critical position. The strategic implications of real estate management within corporations will receive increasing attention in this decade as businesses strive to maximize bottom line performance. Non-financial issues, such as a limited supply of human resources and intense competition to retain staff, create the need for superior workplace design and environments. Creative thinking and structuring of these asset types can create a significant impact on the both the financial and non-financial performance factors of the firm. Corporate real estate should be evaluated and aligned with the company's objectives with as much depth and scrutiny as any other capital investment of the firm would undergo.

The recent challenge for firms to maximize the dollars spent on real estate has brought about a new leasing structure called, a synthetic lease. The synthetic lease claims to provide a company with the optimal way to control their real estate holdings – one with all the tax and accounting benefits of ownership without the financial drain on the company's financials. This innovation has made a significant impact on the way corporate America considers structuring their real estate transactions. Previously companies had to choose between outright ownership and traditional leasing. For some companies, Synthetic leases may provide an ideal blend of the owning and leasing.

More companies are looking at newer options such as the synthetic lease to finance the acquisition or construction of new facilities. But amidst the evolution in corporate real estate strategy and with the introduction of new deal structures, there still

lingers the fundamental debate of whether it is best to own or lease their physical structures. The battle of choosing between ownership and the control it affords versus the flexibility and lower capital requirements that a lease can offer must be measured before a firm can evaluate the potential benefits of an alternative transaction type.

Understanding the issues involved in the lease/buy decision will highlight how alternative transaction types such as the synthetic lease can benefit modern companies. Can they actually offer the ideal mix of the benefits of ownership and the benefits of leasing? And do synthetic leases work for every type of public company and every deal? From my research, I will show that synthetic leases are in fact a viable option for companies acquiring new space. However, they are not an appropriate tool for every company and every deal type. All too often, companies are choosing synthetic leases solely because they provided the lowest cost alternative of a financial analysis. Firms fail to give proper heed to the short-term nature and important non-financial considerations of these leases that are not part of a pure financial analysis decision-making process.

The examination of synthetic leases will be from the perspective of the corporate user since the guidelines require that user of synthetic leases be a publicly traded corporation. And although synthetic leasing has been used for the manufacturing, industrial and retail facilities of firms, discussions in this paper will focus only on the office property-type. This will allow for a more balanced critique of the issues because the physical nature of corporate office spaces are less varied.

## **II. Ownership versus Leasing**

There is little agreement among corporate executives about how a non-real estate company should manage its real estate. Some executives argue that their companies are not in the real estate business while others assert that the underlying necessity of property puts companies into the business whether they like wish to be there or not.<sup>1</sup>

Resolution of the controversy about whether or not a given company is in the real estate business is not particularly useful. Arguing about this is analogous to arguing over whether or not a company is in the financial services business because it holds accounts receivables. Twenty years ago companies rarely considered issues such as aligning the portfolio of corporate real estate assets with future space and labor needs, marketing and distribution strategies, or requirements of new and emerging technologies when making real estate decisions.

What today's corporate leaders can agree upon is that the overall responsibility of the corporate real estate function is to maximize the value and investment of their real estate to the firm as part of the optimization of the firms business and shareholder values. As mentioned, real estate typically represents a major corporate investment, accounting for 20% to 30 % of total assets.<sup>2</sup> Occupancy costs, real estate-related interest and capital costs all significantly affect the corporate income and operating statements.

Emerging business trends put an even greater source of pressure on the corporation to closely evaluate the structure and performance of its real estate assets. Globalization and the necessity to consolidate and compete through mergers and acquisitions require a firm to have short-term flexibility of occupancy and ease of disposition. Connection to capital markets has changed the availability of capital for corporations and has increased the level of sophistication of how their real estate investments and holdings are assessed. Incorporation of corporate real estate as an integral part of a firms' whole business process calls for a very different approach to considering corporate real estate.

Many factors go into the own/lease analysis depending on the objectives and strategies of a particular firm. As with any other asset type, it is also important to recognize that within the company, real estate is considered from a variety of perspectives ranging from accountants, the actual occupants, the CFO, to human

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<sup>1</sup> Sheila Muto, "Firms Flock to type of Leasing," Wall Street Journal (April 1997) p. 2, 23.

<sup>2</sup> Thomas Dorsey, "Maximizing profits with a synthetic Lease," The Appraisal Journal (Jan 2000) p.93-96.

resources. And depending on one's perspective, the weight that gets applied to the numerous factors surrounding the own/lease decision will also vary. However, two encompassing issues – flexibility and financial merit – are at the core of every lease/own evaluation process.

### **Flexibility**

Taking into consideration the perspective of the person making real estate decisions is important in considering the flexibility of the real estate asset. “As a physical asset, corporate real estate managers are concerned with aspects of design, including floor plate sizes, column placement and building services. As a functional asset, corporate real estate managers consider what activities can actually be conducted inside a building. As a financial asset, corporate real estate managers examine the terms of contracts and the ability (and costs) to terminate those obligations.”<sup>3</sup> In making the own/lease decision each of these types of flexibility should be taken into consideration and evaluated. Is choosing the alternative that offers the highest degree of physical flexibility important enough to pay a premium for?

### ***Functional flexibility***

Functional flexibility entails evaluating an office by the amount and type of activities it could support. What functions would be suitable within this building? If the need arises, could another work group use this space? As organizations adjust to changing environments the activities and tasks their employees perform change with along with them. For instance, as many paper-processing activities become more automated, more and more clerical workers are being replaced by IT type support functions and knowledge workers.

The functional flexibility debate also includes much of the work focusing on the future of the workplace. Team space, meeting areas, free address areas, and enclosed offices are all potentially needed within a modern office environment.<sup>4</sup> Functional flexibility should also include the ability of the potential space to be

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<sup>3</sup> Ibid.

designed and used so that individuals and teams can relocate within the organization with minimum downtime and cost, or the inclusive cost of churn.

Many of the considerations involved in functional flexibility play a role in the physical flexibility discussion such as the type and level of IT infrastructure that a building can house, the location of the buildings and any potential planning restrictions.

#### *Physical flexibility*

Physical flexibility is often times an important factor when a new building is being considered. When a firm is considering investing in an asset it is understandable to want that asset to be able to grow and evolve just as the company will over time. In looking for a flexible building, the firm is really evaluating the way the internal space can be used. The aspects of the property being appraised include the variety of layouts a building may support; the location of columns; the shape and size of the floor plates; and the adequacy of the building services. Physically, flexibility has been expressed in terms of building design, including useable areas, modular floor plates and the ability to change the internal configuration of the space.

#### *Financial flexibility*

This aspect of flexibility concerns the firm's need to manage the financial risk and exposure of any real estate decision. It concerns the type of tenure and the terms of any real estate agreement, owned or leased. Although a more in depth discussion follows in the upcoming financial merit section, it is important to address the financial issues from the perspective of flexibility. With the fast pace of change, companies increasingly need to know how quickly they could exit a property and what the cost to do so would be. Although the occupancy costs may be higher, the financial flexibility, the ability to use the space on a very short-term basis or to exit quickly – is sometimes seen as a priority for e firms in their

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<sup>4</sup> Becker, F, *Workplace by Design*. San Francisco: Jossey-Bass Ltd, 1995

decision making process and is, therefore worth any extra expense.<sup>5</sup> For example, if a company is forecasting tremendous growth 5 years from now, then it would be reasonable to structure its current real estate needs in a way that allows the company to leave its current space and move into larger space in five years. The additional costs of such an option would potentially be considerable less than the benefits of moving into space that enhanced the expected growth.

### **Financial Merits**

Contemporary own/ lease evaluations are predominantly financial decisions. The amount and type of flexibility that the alternatives offer certainly impact the analysis; but most often at the heart of the analysis and final decision is the economics of the deal. Which option makes better financial sense? Which option is cheaper? Which option best uses the company's limited supply of capital resources?

Research provides an abundant supply of ideas on how to best evaluate the financial implications of leasing and ownership options. Varying degrees of expertise and levels of detail add to the disparity among corporate real estate executives. Amidst all of the ideas, there are two fundamental methods – the present value of cash outflows and the internal rate of return – that are included in almost all comprehensive buy/lease analyses.

#### *Present value of cash outflows*

This methodology involves a comparison of the present value of cash flows associated with the two options. The cash outflows associated with the ownership alternative in any period consists of the period's principal payment plus after-tax interest less the tax savings associated with that period's depreciation (i.e. the tax rate multiplied by the year's depreciation) less any investment tax residual value if the period in question is the final period of analysis. The cash outflows associated with the ownership options are, therefore, simply the after-tax loan payments less the tax benefits and residual value

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<sup>5</sup> Avis, M, *Real Estate Resource Management*, Wallingford England: GTI Specialists Publishers, 1995.

associated with owning the asset. The cash outflow involved in the leasing option in any period consists of the after-tax lease payment.

The cash outflows for both alternatives are then discounted at a rate of return to determine the present value of cash outflow. (The appropriate rate of return is an issue of great debate and will be discussed in further detail later on in this section.) After discounting the cash flows associated with each option, the resulting present values are compared. The alternative with the smaller present value of cash outflows is considered the less costly option.

### *Internal Rate of Return*

This methodology involves a comparison of the (percentage) cost associated with each alternative. The cost associated with the ownership option is simply the after-tax cost of borrowing. Internal rate of return analysis is employed to determine the cost of leasing. By leasing instead of buying, the firm saves the initial purchase price but loses the tax savings and residual value associated with ownership as well as incurring the lease payments. Therefore, the cash outflows employed in the internal rate of return analysis should include as a *cash inflow*, the purchase price at the beginning of the first period (or at period zero) and in that and subsequent periods cash outflows equal to the after-tax lease payments, the tax savings associated with depreciation and the investment tax credit, and in the final period, the asset's estimated after-tax residual value.

The internal rate of return is the discount rate at which the present value of these cash flows is zero. In other words, at a discount rate equal to the internal rate of return, the present value of the after-tax lease payments, the tax benefits, and the residual value equals the initial purchase price. Since these cash flows represent the incremental cash flows associated with leasing instead of owning, the resulting internal rate of return is the implicit (percentage) cost associated with leasing. After calculating the implicit cost of leasing using the internal rate of return analysis, the resulting cost of leasing is compared to the after-tax cost of

owning. The alternative with the lowest cost is considered the less costly option. An advantage to this approach is that it avoids having to specify a discount rate.

### *Appropriate discount rates*

The appropriate discount rate to use in a cash flow analysis is a controversial topic and lies at the heart of the difference between corporations with different policies. Two discount rates are used most often, the weighted cost of capital and the company's debt cost.

Many firms believe that the appropriate discount rate to use is the weighted cost of capital of the firm. This opinion is based on the premise that any capital invested in real estate is obtained at the company's cost of capital. Therefore, any real estate project in which the company invests should earn at least that rate of return, or a financial profit will not be earned on the firm's investment.

One rationale for making use of the weighted average cost of capital as the discount rate is that the stock market pays no attention to real estate transactions. If this were the case, then individual real estate investments would go unnoticed by the market and the company's return expectations would be unaffected by the addition or disposition of a corporate real estate asset. This line of reasoning suggests that the market, analyst and investors, can be deceived.

The other discount rate used by corporations is their debt rate. The rationale behind this is that if the money were not used to invest in the real estate it would be left in cash or short-term debt instruments earning interest. Therefore, the true opportunity cost of using the cash would be the interest that the company didn't earn.

But what about risk? To properly evaluate projects, appropriate levels of risk should be identified and measured accordingly. The weighted cost of capital

rate assumes that every investment that the corporation makes is of the same risk level as the corporation overall. This is obviously not valid, because certain types of assets are less risky while others are more risky. Using the weighted average cost of capital rate will constantly drive the corporation towards a higher risk profile over time. This is because investments with lower than average risk have lower returns and therefore will be unable to reach the hurdle rate even if they are good values. Likewise, risky projects will earn high returns and therefore be constantly accepted, even if the return is not commensurate with the risk the corporation is taking. Alternatively if the debt rate is used, the reverse becomes true; the risk of a real estate investment is much higher than that of quality short-term securities and therefore must carry a higher return. Given the limitations of both discount rates in regards to incorporating risk into an analysis, it is still important that risk levels be identified and compared in an effort to fairly evaluate leasing versus ownership options.

### **Other Issues Related to Financial Merit Analysis**

Beyond the present value of cash flows and internal rate of return calculations, there are four other very important factors that are critical to the overall financial evaluation of the buy/lease analysis;

1. The ease in which a company can get out of the asset (disposition),
2. The value at the end of the lease or upon selling the property (residual value)
3. The affect the decision has on the company's federal, state and local tax liabilities.
4. Financial accounting versus after-tax cash flows

### *Ease of disposition*

Ease of disposition is strongly related to value retention. A desirable building will retain its value but will also be easier to sell. However, it can differ because of issues such as market size and timing of the real estate cycle. For example, well located, quality buildings can still have a limited market demand if they are in a small, limited marketplace. As a result, they can sit unsold for years, particularly if they are being sold during a down cycle. Poor disposition timing happens more often than not since corporations tend to cut back on their occupancies during recessions, which usually coincide with weak real estate markets.

Unlike value retention, the own/lease decision can have an impact on ease of disposition. Ease of disposition is often easier to achieve in leasing. When a lease expires, it's the equivalent of an instant and costless disposition. However, this is only a benefit if the corporate user *wants* to leave the space. If the user does not want to leave, then the lease must be renewed and the potential for an easy disposition is lost. Leasing, therefore, can be more flexible than ownership if the need for the space can be matched very closely with the lease expiration. This is often difficult to do. If for some reason the company wants to vacate the property prior to the lease expiration, leasing is often thought to be less flexible than ownership, since it is very difficult and expensive to negotiate a release or to sublet the space. Alternatively, ownership could present equally limited flexibility if the company is trying to sell in a bad market or during a recession. With such ambiguity, the specifics of each transaction become important such as lease terms, the overall market condition, and demand for that kind of space.

### *Residual Value*

The residual is difficult to value and is the basis of struggle in most real estate deals. There are two determinants of the present value of the residual. The first is the assumed value of the property at the end of the lease. The second is the appropriate return for the residual value as reflected in the discount rate.

There are several methods used in attempting to value a piece of real estate at the end of a lease. Institutional investors tend to use a residual capitalization rate against the assumed income stream. One reason for this is that the income stream that is used to capitalize the asset on does not always represent true market levels. Often the lease payments that are used in this calculation are set at levels necessary to pay for the money invested and not based solely on the market. Therefore a market lease rate has to be assumed roughly ten years from now without the benefit of knowing what it really was at lease inception. For this reason, a replacement value methodology is often more appropriate. It has the added benefits of eliminating market fluctuations from the calculation since, over the long term, the market value of buildings track replacement cost. In this method, the replacement value is calculated beginning with the total project costs, which is then reduced by company-specific tenant improvements, then inflated and reduced by economic depreciation. In many cases this leads to a value roughly equivalent to the original total project cost.<sup>6</sup>

Selecting the appropriate rate of return in determining residual value has gotten much needed assistance from the capital markets. As with all return estimates, the place to go for an answer is the market. What return would an investor expect to receive on this property ten years from now? With the growing number of publicly traded real estate firms within the market, finding a competitive, appropriate rate seems to be easier. The capital markets are infusing some stability into the real estate arena, but there still exist uncertainty and differing viewpoints.

#### *Taxation*

The endlessly changing tax laws of the United States require constant vigilance in financial analysis of the own/lease decision. Although ownership does produce tax benefits from depreciation, the tax benefits provided by leasing

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<sup>6</sup> Robert W. Johnson, "Analysis of the Lease-Or-Buy Decision," *Journal of Finance* (1997) p. 815-825.

are often equally beneficial. With ownership the cash to buy or build the building is spent upfront but cannot be deducted at that time. The tax benefit is instead derived slowly over time as the building gets depreciated. Lease payments, however are fully deductible at the time they are made and can offer immediate impact on the company's financial statements.

The old tax laws allowed for shorter accelerated depreciation schedules. Those greater depreciation amounts most often exceeded the rent being generated by the building thus making many real estate investments tax shelters. But with today's rules, the amount of allowable depreciation expense is significantly less than the market rent for the building and since rent is fully deductible, leasing can become more tax advantageous for a corporate user than owning.

#### *Financial Accounting versus After-Tax Cash Flows*

Up to this point, discussions on how firms consider the financial aspects of leasing versus owning have focused on evaluating firms' after-tax cash flows. It is equally important to understand how the own/lease structures are treated from a financial accounting perspective and how the financial ratios of the company are affected.

An asset that is owned is recorded differently than a leased asset on a company's financial statements. The relevance of how real estate is handled from an accounting perspective affects the company's tax liabilities as well as the financial ratios of the firm, specifically return on assets, return on equity, debt/equity and interest coverage ratios. For example, when a firm owns a real estate asset and that asset is recorded as such on the balance sheet, the company is allowed to depreciate the property and deduct all interest expenses associated with the financing of the asset. These two benefits present significant tax and cash savings to the firm. The debt that was undertaken to acquire the asset is recorded as a liability. The existence of such a large liability on the financial statements weakens the firms' financial ratios. If the company chooses to lease its real estate

facility, the lease payments are recorded as a liability. These lease payments are most often tax deductible. Because of the lease, the firm does not have to borrow money to build or buy the property. As a result, the debt/equity ratio of the lessee will be lower than it would have been with a leveraged purchase of the asset.

Evaluating the affects of the accounting treatments as part of the buy/lease analysis is very important, especially to publicly traded corporations. Financial analysts, lenders and investors depend on the financial ratios that are derived from a firm's financial statements to help make investment decisions, to evaluate the over-all health of the company and to assign an overall value to the company.

The lease/own decision is inherently a complex one. Although the issues appear to be somewhat straightforward, they are interpreted differently depending upon individual perspectives, company objectives and market conditions. Considering the crucial qualitative factors of flexibility and optimal space utilization and the quantitative factors involved in the financial analysis requires a great deal of work from corporate real estate departments. There is no simple formula or template for this type of complex evaluation. The optimal process involves performing financial calculations with as accurate data as possible. From these calculations, the economic advantages and disadvantages will surface. By applying the qualitative and the company-wide objectives to the financial results, the choice between ownership and leasing should be evident.

### **III. The other new options: REITs, Sale-Leasebacks of Build-to-Suits and Synthetic Leases**

Ownership and traditional leases are no longer the only options that today's corporations have to structure real estate transactions. Several new methods have emerged as the demand to find the optimal solution for firms has increased. The most notable of these new alternatives are real estate investment trusts (REIT's), sales-leasebacks of build to suit buildings and synthetic leases. Although the focus of this paper

is on the synthetic lease option, it is important to understand what REIT's and sale-leasebacks are and what benefits they might offer.

### REITs

Congress created REITs in 1960. Initially they allowed small investors to make investments in large scale, income producing real estate. More recently, the capital markets recovering from the real estate woes of the mid 1980's and early 1990's have used them.

The essential tax benefits of REITs come from being able to deduct the dividends from the company's tax bill if the payout is at least 95% of earnings and as long as the REIT derives its income mainly from real estate assets.<sup>7</sup> The reasons for the company to consider a REIT are the same as a sale/leaseback and synthetic lease structure. REITs provide balance sheet flexibility, a potentially higher return on capital assets, lower corporate overhead and the opportunity to take proceeds in various forms, such as cash, notes or equity. Not only does the REIT provide a funding source to provide capital, but the company also can optimize equity investments by getting real estate assets off the balance sheet.

AMC movie theaters recently blazed a trail in the corporate REIT sector by securitizing a group of AMC movie theater location in a NYSE listed REIT known as AMC Entertainment. The opportunity exists for corporations in other sectors to structure similar REITs to hold all or a portion of the corporations' real estate assets. Corporations with very large real estate holdings such as retailers, public utilities and health care providers seem particularly likely to benefit from the REIT structure.

The disadvantages of a REIT structure stem from the fact that it is a public vehicle, vulnerable to scrutiny, short-term thinking and the constraints of public

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<sup>7</sup> James Ryan, "Strategic Alternatives to Synthetic Leasing," Site Selection (Jan 2000), p. 12-13.

reporting. Consequently, the REIT stock is often more volatile than the value of the actual real estate.<sup>8</sup>

REITs have experienced tremendous growth over the last six years. However, some may experience difficulties in the near future due to their market focus and limited diversification. There is sure to be an increased institutional emphasis on diversification, coupled with the incorporation of much needed practices already being implemented such as the employment of a focused management team and the reliance on economies of scale.

Experts agree that although the transfer of corporate real estate assets into a REIT is a provocative notion, the idea of a corporate real estate group embarking on an initial public offering (IPO) is one that should be approached with caution. The lack of a track record in building a real estate business and the inability to manage and grow a portfolio within the capital market arena provide significant hurdles for this vehicle.

### **Sale-Leasebacks of Build to Suits**

A sale-leaseback involves the sale of a corporate headquarters, distribution facility, manufacturing facility, laboratory or any other physical property that will continue to be used by the seller. The divested asset can include one specific property in a single location or multiple properties in a number of locations. As part of the arrangement, the former corporate owner leases the facility back from the purchaser for a period of time, typically 10-25 years and the seller retains control of the property. Many sale-leasebacks are structured as triple-net, meaning that the seller/lessee remains responsible for all of the operating expenses, insurance, taxes and maintenance of the property. The buyer is often an established entity that has access to capital on more attractive terms than the corporation may be able to obtain independently. Only build to suit properties will be discussed in order to fairly compare this transaction type against the other options. In a build to suit the asset is identical whether the corporation chooses to own or to lease.

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<sup>8</sup> James Ryan, "Strategic Alternatives to Synthetic Leasing," Site Selection (Jan 2000), p. 12-13.

In a leasing scenario, the benefits to a corporation are manifold: the developer provides the construction and permanent financing, the tenant can lease the building with a purchase option upon completion, and the developer assumes all of the real estate risk through the lease term.

Because the sale-leaseback arrangement is an off-balance sheet transaction none of the firms' capital is tied up in the asset, which can greatly affect the company's growth opportunities and financial ratios. Also, the tenant is able to lock in a long-term lease rate which could provide the firm with a below market rate toward the end of the lease term, depending on how the overall market performs.

A significant drawback of the sale-leaseback structure is that in order for the developer to agree to the project, the corporation is usually required to sign a lease for a minimum of ten years. This is an obvious deterrent to the company's flexibility. Control is also affected, because the owner retains and directs control over the building.

The costs associated with a sale-leaseback are often higher than the other options because the fee or return to the developer/owner are imbedded into the lease rate. The owner also captures any and all future appreciation in the value of the property.

### **Synthetic Leases**

The emergence of the synthetic lease, perhaps more than any other development in the last 10 years, has allowed corporate America to maximize the value of its real estate assets.<sup>9</sup>

The philosophy behind structuring synthetic leases, often referred to as tax related operating leases or off-balance sheet financing, is relatively new within the real estate industry. The lease structure has traditionally been used only for equipment leasing. Synthetic leases first came into widespread use during the 1990's when fast growing

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<sup>9</sup> Thomas Dorsey, "Maximizing profits with a synthetic Lease," The Appraisal Journal (Jan 2000) p.93-96.

companies discovered how these leases could help them finance expansion. Today, a wide variety of companies have recognized how this strategy can be viable for them.

A synthetic lease is a complex financing tool that lets corporations enjoy the tax benefits of owning real estate while keeping it off their balance sheets. The company must be a publicly traded one – or one considering going public. With these transactions, the objective is to maximize profit through asset control, although the degree of control that results is equivalent to ownership.

Under a synthetic lease, the property owner retains all the benefits and burdens of ownership, while transferring title (for financial accounting purposes only) to an unrelated third party that serves as the lessor. The lessor is typically a special-purpose entity, created to facilitate the financing of a real estate project.

Synthetic leases are much more widely used than the REIT option and probably less often used than sale-leasebacks. The sale-leaseback transaction, however, does not require that the company be a publicly traded one. Although both the REIT and the sale-leaseback structure offer alternative ways to structure real estate transactions, neither claims to offer companies a hybrid of the ownership and the traditional lease options. The remainder of this paper will discuss what synthetic leases are, how they are structured and the advantages and disadvantages they offer publicly traded US companies. Can they be the perfect combination of ownership and leasing?

#### **IV. Who are the Users of Synthetic Leases?**

Although synthetic leases are a relatively new financing tool for real estate transactions they are steadily gaining in popularity.<sup>10</sup> The recent growth can be attributed to several factors;

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<sup>10</sup> Micheal Smith, "Synthetic Leases: New Tool to Save on Real Estate," Washington Business Journal (April 2000), p. 7-9.

1. The collapse of traditional sources of commercial real estate financing during the real estate recession in the late 1980's and early 1990's<sup>11</sup>
2. The pressure on the corporate entities to show strong debt-equity ratios and to increase stock values
3. The desire of capital investors to diversify into areas other than equipment financing, while avoiding the operating and residual risks associated with traditional real estate transactions<sup>12</sup>
4. The issuance of accounting, tax, and legal opinions, regulations, and pronouncements clarifying the circumstances under which real estate transactions qualify for off balance sheet financing treatment.
5. The emergence of the west coast high tech start-up industry which, according to both west coast suppliers and buyers of synthetic leases, has created a breed of risk-taking real estate and finance executives looking for any and all ways to improve upon and maximize their company's asset performance.<sup>13</sup>

Recently, economic changes have brought the issue of strategic alternatives of corporate real estate to the forefront of most corporate real estate directors' minds. But potential changes in accounting and tax rules with the addition of some new kinds of financing alternatives threaten the use of synthetic leases for corporate America.

Off balance sheet real estate financing is most attractive to large, publicly traded, credit worthy corporations and businesses, such as manufacturers, supermarket and drug store chains, food service businesses, computer, transportation and energy companies, financial institutions, health maintenance operations and retailers. Major users of commercial real estate seeking medium-term, revolving-credit financing, that have substantial and highly specialized build-out costs, and that seek an opportunity to maximize the value of their companies stock, are likely to benefit from the off-balance sheet financing of synthetic leases. This structure may also be employed in connection

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<sup>11</sup> John C. Murray, "Off-Balance Sheet Financing: Synthetic leases," First American Corporation (2000)

<sup>12</sup> *ibid.*

with a number of planned corporate acquisitions by developing a master lease facility for the inclusion of numerous properties, to be brought into the facility as they are identified and acquired. Synthetic leases are less appropriate for smaller companies and smaller transactions because of the significant structuring, documentation and compliance expenses.

The kinds of companies choosing to explore alternative-financing vehicles such as sale-leasebacks, synthetic leases and/or REITs generally fall into three categories;

- Companies with strong credit that have sizable office or industrial holdings and are looking to reduce the real estate assets on their balance sheets
- Corporations with assets of a similar nature that require capital for expansion
- Companies with fair credit and real estate assets that can be adapted easily to alternative uses and who are attempting to reduce they're cost of funds.

Besides company categories, there exist other factors that make the use of a synthetic lease more or less appropriate;

- Length of occupancy - If a firm isn't sure how long it will occupy the space, because of a possible merger or other potential upcoming events, a synthetic lease might not offer the company enough flexibility as compared to out right ownership or a short-term market lease.
- Size of asset – The physical size of the asset in question should be large enough to support the transaction fees involved in creating a synthetic lease. Buildings of less than 20,000 square feet are usually not considered.

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<sup>13</sup> Nortec Corporation, CFO, and the Vice president of a West Coast synthetic lease supplier

- Market cycle timing – How the market is affecting interest rates, lease terms and access to capital will affect the attractiveness of synthetic leases over other options.
- Degree of company-specific tenant improvements- a company that requires very specialized space will probably value control more than other, less specialized users. A synthetic lease can be helpful in this situation.
- Tax position – The tax strategy of any firm will affect how that firm should structure large capital assets and investments. Tax lawyers, accountants and the internal tax department of the firm should be consulted.
- Company status – It is important to align this type of decision with the stage (growth vs. mature) of the firm as well as the financial health, needs for capital and future direction of the company.

## **V. Mechanics and Structure of a Synthetic Lease**

In order to structure a synthetic lease, an entity unrelated to the intended user (the “lessor”) is created to purchase the property and enter into a lease with the company. A facilitator may be engaged by the corporate user to negotiate the transaction. In this case, an affiliate of the facilitator will usually serve as the lessor. In most cases, the lender will furnish an affiliate of its leasing subsidiary to serve as the lessor. (Note: Although there are business reasons to use a special purpose entity (SPE) as the lessor, it is easier to achieve the desired accounting treatment in an entity with other assets is used, to avoid consolidation with the lessee/corporate user.) Occasionally, a trust is used to serve as the lessor. The property may be raw land or a completed or partially completed building; the synthetic lease provides for construction or renovation to the lessor’s specifications. Using the corporation’s lease (really it’s good credit) as security, the lessor obtains

financing (generally non-recourse) to fund 100% of the total cost of the project. The corporation is fully liable for its lease (“loan”) obligations, although in certain circumstances the corporation’s “deficiency” liability may be limited to approximately 85% of the total lease obligations. This limitation of liability is generally applicable only if the corporate user decided to cause the property to be sold to a third party at maturity, and it declines to extend the existing synthetic lease or purchase the property outright for its own use. The limitation of liability is usually not available if the lessor defaults on its lease obligations during the lease term, or decides to cause an early termination of the lease. (i.e., a prepayment of the “loan”)

### **Rent**

A typical synthetic lease requires that the tenant pay as rent the negotiated return/interest rate on the total cost (debt and equity), any principal reduction negotiated by the parties, and all cost associated with owning, maintaining and managing the real estate during the lease term (i.e. triple net lease). In virtually all cases, the rent also includes an environmental indemnity for the lessor and the lender. This environmental indemnity is generally far more expansive than a tenant’s environmental liability to a landlord under a standard lease arrangement.

### **Special Purpose Entity**

In many current forms of real estate financing, a lender commonly requires that the borrower or developer be an SPE with no assets or operations other than the real estate project providing the security for the loan. In many synthetic lease-financing transactions, an SPE (usually a pass through entity such as a business trust, special purpose corporation, limited partnership, or limited liability corporation) is formed. The SPE then takes title to the property, either directly or by assignment of the purchase contract, constructs the building, and leases the property to the lessee/corporate user or its subsidiary. A synthetic lease of real estate using a SPE commonly requires rental payments from the lessee equal to the sum of the interest on the SPE’s debt plus a return on the SPE’s equity investment, with no amortization of the debt’s principal or return of it’s equity during the term of the lease. The SPE, acting as lessor, obtains financing for

the transaction with a small equity investment in the project, usually 3%, and debt financing for the balance. The debt financing is usually in the form of commercial paper or commercial bank debt, often in combination with mortgage financing. Customarily, two separate classes, or tranches are created for the debt portion of the financing. The first tranche holds from 81%-89% of the debt financing in the form of standard, corporate credit risk financing secured by a deficiency guarantee, with additional collateral required if the lessee does not maintain an investment grade credit rating. The second tranche holds 12%-16% of the debt financing, usually in the form of a first mortgage to the SPE. These separate tranches reflect different risk levels, yields, maturities and other capital and risk attributes and objectives of the investors in the transaction.

### **Purchase Option**

At the inception of the synthetic lease, the parties commit to a fixed price purchase option that is excisable by the corporation on the expiration of the lease term. This purchase price is negotiable, but it will always be at least equal to the sum of the total cost (debt and equity) plus the negotiated return/interest costs. On expiration of the lease term, the corporation can purchase the property at the negotiated purchase price, or direct that the property be sold to a third party. If a deficiency would result from the third party sale, the corporation must pay that deficiency up to the maximum guaranteed amount (usually 80-87% of the principal component of the loan).

Any appreciation in value of the project during the lease term is generally paid to the corporation. If the property declines in value during the lease term, the lessee bears the entire burden of the loss.

Synthetic lease documents frequently provide that the lessee may walk away from the property at the end of the lease term by paying the entire unpaid balance of the principal and accrued interest (rent) on the loan but the size of the payoff amount usually makes this a very unattractive option for the lessee

## **Terms**

The specific terms of a synthetic lease follow no definitive guidelines. Terms are negotiated based on the lessee's financial position, bargaining power and specific transactional needs. The Financial Accounting Standards Board does require that the leases comply with the operating lease criteria set forth in Statement of Financial Accounting Standards Bulletin 13.

## **Operational Risks**

The lessee assumes all risks associated with the ownership of the property, including casualty and condemnation. The lessee is also required to pay all taxes, insurance, utility, and other charges normally paid by the property owner. The lease usually contains a clause requiring the lessee to pay rent regardless of the occurrence, damage, destruction to or taking of the property.

## **Construction Agent and Costs**

In the case of new construction, the lessee is appointed to act as the construction agent for the lessor to design, acquire, and construct the improvements. The lessee is usually responsible for the development of the plans and specifications and also to select and manage the construction contractor. If construction cost overruns occur, they are the responsibility of the lessee.

## **Accounting**

To achieve the benefits of a synthetic lease transaction, the parties must comply with certain accounting rules set forth by the Financial Accounting Standards Board (FASB). The lease will not receive the desired off-balance sheet treatment if it meets any of the following four criteria from the Accounting Standards (SFAS) number 13.

- It transfers ownership to the lessee at the end of the lease
- It contains an option for the lessor to purchase the real estate at a bargain purchase price

- The non-cancelable lease term is equal to or greater than 75 percent of the estimated economic life of the real estate.
- The present value of the rents and other minimum lease payments equal or exceed 90 percent of the fair market value of the leased property.<sup>14</sup>

To avoid meeting these criteria, a typical synthetic lease should include;

- A market-rate, fixed price purchase option
- A relatively short lease term
- A lease payment stream with a present value of less than 90 percent of the fair market value of the leased property

It is important to recognize that the FASB could, at any time adopt new accounting rules or requirements that restrict the use of synthetic leases for real estate transactions. Understandably this creates a level of uncertainty for users of synthetic leases that should be recognized and if possible, planned for.

A detail summary of each of the relevant FASB standards and sections is given in exhibit 1 of this paper.

### **Tax Treatment**

A properly structured synthetic lease will be treated as a financing transaction (loan) for federal income tax purposes, allowing interest expense and depreciation deductions to the lessee (rather than rent expense). While the lessee does not hold actual title to the property, the lessee will retain, in substance, the significant tax benefits and burdens of ownership.

Two key issues are at the core of receiving financing treatment for federal income tax purposes: disregarding the transaction's form (a lease) in favor of its economic substance (a financing arrangement) and proving that the lessee retains the benefits and

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<sup>14</sup> "Accounting for Leases", Statement of Financial Accounting Standards (Financial Accounting Standards Board. 1996)

burdens of ownership. Ultimately, the second issue tends to govern the outcome of the tax treatment because it points directly to the financial realities and substance of the transaction.<sup>15</sup>

In regards to state laws, most state income tax statutes follow the federal law. Accordingly, if the transaction is treated as a loan for federal income purposes, it will be treated as a loan under state law also. The lease usually included a provision stating that the parties intend the transaction to be characterized as a loan for tax purposes. The documents also contain a tax indemnity by the lessee (corporate user) in the event that, notwithstanding the intent of the parties, the tax treatment as a loan is not upheld.

Because the transaction is nominally a lease, certain other state and local taxes may apply. For example some towns impose a rents tax on rents received by the lessor. This type of taxes can often be avoided simply by persuading local taxing authorities that the substance of the transaction is a loan.<sup>16</sup> If not, any such tax payable by the lessor is also usually subject to indemnification by the lessee.

## **VII. Benefits and Drawbacks of Synthetic Leases**

Before presenting three real-life examples of companies that have used synthetic leases, it is appropriate to summarize the benefits and drawbacks of these lease types as discussed thus far. This should prove helpful when reading about the case study companies and the situations that brought them to choose synthetic leases.

### **Advantages of a Synthetic Lease**

Synthetic lease structures have the following advantages;

- The corporation gets the dual tax benefits of deducting the interest (component of the rent) and depreciating the property

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<sup>15</sup> John C. Murray, "IRS Issues Filed Service Advisory on Synthetic Leases," First American Corporation (2000)

<sup>16</sup> John C. Murray, "IRS Issues Filed Service Advisory on Synthetic Leases," First American Corporation (2000)

- The real estate does not appear as an asset on the corporation's books and therefore, is not subject to return on assets test that might otherwise be applied
- The financing does not appear as debt on the corporation's books
- The transaction is priced as a corporate credit, which usually results in a lower interest rate to the corporation than a standard real estate loan
- At the end of the lease term, the corporation, in most cases, is able to realize the benefits of any increase in value of the property. If the property has decreased in value, the corporation's liability may be limited to an agreed upon percentage of the total cost (generally 80% to 90%)
- The company has full operating control of the property

### **Disadvantages of Synthetic Leases**

A synthetic lease poses the following drawbacks;

- The lease term generally will be for a relatively short period (3-10 years), although the corporation usually has the option at the end of the lease term to purchase the property or to continue to lease the property by negotiating an extension to the existing synthetic lease or by causing the property to be sold to a new lessor.
- The transaction costs including title insurance, appraisal, accounting and legal costs usually exceed the transaction costs for ownership or other lease options. Obviously, the larger the synthetic lease transaction is, the lower the ratio of transaction cost to the properties value. For this reason, many firms find it beneficial to negotiate multiple-asset synthetic leases to finance their properties.
- The corporation must work closely with its accountants throughout the negotiation and documentation of the synthetic lease to assure that the accountants will not require that the asset or the debt be reflected in the firm's financial statements. If this is not performed properly, the synthetic lease will have no value to the firm.

- Synthetic leases are only applicable to newly built or obtained properties. A firm cannot use a synthetic lease for a property it is already occupying.
- There is the risk that the rules regarding the accounting and tax treatment of synthetic leases will be revised.
- Under bankruptcy laws, the lessee may be deemed to be the actual borrowing entity. In this case, the leasing limitations on a tenant's liability under the bankruptcy laws may not apply, leaving the company fully responsible.
- Synthetic leases use short-term funds to finance a long-term asset. Many financial managers consider this to be a poor financial management practice and argue that the maturity of the financing matches the economic life of the asset.
- The financial ratios of the firm will indeed improve when a synthetic lease is used, however, most analyst are savvy enough to recognize the reason for the improvement and adjust their findings accordingly.

## **VIII. Case Studies**

Thus far, material has been presented regarding the issues of traditional corporate real estate decision making and introducing new alternatives, specifically the synthetic lease structure. Building upon this information, the next logical step is to apply this framework to several corporate users that are using synthetic leases. Each of these companies had the option of a conventional ownership or leasing deal structure but opted to make use of a synthetic lease.

Looking at specific company examples will illustrate the actual process that the companies undertook in evaluating how best to structure their company's real estate assets. Was the decision making criteria similar to what was presented in the ownership versus leasing section? Did the company fit the profile that was presented in the appropriate users chapter? Did the perceived advantages and disadvantages match those

that were listed within this paper? And what were the specific benefits to the company by using a synthetic lease?

The companies that have been used were not selected at random. The companies were chosen specifically to provide examples of different phases within the business life cycle. The idea was to find one company early in its life, one company in a growth stage and one very established and mature company. I wanted to see whether or not synthetic leases were being used more by companies in one particular growth period or whether they were applicable to all kinds of companies, new, growing or mature. By researching which companies had synthetic leases in place, I could gather data to explore this question.

Companies were also selected by geographic and industry type for the identical reason. In the initial research, most companies cited were located on the West Coast of the United States and were involved in the high-tech industry. Did high tech firms on the West Coast use synthetic leases more often and if so, why did synthetic leases benefit companies with these characteristics more than others?

Data on firms using synthetic leases is not private since the guidelines require synthetic leasing to be used by publicly traded firms. However, nowhere is there a compilation of all of the firms using synthetic leases and often times companies choose not to publicize the fact that they are using synthetic leases for reasons that will be discussed. Therefore the main source for finding firms with synthetic leases in place was by way of talking to the suppliers or firms that put together synthetic lease transactions. As has been mentioned, synthetic leases are very complicated and require corporations to engage specialists, specifically trained in assembling a synthetic lease transaction. Because of the specialized nature of these suppliers, there are a limited number of them in existence. These firms also provided valuable data on synthetic leases from a non-corporate perspective.

After much research, three companies were selected. Two of the companies asked not to have their company names used. For this reason, the last two case studies represent actual transactions and real company information however, the company names have been changed to preserve anonymity. The material presented in each case is organized into three sections, company profile, choosing a transaction structure, results. The three case studies to be discussed are;

<b>Company Name</b>	<b>Industry Type</b>	<b>Location of Synthetic Lease Deal</b>	<b>Square Footage of the Property</b>	<b>\$ Value of the Deal</b>	<b>Life-Cycle Stage</b>
<i>AT&amp;T</i>	<i>Communications</i>	<i>East COAST??</i>	<i>800,000 (2 properties)</i>	<i>\$82.5 million</i>	<i>Mature</i>
<i>Nortec Corporation</i>	<i>Software</i>	<i>West Coast</i>	<i>160,000</i>	<i>\$45 million</i>	<i>Growth</i>
<i>Chipman Corporation</i>	<i>Computer Equipment Manufacturer</i>	<i>West Coast</i>	<i>585,000</i>	<i>\$115 million</i>	<i>Growth</i>

## **Case Study: AT&T**

### **Company Profile**

AT&T Corporation is among the world's premier voice, data and video communications companies. The company has the need for an excess of 1 billion square feet of real estate globally consisting over office and industrial type space. Over 80% of that space is owned by AT&T Corporation or one of its subsidiaries. All AT&T real estate is managed by an internal corporate real estate department consisting of over 100 employees. The company's real estate department is responsible for all real estate functions including acquisition and disposition strategy, analysis and execution; property and asset management, lease negotiations and space planning and design.

### **Choosing a Transaction Structure**

AT&T has historically preferred to buy the space it needs for operations primarily because of the vast amount of equipment that is needed in most of the facilities.

In 1999 AT&T was in the midst of a corporate restructuring process. Although the company had enjoyed domination in the telecommunications industry in the past, recent government regulations and new competition was forcing AT&T to sharpen its business operations and structure. As part of that restructuring plan, the decision had been made to relocate two business units from New York City to New Jersey to take advantage of considerably lower occupancy costs and greater access to a less expensive pool of available labor. Most of the corporate administrative departments and the entire east coast Web hosting function were now to be located in New Jersey. The corporate real estate department had selected northern New Jersey, specifically Piscataway and had identified

two buildings to house these functions. Once that work had been completed, the crucial analysis of the how best to acquire the properties began.

The real estate group within AT&T considered three viable options, a market-based lease, an outright purchase and a synthetic lease. Because of the vast amount of real estate needs of the company, the analyst among the real estate group at AT&T was very experienced and sophisticated. All types of real estate assets were evaluated by the following methods;

- Lease versus buy analysis
- NPV comparison of all alternatives using the after-tax cost of debt as the discount rate
- Budget evaluation

The lease versus buy analysis for AT&T consisted of a standard template that the real estate group has developed for its internal use. Weights were given to quantitative factors such as length of expected use, degree of specialization and expense of the internal build-out and expected need to expansion and growth. The real estate group worked with the intended end user to determine how the factors relate to one another in terms of priority. The financial part of the template consisted of evaluating cash inflows and outflows of each alternative. The main objective of the financial section of the lease versus buy analysis was to provide information on the timing of cash requirements and differences in occupancy costs.

A net present value calculation was done on each option using the after-tax cost of debt as the discount rate. The company felt that this was the appropriate rate to use because it allowed them to most accurately determine the best use of the firm's capital resources. The net present value calculations also provided a point of comparison across deal structures employed by the company to determine how each deal differed in cost.

Budgets were evaluated to determine the impact each option would have on earnings before interest and tax (EBIT) and on net income. A general review of the

capital budgets of either the subsidiary or the parent company were also performed in an effort to determine the amount of available capital and the best use of it's capital resources.

AT&T considered itself a pioneer in using synthetic leases for real estate. The first synthetic lease was used in 1995 for a property in Charlotte, NC. To date, AT&T has done ten synthetic lease deals, totaling \$860 million dollars with four deals pending for an additional \$300 million. Of this portfolio, AT&T used three different companies to construct and execute the deals, Atlantic Financial Group, Brazos River Partners and Chase Manhattan Bank. The average length of time from the initial evaluation to lease signing averaged eight weeks.

## **Results**

After review of the three options for the Piscataway, New Jersey properties, the synthetic lease alternative was selected for the following reasons;

- The transaction was innovative
- Using a synthetic leases conserved capital which was in-line with the new corporate restructuring plan
- The off-balance sheet treatment of the assets improved the company's financial ratios
- The annual expenses of occupancy were lower than the market-based lease option
- It permitted AT&T to control the asset and it's residual value
- It allowed for a potential delayed purchase of the two buildings. AT&T may opt to purchase the facilities depending on market and company conditions at the end of the 5-year lease term. In EFFECT, using a synthetic lease gives AT&T a call option to purchase in the future.

The synthetic lease provided a flexible exit strategy for the company due to the short 5-year term of the lease.

The AT&T real estate executives involved in this transaction made repeated mention of the importance of aligning the real estate function with the overall corporate objectives and strategy. At the time of this transaction, AT&T was undergoing a comprehensive restructuring plan. The company was also facing new competition and a rapidly changing business environment. As large as the company was, the amount of real estate it needed for operation required a very substantial amount of the company's capital. This synthetic lease transaction provided the space to restructure without having to spend millions of dollars. The lease term was for five years with an option to renew or purchase. AT&T intends to renew the lease for another five-year term and then purchase both properties at the expiration of that lease.

## **Case Study: Nortec Corporation**

### **Company Profile**

Headquartered on the West Coast, Nortec Corporation is a world leader in Internet security technology. The company provides a broad range of content and network security solutions to individual consumers and businesses. Nortec's brand of consumer security products leads the market worldwide in retail sales and industry awards despite intense competition within the industry.

Started in 1982, the company now uses real estate in 37 countries and employs more than 4,000 people worldwide. In 1994 Nortec moved its main manufacturing facility to Dublin, Ireland. Nortec has chosen to own its larger facilities such as the corporate headquarters and the manufacturing facilities. The smaller regional offices are either owned or leased through a traditional lease structure.

### **Choosing a Transaction Structure**

Nearly twenty years after the company was founded, Nortec had grown into a world leader within its industry. With the robust US economy and an exploding high tech industry, demand for Nortec's products was escalating beyond capacity. The company was spending millions of dollars in expanding production, R&D, and customer support facilities across the world. In 1999 Nortec had outgrown its' corporate headquarters and was looking for options. There was no doubt that the firm wanted to stay within a few miles of its current location because of the limited amount and fierce competition for skilled labor. Location was also important given that 83% of it's sales were generated by companies within the geographic location.

The real estate market in the area was also experiencing tremendous growth and very limited amounts of supply for the increased demand. Although Nortec looked for

existing space to occupy, there was nothing suitable and the decision was made to build a new facility either through outright ownership or a synthetic lease. The company did not consider leasing as an option because it planned on being in the facility long term and wanted control over their investment.

Nortec had not used a synthetic lease structure prior to this deal but the CFO had read about them and was interested in finding out if they could benefit Nortec. He engaged a real estate advisory firm that specialized in synthetic leases to prepare an analysis of the ownership versus synthetic lease alternatives. The company claimed that internally there existed no standard approach to deciding how best to structure their real estate transactions. They did recognize that real estate was not their core business even though they had very large space requirements. For this reason they often hired consultants and or real estate firms to advise and provide guidance. Internally they evaluated their current and projected capital needs as well as the product forecasts and overall economic market conditions.

The advisory firm evaluated the ownership and synthetic lease options by doing a financial analysis showing the after tax cost of both alternatives. The synthetic lease provided a significantly lower occupancy cost than the ownership option and consequently, Nortec decided to structure their new headquarters as a synthetic lease transaction.

## **Results**

The CFO attributed the decision to use a synthetic lease to the financial benefits that the structure offered. He maintained that, “utilizing a synthetic lease allowed us to reduce our rent expense by over 30%. Moreover, it provided us complete control over our facilities at a significantly reduced cost and had the best results for our company’s balance sheet”<sup>17</sup> At the time the new headquarters was needed, the company was experiencing so much growth that it needed all of its available credit and capital to keep

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<sup>17</sup> Nortec Corporation, CFO

up with their product demand and support their product lines. Their stock was trading at a very high price and investors were watching the company's financial management of this growth period very carefully. By using a synthetic lease, Nortec could preserve capital and maintain competitive financial ratios - both important outcomes for a growing company..

The synthetic lease transaction took 8 weeks from the initial analysis to when the lease negotiations were completed. The lease term was for seven years with an option to renew or purchase. Although the decision is years away, the company believed it would choose to renew the lease and put off buying the building. Nortec was in the middle of negotiating their third synthetic lease deal for a new manufacturing facility also located on the West Coast.

## **Case Study: Chipman Systems Corporation**

### **Company Profile**

Chipman Data Systems, Inc. began in 1979 as a computer manufacturer and maker of disk operating systems. In January of 1983, a venture capital firm reincorporated CDS, Inc. into Chipman Systems Corporation to design and market software and hardware used for data networks.

Chipman helped found the corporate network market with the introduction of the LAN. In 1983, Chipman Systems introduced the first LAN software based on a file server technology. Chipman was amongst several emerging companies that developed a personal computing networking system that designated one machine to manage the network and control access to shared devices, such as disk drives and printers. This marked an important and revolutionary early step in the network revolution that makes up much of today's high tech groundwork.

Today Chipman Systems has offices in 43 countries around the world. Up until 1998, both the corporate headquarters and main manufacturing facilities were located on the West Coast. In 1998 the company made the decision to relocate its corporate headquarters out of state and used a synthetic lease for the entire new corporate facility.

### **Choosing a Transaction Structure**

By the time of the surge of the high tech industry in the United States and throughout the world, Chipman Systems was a leader in networking software and systems. However, the expansion of the high tech industry, particularly on the West Coast had a significant impact on the company's growth. The majority of Chipman's real estate was located on the West Coast and was owned by the company. Chipman valued

the physical and functional flexibility that ownership of its' headquarters and manufacturing facilities afforded a growing company. The regional offices were comprised mostly of sales offices and required relatively small amounts of physical space. Almost all of these sales offices were leased through traditional lease structures.

Given the increased demand for its products, Chipman was outgrowing both its corporate offices and their manufacturing facilities. Because the company was located in an area dense with other growing high tech companies needing more space, real estate prices had become especially expensive. Chipman was looking for alternative sites and was attracted to the idea of relocating out of state in part for the new state's high quality of living and in part by the attractive package the governor's economic development staff was offering. Chipman also recognized that although a significant portion of its current headquarter employees would relocate with the company the new state offered a large supply of less expensive workers. The decision was made to move all of its' corporate functions to the new state. This freed up space for manufacturing, R&D, and product support groups, which were all remaining in the original location.

The corporate real estate and corporate services group within Chipman Systems managed this entire evaluation, negotiation and relocation process for the company. As part of the relocation decision, Chipman, along with economic development staff from the new state looked at several alternatives for the construction of the new headquarters. Four options were considered, a sale-leaseback, ownership, a traditional lease and a synthetic lease. Both the sales-leaseback and the conventional lease were to be build-to-suit projects. The state was offering a variety of incentives to Chipman as part of their relocation.

Prior to this event, the internal real estate group had not performed this level of analysis of different deal structures. It was considered company policy to lease the regional sales offices while owning the large headquarter and manufacturing facilities. The reason given for leasing the regional offices was predominantly to provide maximum flexibility and ease of disposition because local space requirements seemed to change

frequently. The corporate and manufacturing space was owned for a variety of reasons including control over use of space, pride of ownership, tax advantages of owning real estate and investment in an appreciating asset. To assist Chipman's real estate department Chipman hired a variety of outside firms such as legal, accounting, tax specialists, and real estate analyst. The real estate company that was engaged to perform the financial analysis considered the after tax cash flows of each alternative and the resulting internal rate of return and net present value results. They carefully reviewed how each option would be recorded for financial accounting purposes and would ultimately affect Chipman's financial ratios.

## **Results**

After four months of analysis, the company selected the synthetic lease option. According to Chipman, the factors that made the synthetic leases the optimal choice listed by order of importance were;

- Least costly alternative taking into account all aspects of the investment
- Conserved the company's capital and allowed that resource to be used for profit generating uses.
- Provided ownership-like control of the asset
- Made maximum use of the incentives being offered by the new state. (the specifics of the incentive package were unavailable.)

A Chipman real estate executive said, "this lease freed up the full original line of credit to invest in R&D activities. We didn't have to divert millions of dollars for bricks and mortar."<sup>18</sup> For Chipman this synthetic lease deal was a small part of a large corporate facilities plan that involved moving a significant portion of its operations out of state. The synthetic lease was in no part the impetus for the move, but it did support the company's goals by conserving company cash and providing substantial control over the new facilities.

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<sup>18</sup> Chipman Corporation, Treasurer

## VIII. Analysis of the Case Studies

The three case studies that have been presented add a critical piece to evaluating the use and value of synthetic leases to corporate America.

Two out of the three companies are involved in the high tech computer industry. Does this suggest that companies within this trade are better suited for synthetic leases? Because a complete list of companies using synthetic leases does not exist, I do not believe there is enough data to support such a claim. However, I would propose that there are certain characteristics that high tech companies tend to have in common that do in fact make synthetic leases particularly attractive.

- Because of the nature of their business, they often require a significant amount of space for both manufacturing and R&D activities.
- The high tech industry is relatively new and most of the companies are younger, publicly traded companies. This puts a great amount of pressure on the firms to use what limited amount of capital the company raised for its core business development and to provide investors with significant returns in an effort to accumulate stock value.
- Because most high-tech firms are publicly traded, the companies must pay special attention to their financial statements and ratios. The off-balance sheet nature of synthetic leasing provides a significant boost to a firm's financial statements.
- The majority of high tech firms are located on the west coast. Again it is not reasonable from this research study to make the broad assumption that west coast firms are less risk adverse. However, most of the suppliers of synthetic leases are located on the west coast and assert that selling the idea of synthetic

leases is considerably harder on the east coast than the west coast.<sup>19</sup> Perhaps it is nothing more than a follow-the-leader mentality that started when Cisco Systems, one of the most revered west coast, high tech firms was among the first to use a synthetic lease

- High-tech firms have also experienced tremendous growth in the recent years. Without question, synthetic leases allow companies the ability to add more space without having to invest a large amount of capital. This frees up the needed cash for production and staff increases.

The request for anonymity by two of the three companies is also a significant observation to surface from the case study research. For what reasons would a publicly traded company not want to use its name as part of a synthetic lease research study? When asked, the companies were straightforward, saying one of the important features of synthetic leases is they way it enhances their financial ratios and financial statements. For financial accounting practices, the leases are recorded off-balance sheet thus greatly enhancing the financial statements of the firm. The concern is that when investors and analyst learn of the firms' use of the synthetic lease structure and how they are treated from a financial accounting standpoint, the market would assign less value to the firm's financial ratios. This relates to the discussion within Section II on the impact of the capital markets and real estate decision-making. Do analyst and investors catch the off balance sheet treatment of a synthetic lease and re-assess the company's financial ratios and statements? The simple answer to this depends on the level of sophistication and experience of the analyst or investor. Analysts working full-time on Wall Street that have either real estate experience or internal real estate analyst will probably not miss the lease treatment while other part time traders or less experienced analyst might very well fail to recognize the potential impact. As synthetic leases become more popular and better understood, using them as a tool to manipulate financial ratios and statements will become less of an effective strategy.

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Senior Vice President, West Coast Synthetic Lease Provider

Several of the reasons for using a synthetic lease were shared by each of the case study companies; the preservation of the company's capital so that it might be spent on the core business development, the ability to have ownership-like control of the asset during its useful life and at the time of disposition, an overall lower cost of occupancy and the off-balance sheet treatment that improved the company's financial ratios. Three of these four reasons are purely financially motivated, (preserving capital, lower occupancy costs and improved financial ratios) while the third factor as both financial and non-financial aspects. This finding is in-line with the previous suggestion that greatest determinant of the way a company structures its real estate transactions is based on the economics of the deal. The nature of the deal, ownership, traditional leasing or synthetic leasing seems not to matter. What matters is which option provides the most financial benefit to the company given the company's current situation.

Taken as a whole, what information can be derived by these case studies that will support a conclusion of whether or not synthetic leases are a viable third option to corporations considering the lease/buy decision? The key points that resulted from the examples are;

- Synthetic leases are used by companies that are experiencing growth or restructuring as a means of preserving credit and capital resources that are better invested in core business development and growth activities
- Firms place a high value on the ownership-like control that synthetic leases provide
- Synthetic leases are used because of the off-balance sheet treatments of the corporate assets that enhance the firms' financial statements and ratios
- Synthetic leases can provide a lower cost of occupancy than traditional leasing or ownership

These four points were shared by each of the companies used in the case study analysis and will support the concluding thoughts on using synthetic leases within the corporate real estate structure.

## **X. Conclusions**

As much as corporations have changed over the past decades, the issue of whether it is best to own or lease the space it needs still challenges corporate America. This quandary remains at the center of all corporate real estate decisions. The case studies, representing three very successful, innovative and growing firms all struggled with the age-old basic lease/buy decision. What can be learned from the research and the case study analysis is that there are several common objectives. When it comes to buying or leasing office space, a company must decide on its own individual merits. No single financial test can provide the final answer. The company must examine a broad range of cost benefits and related risks before reaching a decision. It must assess both its current and future organizational and financial condition and incorporate this information into the decision making process.

The main reason for buying real estate rather than leasing appears to be the acquisition of an asset. The asset's value must be realized and must be large enough to offset the usually greater cost of buying over leasing and the risks associated with owning. Consideration must be given to opportunity cost, return on investment, finance charges, future space needs, getting the market rate for rent, building maintenance, the potential for capital appreciation, and corporate identity. Leasing frees a company from the heavy responsibility of ownership and can often provide flexibility in moving in and out. But the costs or benefits that apply to either option are as individual as the companies making the decision. What one firm views as a benefit, another firm interprets as a disadvantage. The only way to come up with the correct answer to the lease/buy decision is to thoroughly consider all qualitative and quantitative factors in the most relevant way to the company making the lease/buy decision.

It is partly because the line between ownership and leasing is not clear that synthetic leases have come into existence. Companies search for another alternative, a blend of the owning and leasing. The synthetic lease is a hybrid form of structuring real estate offering some of the benefits of ownership and some benefits of leasing as

described in section 6. The question that persists is whether or not synthetic leases actually do offer firms an effective mixture of ownership and leasing.

To answer this question, the research began by exploring the issues of the traditional lease/buy decision. It was necessary to start at that point in order to understand what factors were brought into a firm's decision making process and how each company undertook the analysis. With this knowledge, new types of real estate structures besides the synthetic lease were introduced such as REITs and sale-leasebacks. A brief overview of these structures gave some insight into other kinds of deal structures that modern day finance and real estate has created. In section 4, 5, 6 and 7 synthetic leases were presented. Three examples of companies using synthetic leases were discussed in section 8. From these case studies, 4 of the most compelling reasons for using synthetic leases emerged,

- Synthetic leases are used by companies that are experiencing growth or restructuring as a means of preserving credit and capital resources that are better invested in core business development and growth activities
- Firms place a high value on the ownership-like control that synthetic leases provide
- Synthetic leases are used because of the off-balance sheet treatments of the corporate assets that enhance the firms' financial statements and ratios
- Synthetic leases can provide a lower cost of occupancy than traditional leasing or ownership

These four benefits to synthetic leases, however, do not answer whether or not synthetic leases are an effective hybrid option for firms. This question, however, can be answered just as the question of whether it is best to lease or own..... it depends. There will never be one blanket answer to whether a synthetic lease offers companies an ideal mixture of owning/leasing. It depends completely on the company.

Some questions to ask in deciding if a synthetic lease is right for a company include:

1. Is the company prepared to make a long-term commitment to the property?
2. Does the firm want/need to have a level of control that is equivalent to ownership?
3. Would the company be willing to own the asset?
4. Is your credit rating better than the prospective landlord's?
5. Is there another corporate investment alternative that would produce a higher return?
6. Does the company expect significant changes in growth in the future?
7. Is there a link between the business and property strategy of the company that this asset fits into?

Unfortunately many of these questions cannot be answered by easy calculation – no matter how sophisticated the company's financial models are. In grappling with the lease/buy/synthetic question, we are not dealing with an absolute science. Guessing the future of the firm is pure speculation. Even many of the financial analysis involved are subject to some level of guesswork. The implication is that a company can perform all of the financial and non-financial analysis comparing ownership, leasing or synthetic leasing and derive and select the optimal mix of financial and non-financial results given the assumptions and current strategy of the firm. Financial analysis alone, cannot select the strategy.

Synthetic leases do have a significant amount of uncertainty and risk attached to them. If the FASB or IRS reviews the transaction type and rules that synthetic leases and the way they have been treated for either tax or accounting purposes is no longer acceptable. Synthetic leases are also a short-term option. The typical lease terms of the three case studies were less than ten years, which introduces a level of uncertainty of what to do upon lease expiration. If business is good and the real estate market is strong, and the company has the resources to buy the property then the built in call option to purchase is valuable. On the other hand the economy is weak, the option to purchase might be above market rate and of a disadvantage to the firm. If the company doesn't have the resources to buy the asset upon lease expiration and the lessor does not wish to

renew the lease, the company must go through the process and expense of re-locating. The short-term nature of synthetic leases can be an advantage or a disadvantage and the firm has few ways of predicting the future.

Yes, a synthetic lease is a viable option for companies. Like any other tool, they offer benefits and drawbacks that must be evaluated as part of any decision making process. It is important to assess the priorities and balance short-term needs against the long-term commitments of the transaction type. But they can offer an attractive mixture of ownership and leasing.

## *Exhibit 1*

### **Financial Accounting Standards Board (FASB) Rules**

#### **SFAS 13**

Statement of Financial Accounting Standards (SFAS) No 13 required that all of the following requirements must be met for the lessee to receive off-balance sheet accounting treatment:

- There can be no automatic transfer of title to the lessee at the end of the lease term
- Any option to purchase the property by the lessee cannot be at a “bargain” purchase price
- The term of the lease cannot be 75% more than the economic useful life of the leased property.
- The present value of the minimum rental payments cannot be 90% or more of the fair market value of the property, determined as of the date of the inception of the lease.

#### **SFAS 98**

To obtain the principal benefits of a synthetic lease, a transaction involving real estate should be structured taking into account SFAS 98, which applies to sale-leaseback transactions involving real property. Under SFAS 98, a lessee that owns real property and sells it to the lessor cannot have any “continuing involvement” after entering into the lease other than in a “normal” leaseback arrangement. SFAS 98 cites the following examples of continuing involvement that would not be allowed:

An option or obligation to purchase the property by the lessee

A guarantee by the lessee of the lessor’s investment or return on investment

If SFAS 98 applies to the transaction, the lessee would be deprived of some of the principal benefits of a synthetic lease. To avoid the application of SFAS 98, the lessee cannot own or acquire title to the property before the inception of the synthetic lease. As noted above, the third party seller should convey title to the property directly to the lessor. If the lessee owns title to the land, it is still possible to structure a synthetic lease for improvements if the lessee ground leases the land to the synthetic lease lessor. However, the land would remain on the lessee’s balance sheet in that case.

#### **EITF 90-15**

The Emerging Issues Task Force (EITF) of FASB has addressed circumstances under which the lessor and the lessee are “consolidated” for financial accounting purposes. Under EITF 90-15, the lessee will not receive off-balance sheet accounting treatment if all of the following three tests are met:

1. Substantially all of the activities of the lessor involve assets that are leased to the lessee
2. The lessee bears substantially all of the residual risks and enjoys substantially all of the residual benefits of the leased assets

3. The lessor has not made any substantial investment that is at risk during the term of the lease

EITF 90-15 proposes 3% as the minimum equity that qualifies as a “substantive” investment. Accordingly, the typical synthetic lease is structured with a 3% equity contribution. Because at least one of the three tests are not satisfied, the synthetic lease qualifies for off-balance sheet treatment under EITF 90-15.

#### **EITF 96-21**

EITF 96-21 limits the use of non-recourse debt by lessor to fund its minimum equity contribution. It also provides that structuring fees paid by the lessee to the owners of the lessor must be taken into account for the purposes of applying the 90% test under SFAS 13 as mentioned previously.

#### **EITF 97-1**

EITF 97-1 limits the circumstances in which the lessee can indemnify the lessor for pre-existing environmental conditions. If the risk of loss is not remote, such indemnifications could cause the deal to be treated as a sale-leaseback under FAS 98. In addition, EITF 97-1 describes the circumstances in which the lease arrangement can include defaults that are not related to the lessee’s use of the property, such as defaults based on financial performance. Such defaults, among other things must be customary in financing arrangements and there must be no indication at the commencement of the lease that a default will occur.

#### **EITF 97-10**

EITF 97-10 provides that a lessee that bears substantially all of the construction period risks will be treated as the owner of the assets during the construction period. Under these circumstances, the provisions of SFAS 98 would apply so the transaction is treated as a sale-leaseback upon completion of construction. EITF 97-10 applies a test similar to the 90 % recovery of investment test of SFAS 13 and includes in the lessee’s maximum guarantee any amounts that the lessee is or can be required to make during construction. For example, those amounts include construction amounts guaranteed by the lessee, equity investments or loans to the lessor, any obligation to purchase the project or to fund the cost overruns, rent paid during the construction period and indemnities or guarantees to the lessor. Certain of these circumstances may result in the lessee being treated as the owner even if the 90% test is met.

#### ***A Note on Structuring for Accounting Rules***

Synthetic leases are designed to comply with the accounting rules described above. Although the lessee has an option to purchase the property, it is not intended to be a bargain purchase price, and the transfer is not automatic. In addition, the lessee can elect to return the property to the lessor at the end of the lease term in lieu of purchasing the property.

The contingent rent payment or guaranteed maximum amount paid by the lessee upon termination of the lease is calculated to be an amount that, when added to the rent paid

during the lease term, will not exceed the 90% limitation of SFAS 13. This contingent rent payment is approximately 85 to 87% of the cost of the facility. In real estate transactions, the relatively short term of most synthetic leases complies with SFAS 13.

To avoid the limitations of SFAS 98 for real estate transactions, the lessee should not acquire title to the property before the inception of the lease; title should be acquired by the lessor. However, a synthetic lease can be structured using a ground lease if the lessee owns the land.

The first test of EITF 90-15 is met in a synthetic lease if the transaction is structured using a special purpose entity (SPE), as described below, as the lessor. In addition, the triple-net, bond type lease meets the second test. However the third test can be avoided if the arrangement is structured so there is an equity investment of 3%, the minimum amount necessary to avoid consolidation of the lessor and the lessee for accounting purposes.

Synthetic lease are also evolving to take into account recent accounting announcement such as EITF 96-21, 97-1 and 97-10. Any new accounting policies on consolidation could also affect the structuring of a synthetic lease.

*EXHIBIT 2*

**SAMPLE SYNTHETIC LEASE**

This document prepared by and  
when recorded, return to:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Attention: \_\_\_\_\_

MEMORANDUM OF SITE LEASE NO. \_\_\_\_\_\*

THIS MEMORANDUM OF SITE LEASE NO. \_\_\_\_ (this "Memorandum") dated as of \_\_\_\_\_, 19\_\_, between \_\_\_\_\_, a banking corporation, having its principal office at \_\_\_\_\_, not in its individual capacity except as otherwise expressly stated herein, but solely as Owner Trustee, as the Lessor and as mortgagee for the benefit of the Tranche B Lenders, Tranche A Lenders and the Owner Participants (in each case, as defined below) (the "Lessor") and \_\_\_\_\_, a \_\_\_\_\_ corporation, having a principal office at \_\_\_\_\_, as the Lessee and as mortgagor (the "Lessee").

WITNESSETH:

WHEREAS, the Lessor is the owner in fee simple of the land described on Exhibit A attached hereto (the "Subject Land");

WHEREAS, the Lessor wishes to lease the Subject Land to the Lessee and the Lessee wishes the lease the Subject Land from the Lessor;

NOW THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree to enter into this Memorandum, as follows:

1. Certain Terms. Capitalized terms used but not otherwise defined in this Memorandum have the meanings specified in the Site Lease No. \_\_\_ dated as of the date hereof (as amended, restated, supplemented or otherwise modified from time to time, the "Site Lease"), between the Lessee and the Lessor; and the rules of interpretation specified in the Site Lease shall apply to this Memorandum.

Subject Land. Attached hereto as Exhibit A is the description of the Subject Land. Effective upon the execution and delivery of this Memorandum by the Lessor and the Lessee, the Subject Land shall be subject to the terms and provisions of the Site Lease. Subject to the terms and conditions of the Site Lease, the Lessor hereby leases the Subject Land to the Lessee for the Term (as defined below) of the Site Lease, and the Lessee hereby agrees, expressly for the direct benefit of the Lessor, to lease the Subject Land from the Lessor for the Term.

Lease Term. The term of the Site Lease (the "Term") shall begin on the date hereof and shall end on \_\_\_\_\_, 19\_\_; unless the Term with respect to the Subject Land is renewed or earlier terminated in accordance with the provisions of the Site Lease or the other Operative Documents. For and in consideration of good and valuable consideration paid by the Lessee to the Lessor as described in the Site Lease, the Lessor hereby grants to the Lessee the right to purchase the Subject Land or to market and sell the Subject Land during the Term of the Site Lease on the terms set forth in the Site Lease.

4. Ownership of the Properties. (a) It is the intent of the parties hereto that for all purposes other than financial accounting purposes, including state, real estate, commercial law, bankruptcy and federal, state and local income tax purposes, the transaction contemplated hereby is a financing arrangement and preserves ownership in the Properties in the Lessee.

(b) It is the intent of the parties hereto that (i) the obligations of the Lessee under the Leases to pay Basic Rent and Supplemental Rent or Lease Balance in connection with any purchase of the Properties pursuant to the Leases shall be treated as payments of interest on and principal of, respectively, loans from the Lessor, the Owner Participants and the Lenders to the Lessee, and (ii) the Site Lease grants a security interest and mortgage or deed of trust or lien, as the case may be, on all of the Land demised under the Site Lease (including the Subject Land) to the Lessor to secure the Lessee's Participants for the acquisition of all of the Land demised under each of the Site Leases (corresponding to the value of such Land as indicated on the Appraisal for each Property) under the Leases and the other Operative Documents, together with interest thereon and all other amounts payable under the Operative Documents in connection therewith.

(c) Specifically, without limiting the generality of clause (b) of this Section 4, the Lessor and the Lessee intend and agree that with respect to the nature of the transactions evidenced by the Leases in the context of the exercise of remedies

under the Operative Documents, including, without limitation, in the case of any insolvency or receivership proceedings or a petition under the United States bankruptcy laws or any other applicable insolvency laws or statute of the United States of America or any State or Commonwealth thereof affecting the Lessee, the Lessor, the Owner Participants or any Participant or any enforcement or collection actions, the transactions evidenced by the Leases are loans made by the Owner Participants and the Lenders as unrelated third party lenders to the Lessee secured by the Properties (it being understood the Lessee hereby mortgages and warrants and grants a security interest in the Subject Land (consisting of a fee mortgage with respect to the Subject Land) to the Lessor to secure all Loans and Certificate Amounts advanced by the Participants for the acquisition of all of the Land demised under each of the Site Leases (corresponding to the value of such Land as indicated on the Appraisal for each Property), in the maximum principal amount of \_\_\_\_\_, (\$ \_\_\_\_\_), having a maturity date of \_\_\_\_\_, 19\_\_\_\_, as such maturity date may be extended in accordance with the provisions of the Master Lease or the other Operative Documents, together with interest thereon, and all other amounts payable under the Operative Documents in connection therewith, effective on the date hereof).

(d) Specifically, but without limiting the generality of clause (b) of this Section 4, the Lessor and the Lessee further intend and agree that, for the purpose of securing the Lessee's obligations for the prepayment of the above-described loans from the Owner Participants and the Lenders to the Lessee, (I) the Leases shall also be deemed to be security agreements and financing statements within the meaning of Article 9 of the Uniform Commercial Code and real property mortgages or deeds of trust and (a) pursuant to Section 9-402 of the Uniform Commercial Code, the Lessee authorizes the Lessor to file financing statements with respect to the Land (including the Subject Land) without the signature of the Lessee in such form and in such filing offices as the Lessor reasonably determines appropriate to perfect the security interests of the Lessor provided for hereby; (b) the Lessor and the Lessee agree, to the extent permitted by law, that this Memorandum of Site Lease No. \_\_\_\_\_ shall constitute a financing statement filed as a "fixture filing": within the meaning of Sections 9-313 and 9-402 of the Uniform Commercial Code; (ii) the conveyance provided for hereby and in Article \_\_\_\_\_ of each Site Lease shall be deemed to be a grant by the Lessee to the Lessor of a mortgage lien and security interest in all of the Lessee's rights, title and interest in and to the Land (including the Subject Land) and all proceeds of the conversion, voluntary or involuntary, of the foregoing into cash, investments, securities or other property it being understood that the Lessee hereby mortgages and warrants and grants a security interest in each property (including the Subject Land) to the Lessor to secure all Loans and Certificate Amounts advanced by the Participants for the acquisitions of all of the Land demised under each of the Site Leases (corresponding to the value of such Land as indicated on the Appraisal for each Property), together with interest thereon, and all other amounts payable under the Operative Documents in connection therewith); (iii) the possession by the Lessor or any of its agents of notes and such other items of property as constitute instruments, money, negotiable documents or chattel paper shall be deemed to be

"possession by the security party" for purposes of perfecting the security interest pursuant to Section 9-305 of the Uniform Commercial Code; and (iv) notifications to Persons holding such property, and acknowledgments, receipts or confirmations from financial intermediaries, bankers or agents (as applicable) of the Lessee shall be deemed to have been given for the purpose of perfecting such security interest under Applicable Law. The Lessor and the Lessee shall, to the extent consistent with the Leases, take such actions and execute, deliver, file and record such other documents, financing statements, mortgages and deeds of trust as may be necessary to ensure that, if the Leases were deemed to create security interests in the Properties in accordance with this Section 4, such security interest would be deemed to be perfected security interests of first priority under Applicable Law and will be maintained as such throughout the Term.

(e) As additional security for the payment of all amounts secured by this Memorandum, insurance premiums, taxes and assessments, at the time and in the manner herein agreed, and for the performance of the covenants and agreements herein contained, pursuant to [add citation to appropriate state law], the Lessee does hereby sell, assign, transfer and set over unto the Lessor herein, its successors and assigns, all the rents, profits and income under any lease or leases of the Subject Land (including any extensions, amendments or renewals thereof), whether due or to become due, including all such leases in existence or coming into existence during the period this Memorandum or the Site Lease is in effect. This assignment of rents shall run with the land and be good and valid as against the Lessee herein or those claiming by, under or through the Lessee, from the date of the recording of this instrument. The collection of rents, profits and income from the Property by the Lessor shall in no way waive the right of the Lessor to foreclose the mortgage lien created hereby and in Article \_\_\_\_ of the Site Lease in the event of any default by the Lessee, and this assignment shall continue to be operative during the foreclosure or any other proceedings taken to enforce this Memorandum or the Site Lease. In the event of a sale or foreclosure which shall result in a deficiency, this assignment shall stand as security during the redemption period for the payment of such deficiency. This assignment is given as collateral security only and shall not be construed as obligating the Lessor to perform any of the covenants or undertakings required to be performed by the Lessee contained in any such assigned leases.

In the event of default in any of the terms or covenants of this Memorandum or the Site Lease, the Lessee shall, upon demand therefore made by the Lessor who shall thereafter collect the rents, profits and income therefrom, rent or lease said Property or portion thereof upon such terms and for such time as the Lessor may deem best, terminate any tenancy and maintain proceedings to recover rents or possession of the proceeds of such rent and income for the following purposes: (a) preservation of the Subject Land; (b) payment of taxes; (c) payment of insurance premiums; or (d) payment of installments of interest and principal due under the terms of the Obligations.

In the event that the Lessee fails, refuses or neglects to deliver or surrender such possession, the Lessor shall be entitled to the appointment of a receiver of the Subject Land and of the earnings, income, issue and profits thereof, with such powers as the court making such appointment may confer. The Lessee agrees to execute and deliver to the Lessor assignments of rents on all future leases on the Subject Land during the term of this Memorandum, such assignments to be in form and substance satisfactory to the Lessor. Any default by the Lessee under the terms and/or conditions of any such assignment shall be a default under the terms and conditions of this Memorandum, entitling the Lessor to exercise any and all of the rights and remedies provided by this Memorandum. If the Lessee shall fail to perform or discharge any of the obligations, covenants or agreements required to be performed by it under any such assignment of lease, the Lessor may elect to perform the same; any sums which may be so paid out by the Lessor, including the cost, expenses and attorneys' fees paid out in any suit affecting the same, shall bear interest at the default rate provided in the Notes, from the dates of such payments, shall be paid by the Lessee to the Lessor upon demand and shall be deemed a part of the Obligations hereby secured and recoverable as such in all respects. The Lessee shall assign to the Lessor, upon request, as further security for the Obligations secured hereby, the Lessee's interest in all agreements, contracts, licenses and permits affecting the Subject Land, such assignments to be made by instruments in form satisfactory to the Lessor; but no such assignment shall be construed as a consent by the Lessor to any agreement, contract, license or permit so assigned, or to impose upon the Lessor any obligations with respect thereto.

(f) Failure of the Lessee to pay any taxes, assessments or governmental charges levied or assessed against the Subject Land, or any part thereof, or any installment of any such tax, assessment or charge, or any premium upon any such tax, assessment or charge, or any premium upon any policy of insurance covering any part of the Subject Land, at the time or times such taxes, assessments, charges, installments thereof or insurance premiums are due and payable, shall constitute waste, and in accordance with the provisions of [citation to state law], shall entitle the Lessor to exercise the remedies afforded by such Act. Payment by the Lessor for and on behalf of the Lessee of any such delinquent tax or insurance premium properly payable by the Lessee under the terms of this Memorandum or the Site Lease, shall not cure the default herein described nor shall it in any manner impair the Lessor's right to the appointment of a receiver on account thereof. Upon the happening of any such acts of waste and on proper application made therefore by the Lessor to a court of competent jurisdiction, the Lessor shall forthwith be entitled to the appointment of a receiver of the Subject Land and of the earnings, income, issues and profits thereof, with such powers as the court making such appointment shall confer; the Lessee hereby irrevocably consents to such appointment and waives notice of any application therefore.

5. Power of Sale. Without limiting any other remedies set forth herein, in the event that a court of competent jurisdiction rules that the Site Lease constitutes a mortgage, deed of trust or other secured financing with respect to the Subject Land

as is the intent of the parties pursuant to Article \_\_\_\_ of the Site Lease, then the Lessor and the Lessee agree that notwithstanding anything to the contrary contained herein, the Lessor is authorized and empowered to sell or cause to be sold the Subject Land and to convey the same to the purchaser thereof, pursuant to the provisions of [citation to state law], as amended, pertaining to foreclosure by advertisement, which statute does not require that the Lessee be personally notified of such sale or that a judicial hearing be held before the sale is conducted. The Lessor may direct the sale of the Subject Land in one parcel or several parcels and in any order that the Lessor may elect in its sole discretion. The Lessee further agrees that the Lessor is authorized and empowered to retain out of the sale proceeds monies as are due under the terms of this Memorandum, including but not limited to costs and charges of such sale, and attorney's fees and expenses, rendering the surplus monies, if any, to the Lessee.

**WARNING: THIS MEMORANDUM CONTAINS A POWER OF SALE AND UPON DEFAULT MAY BE FORECLOSED BY ADVERTISEMENT. IN FORECLOSURE BY ADVERTISEMENT AND THE SALE OF THE SUBJECT LAND IN CONNECTION THEREWITH, NO HEARING IS REQUIRED AND THE ONLY NOTICE REQUIRED IS TO PUBLISH NOTICE IN A LOCAL NEWSPAPER AND TO POST A COPY OF THE NOTICE ON THE SUBJECT LAND.\*\***

**WAIVER: THE LESSEE WAIVES ALL RIGHTS UNDER THE CONSTITUTION AND LAWS OF THE UNITED STATES AND UNDER THE CONSTITUTION AND LAWS OF THE STATE OF \_\_\_\_\_ TO A HEARING PRIOR TO SALE IN CONNECTION WITH ANY FORECLOSURE BY ADVERTISEMENT AND ALL NOTICE REQUIREMENTS EXCEPT AS SET FORTH IN THE STATUTE PROVIDING FOR FORECLOSURE BY ADVERTISEMENT.\*\*\***

Upon the occurrence of a Lease Event of Default, the Lessor, in lieu of or in addition to exercising any power of sale hereinabove given, may proceed by a suit or suits in equity or at law, whether for a foreclosure hereunder, or for the sale of the Land (including without limitation the Subject Land), or against the Lessee on a recourse basis for the Lease Balance, or for the specific performance of any covenant or agreement contained herein or in the Site Lease or any other Lease or in and of the execution of any powers granted herein or in the Site Lease or in any other Lease, or for the appointment of a receiver pending any foreclosure hereunder or the sale of the Land (including without limitation, the Subject Land), or for the enforcement of any other appropriate legal or equitable remedy.

6. Ratification. The terms and provisions of the Site Lease are hereby ratified and confirmed and remain in full force and effect. In the event of any conflict between the terms of the Site Lease and the terms of this Memorandum, the terms of the Site Lease shall control.

7. GOVERNING LAW. THE SITE LEASE AND THIS MEMORANDUM SHALL BE GOVERNED BY, AND CONSTRUED

AND INTERPRETED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF \_\_\_\_\_ WITHOUT REGARD TO CONFLICTS OF LAW PRINCIPLES, EXCEPT AS TO MATTERS RELATING TO THE CREATION OF THE LEASEHOLD ESTATES THEREUNDER AND THE EXERCISE OF RIGHTS AND REMEDIES WITH RESPECT THERETO, WHICH SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAW OF THE STATE IN WHICH THE SUBJECT LAND IS LOCATED. WITHOUT LIMITING THE FOREGOING, IN THE EVENT THAT THE SITE LEASE IS DEEMED TO CONSTITUTE A FINANCING, WHICH IS THE INTENTION OF THE PARTIES, THE LAWS OF THE STATE OF \_\_\_\_\_, WITHOUT REGARD TO CONFLICTS OF LAWS PRINCIPLES, SHALL GOVERN THE CREATION, TERMS AND PROVISIONS OF THE INDEBTEDNESS EVIDENCED THEREBY, BUT THE LIEN CREATED THEREBY AND HEREBY AND THE CREATION AND THE ENFORCEMENT OF SAID LIEN SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAW OF THE STATE IN WHICH THE SUBJECT LAND IS LOCATED.

8. Counterpart Execution. This Memorandum may be executed in any number of counterparts and by each of the parties hereto in separate counterparts, all such counterparts together constituting but one and the same instrument.

9. Future Advances. In the event a court of competent jurisdiction rules that this instrument constitutes a mortgage, deed of trust or other secured financing as is the intent of the parties pursuant to Section 4 hereof, then this instrument will be deemed given to secure not only existing financing, but also future advances made pursuant to or as provided in the Site Lease, whether such advances are obligatory or to be made at the option of the Lessor, or otherwise, to the same extent as if such future advances were made on the date of execution of this instrument, although there may be no advance made at the time of execution hereof, and although there may be no financing outstanding at the time any advance is made. To the fullest extent permitted by law, the lien of this instrument shall be valid as to all such amounts, including all future advances, from the time this instrument is recorded. Notwithstanding anything in this instrument to the contrary, although the amount of the financing secured by this instrument may increase or decrease from time to time, the maximum principal amount of the financing secured by this instrument at any one time shall not exceed \_\_\_\_\_ Dollars (\$ \_\_\_\_\_), which amount shall be payable as set forth in the Site Lease, for the matters described in Section 4 hereof, and in any event the final payment shall be payable no later than \_\_\_\_\_, 19\_\_\_\_, unless such date is extended or earlier terminated in accordance with the provisions of the Site Lease, the Master Lease or other Operative Documents, plus all costs of enforcement and collection of this instrument, the Site Lease and the other Operative Documents, plus the total amount of any advances made pursuant thereto to protect the collateral and the security interest and lien created hereby, together with interest on all of the foregoing as provided in the Operative Documents.

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