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Overview of Synthetic Leases Under ASC 842

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A synthetic lease is a credit-based lease financing structure for real estate, equipment, or both. Synthetic leases have been around since the early 1990's and have become increasingly popular under the new lease accounting standard, ASC 842. For companies that report under the International Financial Reporting Standards, IFRS 16 makes the reporting benefits of synthetic leases now possible, and synthetic lease activity for companies that report under IFRS is just beginning.

The synthetic lease is an accounting-driven financing solution used for build-to-suit projects or acquisitions. The synthetic lease is structured to comply with operating lease treatment per ASC 842 (though late-stage conversion to finance lease recognition is possible for companies that prefer this EBITDA-neutral reporting outcome) while avoiding control that will cause sale/leaseback accounting to apply. The corporate lessee in the synthetic lease is treated as the owner for tax and other purposes.

To qualify for a synthetic lease today a company must have: 1. an investment grade rating, 2. demonstrate financial strength equivalent to an investment grade rating, or 3. have financial statements strong enough to support unsecured borrowing. The most common form of synthetic lease is structured much like a syndicated bank term loan or revolver (more like a term loan for an acquisition and a revolver for a build-to-suit project). The lessor and lender participants in a synthetic lease are drawn from global, domestic, and super-regional banks active in syndicated corporate loans. Longer-term, fixed-rate synthetic leases are possible, often using debt from life insurance companies, but these structures increase rent and reduce reporting benefits compared to a shorter-tenor, bank-funded synthetic lease. In our experience, corporate clients overwhelmingly prefer bank-funded synthetic leases when presented with analysis comparing the two alternatives.

Synthetic leases are efficient solutions for build-to-suit projects. The synthetic lease provides 100% financing of all project costs and can include FF&E items not typically funded by conventional real estate capital structures. For acquisitions, the synthetic lease can fund the purchase and any costs for necessary property improvements. No rent is paid or recognized for reporting purposes by the lessee during the construction period, offering significant benefits compared to direct ownership by the company. The lease commences at the end of any construction period, at which point cash rent begins, reported rent is recognized, and the initial balance sheet impact as a right-of-use asset and lease liability is sized and reported.

Synthetic lease rent payments for real estate are typically interest-only, resulting in rent that is significantly lower than payments under leases associated with other capital structures. At the end of synthetic the lease term the lessee must choose from 3 options:

1. purchase the property (including the right to assign the purchase to a 3rd party),
2. negotiate a renewal of the synthetic lease with the lessor and lenders, or
3. vacate and pay-off the residual value guarantee amount or arrange a sale on behalf of the lessor and lenders.

Options 1 and 2 are based upon the outstanding principal balance. Under Option 2, the rate in a renewed synthetic lease will be based on rates and spreads at the time of the renewal. In other words, the cost basis in the property is pre-determined and typically equal to the outstanding principal balance, while the financing rate in the synthetic will be subject to market conditions at the time of the renewal – typical of most corporate debt instruments.

Option 3 assumes the lessee no longer has use for the asset, and this is where the risk in a synthetic lease comes into play for both lessee and lessor. Contractually, the lessee can simply terminate the synthetic lease, pay the full residual value guarantee amount (discussed below), and walk away from the asset. However, this rarely makes economic sense for the lessee. Instead, the lessee can arrange a sale to a third party on behalf of the lessor and lenders. The lessee will retain 100% of sale proceeds in excess of the outstanding principal balance, but is exposed to a majority of any losses. This profile of risk and reward of ownership drives the tax treatment in a synthetic lease.

Under ASC 842 the amount capitalized as a right-of-use asset and lease liability is the PV of rent plus any portion of the residual value guarantee (the obligation the lessee makes as a condition of the synthetic lease) equal to a loss that the lessee believes is probable. The result is that the PV of rent only, and not the guaranteed residual value amount, is capitalized onto the balance sheet. This is initially determined at lease commencement.

Achieving the unique accounting treatment of a synthetic lease requires, among other things, that the PV of the rent plus any probable loss from the residual value guarantee must be less than 90% of the fair value, with fair value often being the cost basis for the real estate. Passing the 90% test means that the lessee takes a first-loss position that is typically between 80% and 85% of the principal amount as its residual value guarantee. This is the maximum amount the lessee can lose in a sale. The lessor in the synthetic lease must take the remainder of any loss from a sale.

Synthetic leases are best suited for larger assets that are core to the business. Therefore, it is highly unlikely that a lessee in a synthetic lease would conclude at lease commencement that it: 1) will vacate and sell on or before the end of the lease term, and 2) can calculate an expected loss that is probable. This variability of outcome, and the fact that a purchase or renewal creates no loss, results in only the PV of rent being capitalized under ASC 842. However, if at any point during the term of lease the company does decide to vacate and sell and can calculate a probable loss, then the amount of probable loss under the residual value guarantee will be added to the PV of the remaining rents and reported as an adjustment to the lease capitalization.

Under ASC 842 the synthetic lease offers the lowest cash and reported rent, and smallest balance sheet impact compared to any other form of lease or financing for ownership. As a result, synthetic leases have become increasingly popular for companies considering build-to-suits or acquisitions of core properties.

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