Effect of New Lease Accounting Standards on the Net Lease Sector

ElmTree Funds
Private Equity Real Estate

ASC 842's Impact on the Net Lease Sector

The anticipation of the potential changes to lease accounting standards incorporated in ASC 842 created some uncertainty throughout the commercial real estate industry and particularly within the net lease sector.

Landlords and investors were initially concerned that the new standards would remove previous guidance that incentivized corporations to often lease commercial real estate properties rather than invest their capital to own the properties themselves. In particular, landlords were concerned that the removal of the off-balance sheet treatment for operating leases would significantly change corporations' decision-making. Additionally, landlords and investors were concerned that adding leases to the balance sheet would potentially result in a negative impact on tenants' coverage and leverage ratios used in credit underwriting.

However, we believe the impact to both tenants' decision-making and credit underwriting will be relatively muted. Tenants will continue to make decisions based on value creation and cash flow analysis and creditors and investors have historically already made adjustments for lease obligations in their underwriting.

Throughout this newsletter, we explore the new lease accounting standards in more detail as well as further expand on our thoughts regarding the potential impact on the net lease sector.

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ASC 842 Overview

In February 2016, the Financial Accounting Standards Board ("FASB") issued its new lease-accounting standards known as ASC 842. ASC 842 took effect for public companies for fiscal years beginning after December 15, 2018. ASC 842 will take place for private companies for fiscal years beginning after December 15, 2019.

Prior to ASC 842, FASB generally required only capital leases (now known as financing leases) to be recognized on a company's balance sheet. As a result, operating leases were generally only reported in the footnotes of corporate financial statements under the old lease accounting standards. ASC 842 requires lessees to record all long-term leases (greater than 12 months) on a company's balance sheet as both a lease liability (based on the present value of future lease payments) and a right-of-use ("ROU") asset (equals the lease liability plus indirect costs (e.g. lease commissions), prepaid rent payments, and lease incentives). The discount rate utilized to calculate the lease liability is typically the rate of interest that equalizes (i) the present value of the lease payments and the amount to be derived from the underlying asset following the end of the lease term and (ii) the fair value of the underlying asset.

Under ASC 842, both operating and finance leases will be recognized on the balance sheet, but the related expense recognition on the income statement will vary for each lease type. For an operating lease, a lessee would recognize lease expense on a straight-line basis over the lease term. For a finance lease, the lessee would recognize both interest expense (by using the effective interest method) and amortization expense. Therefore, the lessee would generally recognize greater expense earlier in the life of the lease for a finance lease than for an operating lease.

Lease Classification Criteria

A lease is classified as a finance lease if it meets any of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When none of the above criteria are met, the lease will be classified as an operating lease.

Variance in Expense Treatment

While the requirements for initial recognition and measurement of the lease liability and ROU asset are the same for leases whether classified as a finance lease or an operating lease, the subsequent measurement and related expense profile differ on the basis of the lease classification. Finance leases generally have a front-loaded expense recognition profile and operating leases have a straight-line expense recognition profile.

For finance leases, the amortization of the ROU asset on a straight-line basis and the interest on the lease liability are included in the income statement. Together, the interest and amortization expense components result in a front-loaded expense profile. In terms of remeasurement, generally, the lease liability is reduced by the lease payments made over time and the ROU asset is reduced by accumulated amortization. For an operating lease, generally, straight-line lease costs are included as an expense on the income statement. The ROU asset and lease liability are decreased respective to lease payments made. In summary, finance leases will be expensed on the income statement as amortization and interest while operating leases will be expensed as lease expenses. For credit underwriting, the variance in expense classification may be a moderately important consideration when calculating EBITDA for coverage and leverage ratios.

Treatment of Purchase and Termination Options

When calculating lease obligations, the treatment of purchase options is based on the likelihood that the lessee will exercise the purchase option. If it is reasonably certain that the lessee will exercise its option to purchase the leased asset as defined in the respective purchase option clause in the lease, the lease obligations utilized to calculate the lease liability should include the exercise price of the purchase option. Additionally, if the lease grants the lessee an option to purchase the underlying asset and the lessee is reasonably certain to exercise the option, the lease is treated as a finance lease rather than an operating lease.

Using similar methodology for termination options, the lease term utilized to calculate the lease liability includes any periods beyond an option to terminate the lease if it is reasonably certain that the lessee will not exercise that option. Similarly, the lease payments would not include a termination penalty if it is reasonably certain that the lessee will not exercise that termination option. On the contrary, if it is not reasonably certain that the lessee will not terminate the lease, the lease term would not include the period past the termination date and the liability calculation would include any related termination penalty.

Impact to Credit & Investment Underwriting

For tenants concerned with meeting debt covenants, an increase on the liability side of the balance sheet may present challenges with lenders and potential investors due to the potential negative impact on coverage and leverage ratios. For example, ratios such as debt to equity and GAAP return-on-assets ratio may decrease materially for companies that have not previously reported significant lease obligations on balance sheet. With that said, credit underwriting agencies and institutional investors have often used non-GAAP figures that were adjusted for lease obligations in their analysis. Thus, the impact to credit underwriting and investment decisions may be more muted than initially anticipated. Certain lender arrangements that specifically utilize GAAP financial statements may be impacted, but the impact will likely depend on the specific reporting requirements for each arrangement (i.e. the arrangement's requirements for adjustments to calculate coverage and leverage ratios). Lastly, the difference in expense reporting for operating (lease expense) vs. finance leases (amortization and interest) may need to be considered when calculating non-GAAP EBITDA calculations.

ASC 842 —Conclusion

The anticipation of the changes incorporated in ASC 842 created some uncertainty throughout the real estate industry and the net lease sector. Landlords and investors were concerned that the new standards would remove previous guidance that incentivized corporations to lease commercial real estate properties rather than invest their own capital to own the property themselves. In particular, landlords and investors were concerned that the removal of the off-balance sheet treatment for operating leases would significantly change corporations' view on lease obligations.

With that said, we do not believe the new standards will cause significant changes to real estate planning decisions made within corporations. Corporations should primarily make major real estate decisions based on value creation, cost of capital analysis, and the impact on overall cash flow generation rather than changes in accounting standards. Additionally, for the net lease sector specifically, corporations can often optimize their lease obligations by signing long-term net leases given net leases provide tenants with long-term certainty regarding rental obligations while also offering additional benefits relative to a gross lease including additional flexibility, liquidity and expense management. More specifically, in a gross lease, the tenant typically pays a fixed base rent amount that takes into consideration estimated expenses for the property while, in a net lease, the tenant pays a fixed based rent and actual real estate taxes and insurance. As a result, real estate taxes and insurance would generally not be included in the measurement of the ROU asset and lease liability, which could be viewed as favorable by corporations. Considering these factors, we believe corporations will continue to sign long-term net leases for mission critical commercial real estate properties particularly given the benefit of securing the long-term use of a strategic real estate asset with an attractive lease structure significantly outweighs the potential minor impact to the company's financial statements.

Additionally, landlords and investors were concerned that adding leases to the balance sheet would result in a negative impact on tenants' coverage and leverage ratios used in credit underwriting. However, given credit underwriting agencies and institutional investors have often used non-GAAP figures that are adjusted for lease obligations in their analysis, we believe the potential impact to credit underwriting and investment decisions will be less significant than anticipated. As a result, corporations should be incentivized to focus on the importance of the underlying real estate asset and its ability to create value for the company when making long-term real estate decisions rather than focusing on the potential impact to the company's GAAP financial statements.

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