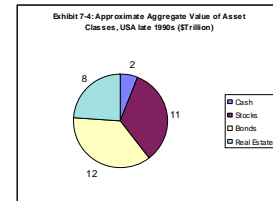


CHAPTER 15

FINANCING CORPORATE REAL ESTATE

Major Real Estate Investment Objectives

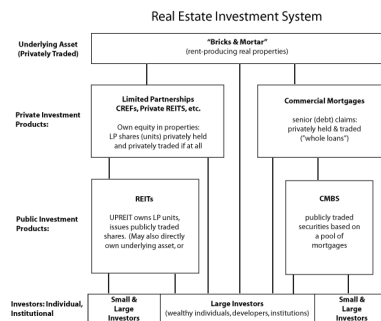
- **Growth** – relatively long-term horizon
- **Income** - Short-term & on-going need for cash.



Firms Own Real Estate for a Variety of Reasons

- **Owning:** is an integrated part of the firms operation
- **Diversification:** from the core business
- **Retaining:** real estate from former business operations
- **Acquiring:** real estate for future expansion or relocation

The System



Source: Geltner & Miller

Lenders & Investors

- Banking Institutions
- Insurance Companies
- Financial Services Companies
 - Non-domestic banks
 - Wall-Street
 - Hedge Funds

Cash Flow from Operations

	Own	Lease	Difference (own-lease)
Sales	\$1,500,000	\$1,500,000	\$0
Cost of Goods Sold	\$750,000	\$750,000	\$0
Gross Income	\$750,000	\$750,000	\$0
Operating Expenses:			
Business	\$200,000	\$200,000	\$0
Real Estate	\$90,000	\$90,000	\$0
Lease Payments	\$0	\$180,000	-\$180,000

Cash Flow from Operations Continued

	<u>Own</u>	<u>Lease</u>	<u>Difference (own-lease)</u>
Interest	\$136,900	\$0	\$136,900
Depreciation	\$50,000	\$0	
Taxable Income	\$273,100	\$280,000	\$6,900
Tax	\$81,930	\$84,000	\$2,070
Income after tax	\$191,170	\$196,000	\$4,830
Plus: depreciation	\$50,000	\$0	\$50,000
After tax cash flow	\$241,170	\$196,000	\$45,170

Cash Flow from Sale

Reversion/owning		\$3,000,000
Mortgage balance		-\$1,369,000
Reversion	\$3,000,000	
Basis	-\$1,050,000	
Gain	\$1,950,000	
Tax		-\$585,000
After tax cash flow		\$1,046,000

Summary After-Tax Flows

	<u>Outlay</u>	<u>Cash Flow</u>	<u>Reversion</u>
Year	0	1-15	15
Own-Lease	-\$431,000	\$45,170	\$1,046,000
IRR	13.79%		

Owning vs. Leasing

- If an ATIRR of 13.79% is not sufficient to warrant the risk associated with owning, it should be leased.
- But....

Other Factors Affecting Own vs. Leasing Decisions

However, in general, there are usually many other factors that come into play.

- Space requirements and need for Flexibility / Expansion
- Length of Time / Space needed
- Ability to bear the residual risk associated with owning
- Ability to manage the property

Other Factors Affecting Own vs. Leasing Decisions Continued

- Ability to lease special purpose buildings (i.e., chip fabrication plants, lead smelters, etc.)
- Tax considerations
- Access to capital to finance the purchase
 - Sometimes corporate debt is cheaper than mortgage debt

Other Factors Affecting Own vs. Leasing Decisions Continued

- Control over the property and location (is it a headquarters building?)
- Effect on financial statements
 - Operating vs. capital lease
 - Balance sheet vs. income statement
- Desire for diversification

Sale-Leaseback

- Source of capital
- Easy way to improve financial ratios
 - Wall Street has not been good about valuing real estate (the various ways to value REITs for example)
- Tax considerations are key
- Mortgage may be at a favorable rate

Capital vs. Operating Lease

FASB 13 (the 4 rules for capital leases)

- 75% of asset life?
- Ownership transfer at end of lease?
- "Bargain purchase" (less than fair market value "FMV")?
- Do lease payments exceed 90% or more of the FMV of the asset?

Synthetic Leases

With a little creativity, you could have the best of both worlds.

- Take the tax benefits of ownership from the IRS
- Account for the property on your books as a lease