

Lease Structuring White Paper

Inland Public Properties Development, Inc.

Inland Public Properties Development, Inc. (IPPD) will deploy its own capital to fund the construction of a facility (as opposed to bond proceeds), and is therefore able to implement innovative lease terms and lease structures to meet the needs of the lessee.

An area where IPPD can provide flexibility in the lease terms is with the payment of certain operational expenses. These expenses include maintenance of the facility, the payment of taxes (real estate and personal property), and facility insurance. The amount of “rent” paid to the lessee can vary greatly depending who is responsible for initiating these services and issuing payment, though at the end of the day, they are paid, in one way or another, by the lessee in any lease. The one main difference is that the more responsibilities and risk the lessor is exposed to, the more compensation above base rent will be required. The following discusses the possibilities available to lessees

Zero-Net vs Triple-Net

One option is a zero-net or gross lease. In this option the insurance, taxes, and maintenance are the responsibility of the lessor and the lessee pays a fixed payment. The benefits of a zero-net lease would include fewer responsibilities for the lessee and fixed annual real estate expenses for budgeting purposes. One downfall of the zero-net lease to the lessee is that the lessor must be compensated for providing the additional services as well as the cost exposure risk inherent in the variability of future expenses.

In contrast, when the lessee is responsible for the maintenance, insurance, and taxes, it is referred to as a triple-net lease (NNN) or net lease. It may be in the lessee’s best interest to be responsible for the maintenance, insurance, and taxes due to access to insurance pools, bulk rate maintenance contracts and other cost saving benefits. When these expenses are passed directly on to the lessee, the amount paid to the lessor is simply for the base rent for the real estate itself.

A third option is called hybrid or expense stop lease. In this scenario, the lessor pays all expenses up to a specific, predefined amount. After reaching this expense stop, all additional expenses are passed through to the lessee.

Regardless of an election by the lessee to choose a zero-net, triple-net or some combination of the two, IPPD is committed to tailoring the lease responsibilities to meet their unique needs.

Lease Purchase vs. True Lease

Another area where IPPD's flexibility can prove advantageous is in the structure of the lease itself. Depending on the objectives of the lessee, there can be huge financial, tax and accounting ramifications simply from how the leasehold relationship is structured.

FASB 13, Accounting for leases, as issued by the Financial Accounting Standards Board (FASB), establishes the criteria for determining the classification of a particular lease Agreement structure. For statutory, as well as Generally Accepted Accounting Principles (GAAP) purposes, there are two fundamental lease classifications; 1) a lease purchase (also called a capital lease) and 2) a true lease (also referred to as an operating lease).

LEASE PURCHASE – Using a lease purchase (aka: capital lease) structure, the lease payments made to the lessor includes an equity build-up component (debt amortization) and at the end of the lease term, the lessee may acquire the leased asset for one dollar. For statutory and GAAP purposes, lease purchase agreements are classified as a long-term debt obligation by the lessee, and generally have a fixed maturity of twenty to thirty years. They appear as a depreciable asset and as a liability on the balance sheet as if the asset was purchased and financed with debt.

This structure effectively transfers the risks and benefits of the leased property to the lessee. Of the benefits, the lessee enjoys lower "taxable income" in earlier years which yields tax savings. In addition, the lessee will have higher operating cash flow since a portion of the annual lease payment will appear as a financing cash flow.

Any lease is considered to be a lease purchase or capital lease if any of the following criteria are met:

1. Title is transferred to the lessee at the end of the lease term
2. A bargain purchase option exists
3. The lease period is greater than or equal to 75% of the assets economic life
4. The present value of the lease payments is 90% of the asset's fair market value

**If any of the above criteria are not met, the classification defaults to an operating lease **

TRUE LEASE – Under a true lease (aka: operating lease) structure, the lessee pays only rent to the lessor and there is no debt amortization or equity build-up component. At the end of the lease term, the Facility is owned by the lessor. As a result, a true lease is not a long-term debt commitment by the lessee, and thus, no asset or liability appears on the balance sheet. This results in higher profit margins and lower leverage ratios for the lessee and since lease payments are charged to the income statement as rent expenses, operating cash flows are reduced.

In a true lease, the term of the initial true lease could be for as many as fifteen years and include up to three, five year lease extensions. Therefore, including the initial lease term of fifteen years and the three, five-year renewal options, the lessee will have the exclusive right to an asset for up to thirty years.

At the discretion of the lessee, a true lease could be converted to a lease purchase agreement during the lease term. If the true lease is converted to a lease purchase, lessee equity build-up (amortization) is initiated and after a pre-determined period, ownership of the asset would be transferred to the lessee for one dollar. This change from a true lease to a lease purchase can take place at any time during the lease and conversion is the unilateral option of the lessee.

Upon the election by the lessee to convert a true lease to a lease purchase, the lease payment would be adjusted upward accordingly in order to provide the amortization component of the lease payment.

The following table breaks down the specific financial and accounting implications of each type of lease structure.

Comparison of Lease Classifications

	Lease Purchase	True Lease
General		
Owner of Property at end of lease term	Lessee	Lessor
Amount of lease payment	Higher	Lower
Equity build-up in lease payment	Yes	No
Term of lease (approximate, with extensions)	20-30 years	15-30 years
Financial Statement Impact of Lease Accounting		
Assets	Higher	Lower
Liabilities (current and long-term)	Higher	Lower
Net income (early years)	Lower	Higher
Net income (later years)	Higher	Lower
Total Net Income	Same	Same
EBIT (operating income)	Higher	Lower
Cash Flow from Operations	Higher	Lower
Cash Flow from Financing	Lower	Higher
Total Cash Flow	Same	Same
Ratio Impact of Lease Accounting		
Current Ratio (CA / CL)	Lower	Higher
Working Capital (CA – CL)	Lower	Higher
Asset Turnover (Sales / Total Assets)	Lower	Higher
Return on Assets	Lower	Higher
Return on Equity	Lower	Higher
Debt / Assets	Higher	Lower
Debt / Equity	Higher	Lower