

A New Era for Leases



How the new Lease
Accounting Standards impact
corporate real estate strategy



Introduction

New lease accounting standards will soon put leases on the balance sheet, and the intricacies of real estate decisions are about to receive new scrutiny from the CFO, the CEO and investors of public companies. Corporate real estate executives must understand the changes

that are coming, not only to make informed real estate decisions, but also to educate partners in finance, accounting, legal and the C-Suite. This piece outlines the most-critical questions raised by the new guidelines and their impact on your corporate real estate portfolio.

What changed?

Both the International Accounting Standards Board (IASB) and the U.S.-based Financial Accounting Standards Board (FASB) issued definitive guides for new lease accounting standards in early 2016. In both cases, the new standards will now require companies to record on the balance sheet any lease with a term longer than 12 months as a “right-of-use” (ROU) asset and a corresponding lease liability. Reported debt loads will rise for many companies as real estate and equipment lease obligations become line items instead of operating expenses on financial statements.

Both sets of new standards follow the same timeline. Beginning in 2019, all public companies reporting under U.S. GAAP and global IFRS will need to comply with the new requirements, and include comparable information for the two years prior. In other words, the new process was activated on January 1, 2017 for calendar-year public companies. Private companies have a bit longer to comply—standards will apply to fiscal years beginning after December 15, 2019 and include a one-year lookback period.

Companies must start preparing now to understand the financial ramifications of the new standards to their business, as well as how the new rules will impact data gathering, reporting and leasing strategy decisions.



Income statement reporting differences in IFRS versus FASB

As organizations start to learn the details of the changes, it will become clear that, though consistent in timeline and financial ramifications, there is one key difference: income statement classification. The crucial point of how leases are classified on income statements will be handled differently for global companies using IFRS versus U.S. companies which must comply with U.S. GAAP. The wording diverges as follows:

- **IFRS income statement reporting guidance** – All real estate and equipment leases will be recognized on the income statement as finance leases (also known as capital leases), with separate charges for depreciation of the ROU asset and amortization of the interest on the lease liability. Expenses will be higher in the earlier years of the lease, just as mortgage interest is higher in the earlier years of a mortgage and lower in later years.

The higher costs recorded in the early years of a lease will depress profits on the balance sheet when the new rules go into effect.

- **U.S. GAAP income statement reporting guidance** – Most real estate leases will be recognized as operating leases, which are recorded on a straight-line basis on the income statement as a single item under lease expense. Finance or capital leases will be recognized with depreciation of lease assets reported separately from interest on lease liabilities.

For multi-national corporations, understanding the difference and its ramifications to income statement reporting for U.S. versus global locations could result in the need to significantly change real estate decision-making. Specifically, companies that report locally must comply with local GAAP (typically aligned to IFRS) standards. However, local nuances may exist.



Back on the balance sheet: a blow to key financial ratios

The lease accounting changes eliminate one of the largest sources of off-balance sheet financing, giving investors a more developed picture of a company's financial obligations and improving their ability to compare financial statements. More than 85% of lease commitments held by listed companies using either set of accounting standards do not currently appear on balance sheets, according to IASB.

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This massive transfer of leasing obligations to the balance sheet will affect many companies' loan covenants and key financial ratios, such as the debt-to-equity and return on assets. For banks specifically, the changes will affect their capital reserve requirements. In some cases, a company may need to renegotiate or redraft its corporate debt covenants to restate the various ratios used to reset the interest rates on debt instruments. PwC and Erasmus University estimate that the average company's reported debt load will increase by an average of 58% as a result of the change. Industries that rely heavily on leasing for their operations, such as retailers, restaurants chains and airlines, will feel the biggest impact.

Lenders, investors and analysts are likely to scrutinize the increased debt load resulting from leasing liabilities, putting new pressures on leasing strategies. The potential impact of the rule changes will raise questions inside the C-suite, such as:

Companies should continue to ground their real estate portfolio decisions in broader financial and operational objectives.

- Will shorter-term leases without options to renew lessen the financial impact on the balance sheet?
- What kind of terms/demands should we negotiate in leasing contracts to minimize the impact?
- Would a different leasing structure be financially advantageous?
- Should we consider more or fewer sale-leasebacks?
- Under what circumstances does ownership make more sense than leasing?
- How will we address increased scrutiny and the administrative burdens of compliance?

The financial impact of the accounting pronouncement is critical—but reporting alone should never dictate leasing decisions. Nor should companies view leases as purely real estate decisions. New balance sheet pressures will force greater collaboration between the finance and real estate functions around leasing decisions. To be successful, all parties will need a better understanding of the broader and long-term impact of leasing decisions on the company.



Leasing strategies: minimizing the financial impact

Improving compliance and reporting processes for leasing activity will be a time-consuming endeavor on its own. However, corporations also need to build in time to comb through current terms and renewal options in their leasing agreements to determine whether a change in strategy is warranted.



Shortening lease terms may seem like the ideal solution for lessening the financial blow of the

new rules. However, the short-term financial advantages must be weighed against other related impacts. In particular, shorter leases typically bring higher rental fees. In addition, landlords are less likely to negotiate incentives with tenants that do not make long-term commitments.



Renewal option clauses should be a key focal point for examination. Current standard practice

is to include several three- or five-year renewal options on a five-year lease. These lease options have been relatively routine to date, but the financial impact on the balance sheet will be significant under the new accounting rules. If a company is reasonably certain that it will exercise its option to renew a lease, then each lease option becomes part of the reported liability under the new standard. In other words, a five-year lease with one five-year renewal option will become a 10-year lease liability on the balance sheet. Careful consideration should be given to the language in option clauses and how many options are reasonably necessary.



Operating expenses in lease agreements should also be carefully reviewed since these fees

are excluded from balance sheet calculations under the new standard. For companies with full-service leases on their books, distinguishing lease payments from operating and service payments will be key to determining correct balance sheet calculations—a potentially complicated and time-consuming endeavor.



Triple net leases, in which the tenant pays a fixed rent fee in addition to property taxes, maintenance

and insurance, eliminate this administrative burden. As such, they are expected to gain more favor under the new rules. Lease structures that minimize lease payment liabilities on the balance sheet will enhance the financial picture of the company.



Reviewing contractual languages to determine whether or not a contract fulfills the definition of a

lease is more important than ever. As part of their preparations, companies should review contractual language of major leasing agreements to determine if the contract is truly a lease or a service contract agreement. Particularly for equipment leases, there may be opportunities to restructure the contractual language to base the arrangement as a service contract rather than a lease, therefore excluding it from the new lease accounting standards. Going forward, there will be more consideration given to how new lease options and underlying asset usages are worded.

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Reconsidering which entities sign a lease is another strategy to minimize the financial

impact of the lease accounting standards. Organizations may consider isolating the financial impact of the changes to key business units by using holding companies to sign leases and then chargeback internal business units for the lease. Keeping regulatory requirements for individual locations in mind, companies should consider the viability of setting up a real estate company to hold all property leases and assets.

All that said, come 2019 real estate lease structures and the assumptions behind their financial implications will be audited. The more creative the leasing terms are, the more work required to justify and defend the deal structure and financial treatment. It could make sense to use a simple deal structure that meets business operational requirements to streamline portfolio management strategies and future audits.

Considering the alternatives



Turnover leases, which tie rent fees to a tenant's site-specific sales revenues, offer the advantage of possible exclusion from the balance sheet. Specifically, the amount of rent that is contingent upon sales and is therefore unknown can remain on the operating expense sheet rather than the balance sheet. Common among retailers and leisure venue operators, turnover lease agreements may be based entirely on annual sales revenues or structured on a base rent-plus-turnover basis. Obviously, turnover-based leases are not appropriate for every type of business—but for some, this approach

may offer a useful alternative to traditional leases.



Avoiding new leases through creative coworking may be an option for some companies. Coworking spaces with short-term memberships of under a year have been popular among smaller businesses and startup companies that want flexibility to accommodate their rapidly evolving needs. The shared office sector only comprises 0.7% of the total U.S. market, but demand is high and further growth is expected over the next two to three years. Smaller businesses that are especially

sensitive to balance sheet changes might be drawn to the benefits of flexible arrangement that are typically based on short-term leases or membership agreements.

However, companies should tread carefully when considering a coworking provider. What kind of data security does the shared space offer? What challenges does it present from a culture or brand standpoint? Does it provide spaces for private phone calls or meetings? Most importantly, does the space match the workstyle and work requirements? Workspace requirements should always be the primary driver of these decisions.

The lease vs. own decision

The accounting rule changes will eliminate some of the capital efficiency benefits of leasing, and is already driving large corporations to re-examine the fundamental question of whether they have more to gain by leasing or owning properties. With both hitting the balance sheet as a liability, the financial difference between a lease and an owned property will become less significant. That said, [Pull quote] capital allocation strategy, economics, portfolio flexibility and operational requirements should still be the primary drivers for a lease vs. own decision.

The only thing that changes is an additional emphasis on how the decision impacts financial reporting and the organization's tolerance for uncertainty.

Among the key issues to examine in light of the new rules:

- Is the lease liability greater than the value of the underlying property?
- How would the lease be structured?
- How important is control over the asset?

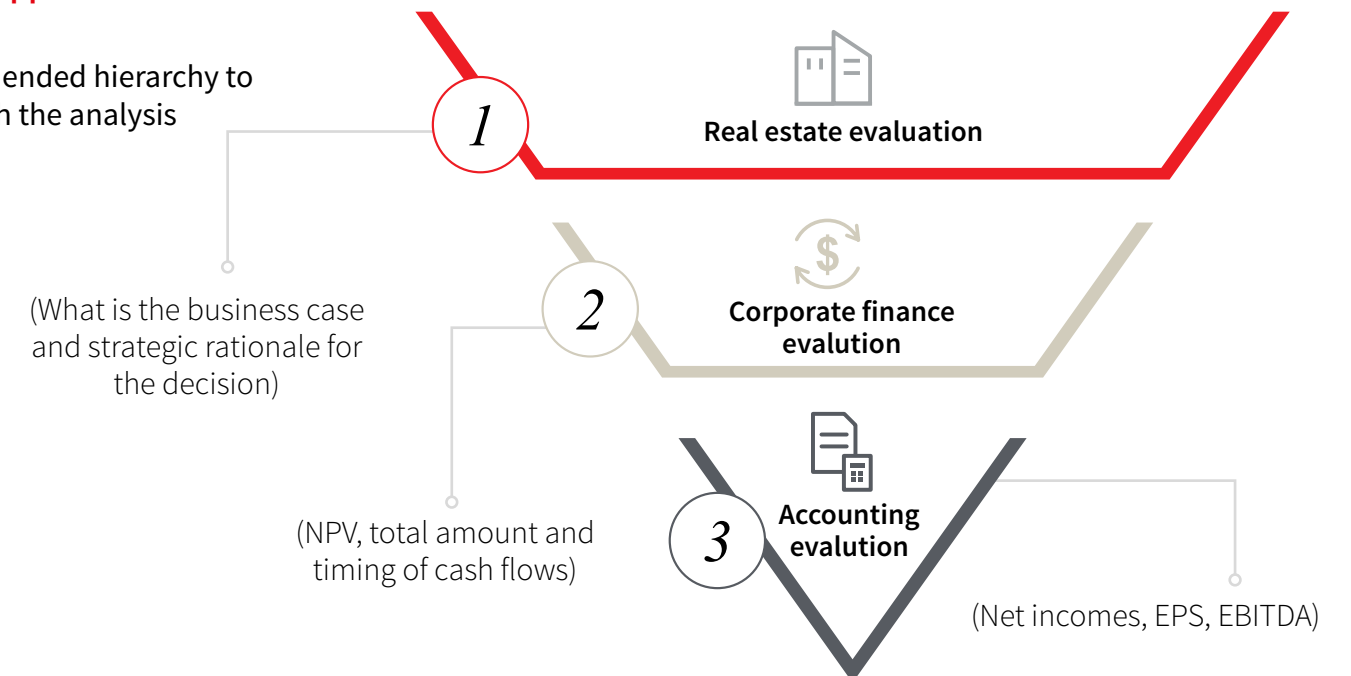
Local market conditions and regional nuances may also impact a company's lease vs. own decision. Asset supply and demand will continue to determine if suitable buildings are available to purchase at the right price for an organization. Or consider if a company is experiencing rapid growth in a specific market, owning an asset could be a difficult decision to make based on constantly changing headcount.

Capital allocation strategy, economics, portfolio flexibility and operational requirements should still be the primary drivers for a lease vs. own decision.

As companies examine all of these elements more closely in light of the new rules, some may find the accounting changes will tip the balance in favor of ownership.

How to approach a CRE decision

Recommended hierarchy to approach the analysis



Comprehensive lease databases and technologies take center stage

Under the new accounting requirements, it's more important than ever to have complete and accurate lease information. In fact, it's foundational to effective preparation and compliance. Not only will organizations need full lease abstracts, including commencement and expiration dates, lease terms and lease options (renewal, purchase and termination), they also need payment histories to prepare for the addition of

the lease obligations to their financials, including the two-year look-back period.

On top of that, organizations need a program in place to keep their lease information up-to-date as portfolios change as well as provide financial reports and forecasts to the finance team. Professional lease administration services provide the complete, accurate and current real estate lease database

and related data points foundational to the new lease accounting entries.

Technologies have also emerged to support the non-lease data required to implement and comply with the new lease accounting rules. These technologies contain functionality beyond legacy lease administration or pure accounting systems and track data points like incremental borrowing rate, lease classification, residual value, direct cost of a leasing transaction, and real estate strategies such as an organization exercising a particular lease option.

While each organization is unique, the right solution may be the best of both worlds: integrating the best lease accounting solution with the best lease administration system supported by professionals. This way, organizations benefit from the expertise in both lease administration and lease accounting, as well as professionals who can analyze current leasing processes and strategies with a keen eye to their impact on financials.



Equipment and non-real estate leases

The new lease accounting requirements apply not only to real estate leases, but also to non-real estate leases like equipment leases. This means companies will need to determine who owns what lease-related activities and how to collaborate to ensure compliance

moving forward. The corporate real estate, fixed-asset, finance and facilities teams should align to capture the necessary information to ensure appropriate accounting treatment. Technology solutions that support both real estate and non-real estate leases should be

considered, including options for both in-house and third-party teams to support the different leased portfolios based on responsibilities and decision-making authorities.



Are you ready?

The lease accounting changes are more than just a “real estate” or “accounting” issue. New reporting process will require the real estate, finance and operations functions to work together more closely, as well as engaging regularly with other parts of the business, including IT, legal, tax, treasury and investor relations. Creating a cross-functional team is a critical first step toward identifying potential areas of impact, developing updated reporting processes and opening the door to input from other business functions into future leasing decisions.

Many layers of complexities are involved in getting compliance-ready for the lease accounting changes. After creating an action team, consider breaking the work down into the following steps:

- ✓ Map out the work that needs to be done.
- ✓ Develop a complete lease inventory or comprehensive lease database to account for the necessary lease details.
- ✓ Identify resources, systems, data and process gaps for the new reporting requirements, and identify a plan to address the gaps.
- ✓ Evaluate how current leases will impact profit-and-loss statements, financial ratios and loan covenants after the rules go into effect.
- ✓ Re-evaluate the methodology for

making real estate decisions and create a change management plan to ensure all areas of the business understand the new way forward.

Becoming compliance-ready can seem like a daunting task, but taking the time to do each of these steps in a thoughtful and strategic manner can yield other benefits. A strong foundation of the right technology, data management and reporting processes will equip a company to make sound real estate decisions that are the most advantageous regardless of accounting changes, and drive more strategic portfolio management practices.

The new accounting rules shouldn’t be the sole driving force for a company’s leasing strategies, but the change will necessitate a new look at the real estate decision-making processes. Decisions must have a strong business case for both the C-suite and corporate investors. It is in nearly every company’s best interest to start evaluating the impact of the rules immediately and begin applying the insights to today’s real estate decisions with an eye towards tomorrow.



The lessor’s perspective: How to have a productive conversation with your landlord

Landlords’ balance sheets will change little under the new lease accounting standards, but some owners and investors will undoubtedly have concerns about how the new standards affect tenants’ leasing decisions. The rule changes will enable investors to more easily compare the financial perspectives of asset users and asset owners, and invite questions about differences that emerge.

Protecting a building’s valuation is a priority for landlords and property investors, naturally. Some landlords may be less willing to entertain the idea of shorter-term leases that offer them less financial stability, and may hesitate to offer incentives to tenants that are asking for shorter leasing terms.

As real estate markets are more often than not controlled by landlords, it’s unlikely that a landlord will agree to a lease restructure that is non-market conforming. While lease restructures are possible, corporate real estate teams should be realistic in their expectations of how much the landlords will accommodate their requests. It’s critical to understand your local market’s supply and demand to determine how much negotiating power you have.

Regardless of market conditions, it’s a good idea to start conversations with landlords as soon as possible to identify where there may be room for change or the landlord may be open to repackaging rents in a new way.



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