

Corporate Real Estate Decision Making

Key Decision Points

- What Type of Space Do I Need?
- Where Should I Locate?
- How Much Space Do I Need?
- Own Vs. Lease

Faulty Own Versus Rent Model

Linneman Associates Headquarters					
	Year 1	Year 2	Year 3	...	Year 10
Total	(\$40 MM)				
Interest	(\$3.6 MM)	(\$3.6 MM)	(\$3.6 MM)	...	(\$3.6 MM)
Operating Expense	(\$2 MM)	(\$2 MM)	(\$2 MM)	...	(\$2 MM)
Interest Tax Shield	\$1.26 MM	\$1.26 MM	\$1.26 MM	...	\$1.26 MM
Depreciation Tax Shield	\$1.4 MM	\$1.4 MM	\$1.4 MM	...	\$1.4 MM
Total	(\$42.94 MM)	(\$2.94 MM)	(\$2.94 MM)	...	(\$2.94 MM)

Linneman Associates Headquarters	
	Year 10 Sale
Sale Revenue	\$130 MM
Fees	(\$3 MM)
Debt Repayment	(\$60 MM)
Accumulated Depreciation Tax	(\$10 MM)
Capital Gains	(\$4.5 MM)
Total	\$52.5 MM

Faulty Own Versus Rent Model (cont'd)

Linneman Associates Headquarters					
	Year 1	Year 2	Year 3	...	Year 10
Cash Flow	(\$42.94 MM)	(\$2.94 MM)	(\$2.94 MM)		(\$2.94 MM)
Cash Flow from Sale	\$0 MM	\$0 MM	\$0 MM		\$52.5 MM
Net Cash Flow	(\$42.94 MM)	(\$2.94 MM)	(\$2.94 MM)		\$48.06 MM
NPV	(\$34.19 MM)				

Linneman Associates Headquarters					
	Year 1	Year 2	Year 3	...	Year 10
Rent Payment	(\$10 MM)	(\$10 MM)	(\$10 MM)		(\$10 MM)
NPV	(\$61.45 MM)				

What's the Problem?

- Most importantly the user did not take into consideration the opportunity cost of tying up \$40 million of their equity and \$60 million in borrowing capacity in a building for 10 years.
 - The company could have used this \$40 million, and borrowed an additional \$60 million, to invest in their core business, rather than real estate. In the analysis above, equity is treated as free!
 - You must either remove the investment aspect of the purchase option, or credit the rent option for the return realized on the equity which is utilized in core operations.
- Another serious analytical error is that the ownership analysis assumes property value appreciates by 30% over 10 years, while the rental analysis implicitly assumes little or no value increase if the building is owned by a landlord (same rental income in year 10 as in year 1).
 - Specifically, for the property value to increase by 30% one would expect rental rates would be substantially higher in the 10th year.

Corrected Model

Linneman Associates Headquarters					
	Year 1	Year 2	Year 3	...	Year 10
Investment in Operations	(\$40.00 MM)				
Rent Payment	(\$10.00 MM)	(\$10.00 MM)	(\$10.00 MM)	...	(\$10.00 MM)
Interest Payment	(\$3.60 MM)	(\$3.60 MM)	(\$3.60 MM)	...	(\$3.60 MM)
Interest Tax Shield	\$1.26 MM	\$1.26 MM	\$1.26 MM	...	\$1.26 MM
Depreciation Tax Shield	\$3.65 MM	\$3.65 MM	\$3.65 MM	...	\$3.65 MM
CF from Normal Operations	\$12.00 MM	\$12.00 MM	\$12.00 MM	...	\$12.00 MM
Tax on CF from Normal Operations	(\$4.38 MM)	(\$4.38 MM)	(\$4.38 MM)	...	(\$4.38 MM)
Investment in Operations Remaining	\$0.00 MM	\$0.00 MM	\$0.00 MM	...	\$53.75 MM
Total	(\$41.07 MM)	(\$1.07 MM)	(\$1.07 MM)	...	\$52.68 MM

Linneman Associates Headquarters					
	Year 1	Year 2	Year 3	...	Year 10
Investment in Operations	(\$40.00 MM)				
Rent Payment	(\$9.80 MM)	(\$10.04 MM)	(\$10.29 MM)	...	(\$12.20 MM)
Interest Payment	(\$3.60 MM)	(\$3.60 MM)	(\$3.60 MM)	...	(\$3.60 MM)
Interest Tax Shield	\$1.31 MM	\$1.31 MM	\$1.31 MM	...	\$1.31 MM
Depreciation Tax Shield	\$3.65 MM	\$3.65 MM	\$3.65 MM	...	\$3.65 MM
CF from Normal Operations	\$12.00 MM	\$12.00 MM	\$12.00 MM	...	\$12.00 MM
Tax on CF from Normal Operations	(\$4.38 MM)	(\$4.38 MM)	(\$4.38 MM)	...	(\$4.38 MM)
Investment in Operations Remaining	\$0.00 MM	\$0.00 MM	\$0.00 MM	...	\$53.75 MM
Total	(\$40.82 MM)	(\$1.06 MM)	(\$1.30 MM)	...	\$50.53 MM
NPV	(\$26.53 MM)				

Synthetic Leases

- A synthetic lease allows a company with an economic and tax ownership position to hide the ownership (and the accompanying debt) from shareholders.
- A synthetic lease is one of a number of contracts that attempts to convince the IRS that you own the real estate, while at the same time satisfying the SEC (hence securities holders) that you rent it.
 - You want to convince the IRS that you own the building so that you can take depreciation write-offs and use interest payments to shield your taxable income.