THE ORANGE REPORT

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Not For Accountants Only

What a dealmaker needs to know about the new lease accounting standards heading our way.

First, a disclaimer: *I am not an accountant and the less I know about accounting rules, the happier I seem to be. I'm a dealmaker who wants to make transactions happen, getting the right retailers on the right sites at the right time.* What do dealmakers need to know about the arcane rules those accountants use to record assets, liabilities, expenses and profits? We leave that to the bean counters. Just let me find a site/tenant, negotiate lease terms and close a deal.

But not so fast. Effective dealmaking has always required a basic understanding of property accounting in structuring transactions so that occupancy costs can be treated as operating expenses or balance sheet liabilities consistent with the tenant's desire. For years, tenants have negotiated provisions of their leases such as term length, improvement allowances, net versus gross rent, kick-outs, exclusive control, etc, so that their leases do not run afoul of the accounting rules governing how they report their expenses. Most chain tenants have developed a standard set of lease terms that are consistent with their desired accounting treatment giving their real estate representatives, brokers and landlords a basic starting point in a lease negotiation. But this is about to change and the impact of this change could dramatically impact the negotiations over basic lease terms that we had previously accepted as standard.

The change is going to come from the new lease accounting standards which are in the process of being promulgated by the Financial Accounting Standards Board ("FASB"). Expected to be adopted by 2013, revisions to the Generally Accepted Accounting Principles ("GAAP") when accounting for lease commitments will change recognition for leases that are now classified as operating leases and will recast them as capital leases. Under the new standards, for virtually all real estate leases, the "right to use" property for a finite period of time shall be recognized as an ***asset*** whereas the "obligation" to pay rent under a lease contract shall be recognized as a ***liability***. No longer will a business that adheres to GAAP be allowed to treat their rent payments as an operating expense. The concept of off-balance sheet leases will largely disappear. Rent obligations will be treated as debt potentially impacting credit ratings, loan covenants and investor valuations.

While not yet in place, these new standards appear to be inevitable. Corporate finance departments and property accountants are becoming aware of how these new rules will impact their decisions, processes and record-keeping. But what about the guys on the street making the deals? Here are some of the dynamics we can expect to encounter under the new rule when putting together deals for businesses that seek to minimize the impact to their balance sheets from their real estate leases. *(Continued on the next page.)*

Sources: [1]*Kansas City Regional Association of Realtors. Average sales price of new & existing homes.* [2]*U.S. Census Bureau: Estimated monthly, new privately-owned units.* [3]*Kansas City Regional Association of Realtors.* [4]*Kansas City Regional Association of Realtors. Total new & existing inventory per quarter. Supply is a monthly average for the quarter. 5-6 months supply represents a balanced market.* [5]*U.S. Bureau of Labor Statistics, State and Metro Area Employment. Data not seasonally adjusted.*

Kansas City Housing

Average Home Price[1]			
County	Q3-10	Q3-11	% Chg
Cass County, MO	$148,115	$137,742	-7.0%
Clay County, MO	$156,451	$137,230	-12.3%
Jackson County, MO	$117,963	$110,940	-6.0%
Platte County, MO	$194,523	$165,066	-15.1%
Johnson County, KS	$258,788	$243,090	-6.1%
Leavenworth County, KS	$171,181	$150,892	-11.9%
Miami County, KS	$149,798	$144,425	-3.6%
Wyandotte County, KS	$75,761	$74,799	-1.3%

Residential Building Permits[2]			
County	Q3-10	Q3-11	% Chg
Cass County, MO	72	49	-31.9%
Clay County, MO	31	35	12.9%
Jackson County, MO	103	237	130.1%
Platte County, MO	27	42	55.6%
Johnson County, KS	271	542	100.0%
Leavenworth County, KS	38	71	86.8%
Miami County, KS	10	10	0.0%
Wyandotte County, KS	23	24	4.3%
Kansas City Region	**614**	**1037**	**68.9%**

KC MSA Home Sales[3]			KC MSA Housing Inventory[4]		
	New	Existing		# Homes	Supply
Q3-11	472	5,997	Q3-11	49,377	8.9
Q3-10	382	4,757	Q3-10	53,848	8.5
% Chg	23.6%	26.1%	% Chg	-8.3%	5.1%

KC MSA Employment by Industry (Job counts in 1,000s)[5]		
Sep	'11	12 Mo % Ch
Civilian Labor Force	1045.1	N/A
Mining, Logging, & Construction	39.4	-2.2%
Manufacturing	75.8	2.8%
Trade, Transportation, and Utilities	194.6	1.1%
Information	29.5	-6.6%
Financial Activities	68.8	-3.8%
Professional and Business Services	138.7	-2.1%
Education and Health Services	134.8	4.3%
Leisure and Hospitality	92.1	-2.8%
Government	154.2	1.2%

Term lengths will become shorter. Term length will become an even more hotly contested issue in lease negotiations as many tenants will be looking for shorter term length. Under the new rule as proposed, a tenant is required to book the NPV of the longest possible term as a liability at the inception of the lease. In other words, signing a 10-year lease will mean putting twice as much debt on the balance sheet as a five-year lease.

Ownership will be preferred to leasing. The number of companies that insist on owning rather than leasing will increase reducing demand for leased space and increasing demand for space that can be purchased. If you are going to have to account for the property as if you own it, then you might as well have the control and the appreciation of the asset that comes with ownership for your own account.

Gross leases may become extinct. Having to put the rent on the balance sheet is problematic enough. Treating as debt other occupancy costs that are truly operating expenses will be avoided at all costs.

Renewal option terms will become less significant. Under the new standard, the "capitalized" term should represent the "longest possible term that is more likely than not to occur." Options to extend a lease may be included within the lease term based upon factors including nature of the asset, location, cost of relocating, lessee's intentions and past practices. As a result, companies that have entered into leases with renewal options will appear to have more leverage than those that have not. This would distort the financial condition of a potentially more credit-worthy tenant.

Percentage rent will be utilized much less. The new rule actually requires the tenant to project its sales into the future, calculate the amount of overage rent it will pay over the term and book the NPV of those amounts as a liability at the inception of the lease. Ouch!

Rent escalations will be tougher for tenants to stomach. The new rule will require the rent obligations for all leases to be "straight-lined" on the balance sheet even though the rent is lower in the early years and escalates over time. Many tenants will still prefer the cash flow benefit in the early years of the lease as their business grows, but the balance sheet trade-off will make rent escalations less compelling for most companies.

Pat Peery

LANE4 Property Group

LANE4 Property Group specializes in tenant representation, project leasing, property management, incentive services, receivership, development, project management and investment sales throughout the Midwest. Visit our website for up-to-date information on our current projects and services.

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Sources: [6]CoStar: Total existing space, including direct and sub-lease. Change for Average Vacancy Rate represents the difference between 2009 & 2010 percentages. [7]U.S. Census Bureau. Data not seasonally adjusted. [8]U.S. Census Bureau. Data seasonally adjusted. [9]Creighton Economic Forecasting Group. Survey ranges from 0-100 with a score of 50 considered growth neutral. Under 50 indicates a contracting economy for the next three to six months. Mid-America survey states are Kansas, Missouri, Arkansas, Iowa, Minnesota, Nebraska, North Dakota, Oklahoma and South Dakota. [10]U.S. Bureau of Labor Statistics. Unemployment rates seasonally adjusted. CPI for all urban consumers, not seasonally adjusted. [11]U.S. Bureau Of Labor Statistics. Total nonfarm employment. Data not seasonally adjusted.

Kansas City Leasing Data

KC MSA Shopping Center Retail[6]

	Q3-10	Q3-11	% Chg
Total GLA	65,294,147	65,381,007	0.1%
Avg Lease Rate	$12.85	$12.56	-2.3%
Avg Occupancy Rate	11.6%	11.2%	-4.1%

KC MSA Office[6]

	Q3-10	Q3-11	% Chg
Total GLA	108,809,498	108,733,073	-0.07%
Avg Lease Rate	$18.02	$17.20	-4.55%
Avg Occupancy Rate	12.9%	12.5%	0.4%

National & Regional Trends

Housing Starts & Completions (1,000s)[7]

	Q3-10	Q3-11	% Chg
Housing Starts			
U.S.	159.8	170.8	6.9%
Midwest	30.9	26.7	-13.6%
Completions			
U.S.	159.5	170.0	6.6%
Midwest	26.9	29.7	10.4%

U.S. Food & Retail Sales[8]

Period	In Billions
Q3-08	$1117.7
Q3-09	$1031.8
Q3-10	$1089.3
Q3-11	$1176.4

Business Conditions Index[9]

2011	Jul	Aug	Sep
Missouri	51.9	50.7	47.9
Kansas	54.7	43.6	43.8
Mid-America	54.1	52.0	52.2

Unemployment Rate[10]

Sep	'10	'11
Midwest	9.1%	8.7%
U.S.	9.6%	9.1%

Consumer Price Index[10]

2011	Jul	Aug	Sep
Midwest	216.1	216.6	217.0
U.S. City Avg	225.9	226.5	226.9

Job Openings & Turnover[11]

Midwest (1,000s)	Q3-10	Q3-11	% Chg
New Hires	2,867	3,089	7.7%
Job Openings	1,849	2,265	22.5%
Total Separations	3,049	3,190	4.6%
U.S. (1,000s)	**Q3-10**	**Q3-11**	**% Chg**
New Hires	12,695	13,282	4.6%
Job Openings	8,704	10,037	15.3%
Total Separations	13,227	13,529	2.3%