The $500 Billion DISRUPTION

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If you're not already talking with the investors you serve about the potential effects of the Financial Accounting Standards Board's (FASB) new lease accounting standard, you're running late! There is urgency in having this conversation — which really should be an ongoing dialogue — as the update will most certainly change tenant behavior and key marketplace dynamics in ways that could significantly impact investors.

FASB's ASC 842 and a similar update by the International Accounting Standards Board (IASB), IFRS 16, require tenants to include the future value of their lease obligations as liabilities on their balance sheets. Historically, tenants have noted this information in the less scrutinized footnotes of financial statements.

The new requirement is intended to give users of financial statements, such as investors and creditors, a more transparent view of a company's true financial health. This change will affect selected commonly-used performance measures, e.g., return of assets, interest coverage, return on capital and quick ratio as well as loan covenants, credit ratings and the cost of borrowing.

Aptly, business pundits, including hands-on real estate experts, are describing the new standard with terms like "bombshell" and "disruptive," even characterizing it as "the biggest change to hit business owners in decades" (Forbes, May 5, 2017).

The Compliance Challenge for Tenants

To begin gauging the update's scope of impact, RealFoundations, one of the leading professional services firms focused exclusively on commercial real estate, commissioned the first known study to estimate how many commercial real estate leases exist in the world and the possible macro consequences of that finding.

"The Inaugural Global Lease Count Study"[1], a rigorous investigation led by RealFoundations founder David Stanford and Senior Research Consultant Ward S. Caswell, accounts for nearly 4 million office, industrial and retail third-party leases spanning 91 countries. RealFoundations believes that the annual value of those leases is about $500 billion (USD). Researchers derived this number using accepted practices for calculating the total value of investment real estate at the country level and scaling to remove those segments without commercial leases.

Although the study reflects lease counts for only about half of the world's countries, due to limited data availability, the findings are still meaningful because the top 25 nations account for more than 80 percent of all global leases.

The analysis of an individual company's leasing obligations is an enormously challenging undertaking, especially for those with hundreds or thousands of leases throughout the country and the world. Many tenants need in-house and/or outsourced, cross-functional teams of specialists to: gather and digitize relevant documents; identify, extract and verify a plethora of key data; and consolidate the information into consistent systems for financial reporting. In most cases, tenant companies have to purchase and implement new software solutions while some have gone as far as re-designing IT systems and processes.

Tenants must also contemplate the difference between data and information. What do the data mean? Once the data are collected and consolidated, how should the company analyze and use the data? What metrics should the company develop that help enhance corporate value and mitigate risk?

[1] To view The Inaugural Global Lease Count Study and for additional information, visit http://www.realfoundations.net/news/cre-lease-count-study.

Savvier Tenants and New Marketplace Dynamics for Investors

Not surprisingly, the topic of leased space has taken on new importance in the C-suites and boardrooms of the world's largest companies.

"With easier access to better lease data, tenants are now better equipped to provide more sophisticated risk analysis and more effective strategic planning," says Randall Zisler, Ph.D., Chairman, Zisler Capital Associates, a commercial real estate investment banking company serving investors/owners, developers and investment managers with capital placement services, strategic consulting and research. "Transparency and enhanced analysis, in turn, can affect the value of buildings themselves."

CRE veterans predict savvier tenants who will change some of the rules of engagement. They also anticipate new marketplace dynamics. These include:

- **Shorter leases.** Tenants may want less debt showing on their balance sheets as more debt could negatively influence perceptions of their creditworthiness and affect their cost of capital. "We expect tenants to seek short-term leases wherever practical," says Jules "Jay" H. Marling IV, CEO & Managing Principal, Capright, which provides real estate valuation, consulting and due diligence services in the United States and Latin America. Tenants also may want to renegotiate existing leases for briefer durations and fewer option periods. Additionally, notes Zisler, "Better lease data help analysts determine the interest sensitivity of different lease structures, which is important when evaluating leases in the context of the company's liabilities."

- **A surge in co-working.** Co-working already is an attractive, fast growing alternative to traditional office space because it offers shorter rental periods, easier scalability as a company's needs change, more amenities and fewer restrictions. According to Marling, "The fact that leases under one year can still remain off the balance sheet should be a boon for the co-working industry." This is not lost on the leading company in this space, WeWork, a recognized disruptor in the office market in its own right, even before the lease accounting change.

- **Volatility in asset valuations.** "Shorter lease terms, if they develop, could increase the volatility in asset valuations as shorter leases would necessitate an increase in assumptions related to future cash flows," notes John Caruso, Managing Director, Head of Finance, Americas, at TH Real Estate, one of the largest real estate investment management firms in the world.

- **Smaller budgets for tenant improvements.** According to Caruso, "The availability of tenant improvement dollars could be significantly reduced as landlords would have a shorter period to recoup those investments."

- **Higher costs for mortgage financing.** "Costs for mortgage financing could also be impacted as lenders would seek to be compensated for the increased risk from shorter lease terms," Caruso adds.

Investment Managers Should Communicate Proactively

The convergence of these developments could materially influence property valuations and returns. Investment managers should discuss the ramifications of these changes with their clients, manage their expectations and help them avoid surprises. Here are the top four things you can be doing to best serve your investors during this period of change.

1. Educate yourself on the implications of the update. Read everything you can — a lot of information and commentary is available online — and ask strategic business partners for their perspectives.

2. Develop a "house view" on the topic. Socialize it within your organization so all managers are conveying that same perspective to and sharing consistent advice with investors.

3. Evaluate the potential long-term valuation and return impact on assets (and liability for those companies that are lessees) in each investor's portfolios in the post-update world.

4. Actively engage in candid dialogue with your investors about what the update could mean for them so they are not caught off guard when otherwise foreseeable impacts become reality. Have an initial conversation and then follow-up discussions, as industry developments warrant, to prevent blindsiding.

Industry organizations, too, can play a valuable role in helping investors understand and prepare for possible consequences of the new lease accounting standard. This is an important topic for presentations and roundtables at conferences and even online forums where institutional investors and their advisors can easily share knowledge and insight in real time.

No one, including RealFoundations, has all the answers but we know that change is coming. Knowledgeable and proactive advice on this topic will ease the transition for your investors who, after all, capitalize the commercial real estate business.

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