Capital Lease characteristics:

- Term is non-cancelable; <u>and</u>
- Any one of the following:
  a. Transfer of ownership to lessee; <u>or</u>
  b. Bargain purchase option; <u>or</u>
  c. Term >= 75% of useful life; <u>or</u>
  d. PV of rent >= 90% of value of property

(from FAS 13, paragraph 7)

FAS 13, Paragraph 7d
aka The 90% test

Is PV of rent >= 90% of FMV?

Assumptions:
- Rent
- Term
- Discount Rate
- Fair Market Value

Skills Needed to Perform the 90% Test

- Thorough understanding of lease terms
- Ability to prepare multi-year cash flow projections
- Basic understanding of present value analysis
- Humility—You're not an auditor—that's a good fact

Determining the "Analysis Term"

The probable lease duration viewed from lease commencement by a "reasonable person" taking into account the following:

- Bargain renewal option periods, plus
- Periods prior to bargain options, plus
- Periods with penalties for non-renewal

But what is a bargain?

- Below market lease renewal formula
- Fixed escalation in rent applicable to renewal options at a rate less than reasonably expected rent growth

<u>AND ALSO CONSIDER —</u>

- High cost TIs requiring longer amortization
- Unique type of space or location (i.e. one that is not generally available)

Other Key Assumptions—The Numerator:

- Net rent (really net—as in NNN)
- TIs paid for by Tenant (cash or add’l rent)
- Penalties, other payments and fees (payable for use of space)

And, lest we forget —

- The Discount Rate

7d. Rent includes:

- Required payments, <u>plus</u>
- Non-renewal penalties, <u>plus</u>
- Guarantee of residual value

- Executory costs not included:
  – Insurance
  – Maintenance
  – Taxes

7d. Discount Rate

- Lessee's incremental borrowing rate

  The interest rate lessee would have paid at lease commencement to borrow the funds to purchase the asset

Valuing the Premises—
The Denominator:

- Fair market value—market or income approach (lease is not the market)
- Cost Approach (including land)
- The TI paradox (yes you have to add them—but they go on both sides)

7d. Fair value of leased property

- If lessor is a dealer – fair market value
- If lessor is not a dealer – cost
  (+ market adjustment for time)

--To the beta template