Capital Lease characteristics:

- Term is non-cancelable; \textit{and}
- Any one of the following:
  \begin{itemize}
  \item a. Transfer of ownership to lessee; \textit{or}
  \item b. Bargain purchase option; \textit{or}
  \item c. Term $\geq 75\%$ of useful life; \textit{or}
  \item d. PV of rent $\geq 90\%$ of value of property
  \end{itemize}

(from FAS 13, paragraph 7)
FAS 13, Paragraph 7d aka The 90% test

Is PV of rent $\geq$ 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

AND ALSO CONSIDER —

- 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, plus
- Non-renewal penalties, plus
- 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