

## ADVANTAGES FOR CORPORATE FINANCE

The term of years interest and the remainder interest represent deeded ownership of nonoverlapping bundles of rights in property that are essentially independent of each other for economic analysis purposes. The two equity interests together represent an all-equity capital structure for the property. The all-equity feature provides the capital structure with more flexibility than capital structures that generate leverage with debt.

Shares in each equity interest can trade independently without any requirement for approval from holders of the other interest. In general, there is no reason why holders of either equity interest need even be concerned about the identities of holders of the other equity interest.

The federal tax code is responsible for the primary constraint on these investments. Tax disincentives imply that economically related entities should not hold simultaneous investment positions in the respective equity interests.

There is one other apparent constraint: lessees cannot invest in the term of years interest, since financial and tax accounting rules recharacterize leases as debt if the lessees have equity positions in the lessor. However, this suggests an alternate possibility not available with conventional capital structures: lessees can invest in the remainder interest.

The remainder interest holder is not the lessor prior to expiration of the term of years interest, since remainder interest ownership rights do not include the economic benefits that belong to the term of years interest. Thus, unlike lessee investments in the term of years interest, lessee equity positions in the remainder interest do not stretch the boundaries of either the letter or the spirit of financial and tax accounting constraints.

Investment in the remainder interest makes sense from the perspective of corporate business strategy. Corporate CFOs complain frequently that high-quality lessees don't share in the windfall generated for lessors by property valuation increases created during their tenancy. Since the remainder interest holder receives the benefits of all property appreciation other than lease valuation increases, remainder interest investment eliminates the inequity by allowing the lessees to share in the valuation increases.

As with all corporate finance transactions, corporate investors should obtain formal tax and financial accounting opinions that cover the specific circumstances of each implementation. With that caveat, accounting expectations for the synthetic debt structure are generally favorable for lessees. Leases that are off-balance-sheet in conventional all-equity capitalizations usually remain off-balance-sheet in the synthetic debt structure. In contrast to synthetic leases, financial and tax accounting requirements for operating lease accounting treatment are generally consistent.

Remainder interest investment positions are debt-free on-balance-sheet assets for corporate investors, whether or not the investors lease the property. The expected investment return for the remainder interest is higher than the expected return for conventional corporate real estate equity.

Although the synthetic debt finance developed by Electrum Partners has significant corporate finance applications, synthetic debt finance was developed to lower the cost and risk of leverage for leased property investors. Conceptually, synthetic debt finance is nearly the reverse process of synthetic lease finance. Synthetic lease finance transforms conventional mortgage debt into unconventional off-balance-sheet leases for financial accounting purposes. In contrast, synthetic debt finance transforms conventional off-balance-sheet leases into unconventional synthetic debt for investment purposes.

The synthetic debt restructuring takes place solely from the buy-side perspective; nothing changes from the lessee perspective. In other words, synthetic lease finance is exclusively sell-side financial technology, whereas synthetic debt finance is buy-side technology applicable to sell-side finance.