

## COMPLETELY LEASED PROPERTY = SYNTHETIC DEBT

The financial industry has failed to notice a simple fact that has significant investment and financial implications: property ownership constitutes ownership of synthetic debt if all use-related rights to the property have been leased on a noncancellable basis.

This form of synthetic debt does not involve financial derivatives. Accordingly, valuations and financial and tax accounting interpretations are simpler than for synthetic debt in general. This makes the product attractive for a variety of buy-side and sell-side financial applications.

The identification of leased property rights with synthetic debt can be understood in terms of a simple conceptual example: the valuation of fee simple equity in fully-leased property in which the current leases irrevocably transfer all use-related property rights to the lessees. In other words, the leases are perpetual and cannot be cancelled on a unilateral basis. This type of property will be referred to as *completely leased property*.

From the equity holder perspective, completely leased property represents ownership of fixed-income obligations of the lessees with default protection. From the lessee perspective, lease-based fixed-income obligations are not debt. It follows that fee simple ownership of completely leased property meets the criteria for synthetic lessee debt.

The value of commercial property in general is the discounted present value of expected future net rent. This formula is particularly simple in the case of completely leased property, because the existing leases specify all future rent and the discount rate for each rental stream is essentially the lessee cost of credit. Since future rent is locked in by the existing leases, the value of completely leased property varies solely with the lessee cost of credit.

Rising property valuations in response to improved expectations about commercial property do not affect completely leased property because lessors cannot benefit from the improved environment through future leases at higher rents. Similarly, falling property valuations in response to deteriorating expectations about commercial property do not affect completely leased property because lessors will not suffer from the deteriorating environment through future leases at lower rents.

Perpetual leases do not receive attention from financial experts because such leases are not allowed by most legal systems. This is undoubtedly why the identification of fee simple ownership of completely leased property with derivative-free synthetic debt has gone unnoticed.

There is a way in most Anglo-Saxon-based legal systems to create completely leased property without any need for perpetual leases: assume that property is fully leased and the leases are noncancellable. Then separate property ownership into two equity interests: a term of years interest and a remainder interest such that the term of years interest terminates with or before the leases.

The leases irrevocably transfer all use-related property rights represented by ownership of the term of years interest to the lessees in return for noncancellable fixed-income obligations. It follows that the term of years interest is synthetic debt, and the synthetic debt does not involve financial derivatives.