

## LEASE-BASED SYNTHETIC DEBT

Leased property is a blend of fixed-income and non-fixed-income components. The lease constitutes the basis of the fixed-income component.

Lease default covenants provide lessors with timely recourse designed to minimize asset wastage. In the case of high quality corporate leases, lessor default recourse compares favorably with the recourse available to financiers of corporate debt.

In such cases, the fixed-income component has lower investment risk than the other component. Accordingly, lenders considering high-leverage low-cost finance of the property focus on financing the fixed-income component.

Debt finance is not ideal from the lender perspective. Although debt default is most likely to occur as a result of lessee default, lenders do not have timely access to lease default recourse. Property wastage is likely in foreclosure, which lowers the recourse value of collateral.

Debt finance would be more efficient with immediate access to lease recourse for the financier in event of lessee default. Lower financing cost should follow lower financing risk.

There is one way to reduce the time required to transfer control of lease default recourse from lessor to lender: *eliminate the transfer. Merge the roles of lessor and lender into one investor. Design an all-equity capital structure* for leased property with two ownership interests: a fixed-income equity interest with the ownership rights to lessee rent and lease default recourse, and a non-fixed-income equity interest with the ownership rights to the other investment characteristics.

Implementation of this capital structure is cost-effective in many situations, and in particular for single-lessee property with a bondable net lease. In this case, the capital structure is analogous to a leveraged lease. The fixed-income equity interest corresponds to debt in the leveraged lease structure, and the non-fixed-income equity interest corresponds to leveraged lease equity.

The all-equity capital structure compares favorably with the leveraged lease structure. Fixed-income equity has less risk than leveraged lease debt because fixed-income equity owns the rights to lease default recourse. Non-fixed-income equity has less risk than leveraged lease equity because non-fixed-income equity is not encumbered with any lien from the fixed-income interest. Thus the all-equity capital structure has less investment risk for all investors than the leveraged lease capital structure. This illustrates a general financial principle: improved risk allocation can reduce investment risk for all investor classes.

Fixed-income equity has analogous investment characteristics to senior secured lessee debt, although implementation of the all-equity capital structure is a nonevent from the lessee perspective. Thus fixed-income equity is synthetic lessee debt. We refer to implementation of the all-equity capital structure as synthetic debt finance.

It is important to emphasize that synthetic debt finance implements an all-equity capital structure. Synthetic debt is an alternative to conventional debt, not a supplement. Since the debt foreclosure process negates the timeliness advantage of lease default recourse, mixing synthetic debt with conventional debt is like mixing oil and water.