

SYNTHETIC DEBT FROM THE FINANCIER PERSPECTIVE

Fixed-income investors should find synthetic debt to be a low-risk instrument for financing the acquisition of leased assets by conventional non-fixed-income equity investors due to its unique default protection characteristics. Although synthetic debt functions as lease finance from the perspective of the non-fixed-income investors, synthetic debt also provides the fixed-income investors with comparable or superior default protection to investments in conventional senior debt of the lessee.

The core element of synthetic debt finance is a bondable net lease of a tangible asset. Net rent payments from the lease service the financing. Both interest and amortization of principal are included in the rent, which means that synthetic debt is an amortizing financing.

Synthetic debt finance differs from lease finance in that ownership of the asset is separated into two components with respect to time: a term-of-years ownership interest that usually coincides in duration with the length of the primary lease term, and a remainder ownership interest that matures into the possessory interest at the end of the lease term when the term-of-years interest expires.

Unless the lessee defaults, the term-of-years interest entitles its owner to economic benefits consisting precisely of net lease payments during the primary lease term. It follows that the term-of-years interest is a fixed-income asset.

In conventional debt finance the fixed-income investor provides investment capital in return for a note and a lien on the leased asset. In synthetic debt finance the fixed-income investor purchases beneficial ownership of the term-of-years interest in lieu of the note and lien. Accordingly, synthetic debt is actually a fixed-income equity interest in the leased asset.

It follows that the synthetic debt capital structure is an all-equity capital structure for the leased asset. There is no debt in the capital structure because there is no lien on any equity interest. Two classes of equity replace the debt and single equity class of a conventional capital structure.

Cross-linking default covenants in bondable net leases imply that default on any conventional or synthetic debt instrument is a default on all lease-based synthetic debt. It follows that synthetic debt default risk coincides with conventional debt default risk.

Beneficial ownership of the term-of-years interest is a passive investment. It follows that the fixed-income investor is not exposed to nonfinancial investment risk unless the lessee defaults and the investor elects to control the enforcement of default recovery provisions in the lease.

In the event of synthetic debt default in which the financier decides to take control of default recovery enforcement, the financier can complete the transition from passive investor to controlling owner within days of making the decision. Then the financier can negotiate directly with the lessee or bankruptcy trustee about whether to continue the lease, or to cancel the lease, recover the remaining rent due and redeploy the asset. In either case, timely default resolution avoids the risk of asset deterioration frequently associated with protracted mortgage foreclosures.

In general, lease resolution takes precedence over debt resolution in corporate bankruptcy. Accordingly, financiers of synthetic debt should conduct most default recovery and redeployment of investment capital on a much more compact timetable than financiers of conventional secured and unsecured debt. Since synthetic debt minimizes losses associated with the time cost of money during default recovery, financiers should find synthetic debt a worthwhile addition to the family of senior corporate fixed-income securities.