Real Estate Transactions’ Impact on Corporate Financial Statements

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Presenter Introduction

Todd Anderson is Senior Managing Director of CB Richard Ellis' Global Corporate Services group in Los Angeles, California with responsibility for client development of global corporate services contractual relationships, as well as, serving as the Alliance Director providing the strategic oversight and account team management for The Boeing Company's global portfolio of properties.

Mr. Anderson has represented corporate real estate requirements since 1983 and excels at developing integrated solutions to align corporate real estate strategy with business performance measures and delivering implementation and execution platforms and capabilities.

Mr. Anderson graduated from the University of Minnesota with Bachelor of Science degrees in Finance, Economics and History. Mr. Anderson has continued his education through the Institute of Corporate Real Estate and the CoreNet Executive Development Program, where he has received the Masters of Corporate Real Estate designation, a Certificate of Advanced Study in Corporate Real Estate Finance, and the Senior Leader of Corporate Real Estate Certificate. Mr. Anderson is a regular real estate industry speaker and contributing author of articles, as well as, a "Top Rated" faculty member of CoreNet Global each consecutive year since 2000.

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The “silver bullet” question!

Is your client

income statement or ***balance sheet*** **driven?**

EBIT EBITDA EPS ROA RONA ROE EVA D/E EPM

Bottom Line

Agenda

- Fundamentals of Finance
- Operating Lease Acquisition
- Property Purchase
- Break
- Finance Lease
- Sublease
- Financial Ratios
- Income Statement vs. Balance Sheet

“Fundamentals of Finance”

Facts

- Primary focus of a company is on its core business(s)
- Many companies have extensive Real Estate holdings
    - Headquarters Buildings
    - Distribution Centers
    - Manufacturing Plants
    - Sales Offices
    - Retail Units
- With senior management objectives/ focus on the primary business of the company- Real Estate is not equally recognized as other assets.

- CRE Executives who can ***communicate*** the impact of Real Estate on a company’s Financial Statements is valuable to the organization and can contribute to the bottom line.

Goals

- Long term goal of corporate finance is to maximize shareholder wealth.
- Short term goal is maximization of profits.
- Balancing long and short term goals to meet analysts projections.

***Share value= projections, performance, and perception**

Who Cares?

Owners/Shareholders

- Investment vs. Donation
- Appreciation and/or Dividends
- Long and Short Term Goals

CEO

- Accountable to Shareholders through Board
- Responsible for predictable, consistent earnings growth

CFO / Finance Director

- Reports to CEO, Accountable to Board
- Responsible for management of financial resources

Director of Real Estate

- Reports to CFO / Finance Director
- Responsible to provide facilities to house business operations

Annual Reports

- Companies prepare and publish an annual report which includes:
  - Balance Sheet
  - Cashflow Statement
  - Income Statement
  - An Independent Auditors Report
  - Chairman's Statement
  - Notes to the Financial Statements, etc.

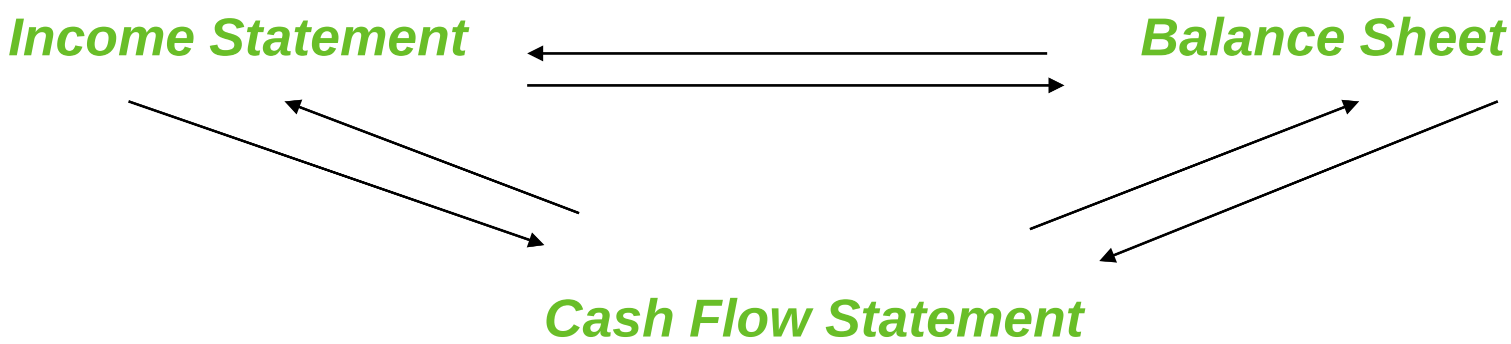
- Annual Report is prepared to satisfy the information needs of:

Shareholders Creditors Customers Investors

Employees Owners Managers Lawyers

“Fundamentals of Finance”

Practically all measurement of a corporation’s business is in a series of financial statements:



**This course will focus on the nature and inter-relationships of these Statements providing practical application for the CRE.*

Income Statement Orientation

Income Statement

- Revenue
- Expense
  - General & Admin
  - Rent
  - Depreciation
  - Amortisation
  - Interest
  - Taxes
- Net Profit

Balance Sheet Orientation

Balance Sheet

- Assets
  - Cash
  - Real Estate (Property, Plant & Equipment)
- Liabilities
  - Debt
- Shareholders Equity

Primary Financial Statements

Income Statement

- Revenue
- Expenses

- Net Income (Profit)

Lease

- Rent

Purchase

Finance Lease

- Depreciation
- Interest

Balance Sheet

- Assets
- Liabilities
- Equity

- Building
- Debt

Cash Flow Statement

1

Introduction to the
Operating Lease Acquisition Case Study

Operating Lease Assumptions

- Revenue $10 million
- General & Administrative $7 million
- 50,000 square foot requirement
- 10 year lease
- $20.00psf rent per annum Net
- Tax 16%

Income Statement Orientation

Income Statement	
Revenue	$ 10,000
Expense	
General & Admin	$ 7,000
Rent	$ 1,000
Depreciation	
Amortisation	
Interest	
Taxes	$ 320
Net Profit	$ 1,680

Balance Sheet

- **Assets**
  - Cash
  - Real Estate (P,P&E)
- **Liabilities**
  - Debt
- **Shareholders Equity**

2 Introduction to the Property Purchase Acquisition Case Study

Purchase Assumptions

- Revenue $10 million
- General & Administrative $7 million
- 50,000 square feet
- $8,000,000 freehold acquisition (12.5% cap)
- 30 year loan, 9% interest
- Tax 16%

Income Statement Orientation

Income Statement

Revenue	$10,000
Expense	
■ General & Admin	$ 7,000
■ Rent	0
■ Depreciation (4%/yr) *	320
■ Amortisation	
■ Interest (9%)	720
■ Taxes	314
Net Profit	$ 1,646

* Not tax deductible in the HK

Balance Sheet

- Assets
- Cash
- Real Estate (P,P&E) $ 7,680
  - Historical Cost
  - Less Building Depreciation

- Liabilities
- Debt $ 7,941
- Shareholders Equity

Income Statement Orientation

Income Statement	Lease	Own
Revenue	$10,000	$10,000
Expense		
■ G&A	$ 7,000	$ 7,000
■ Rent	$ 1,000	$ 0
EBITDA	**$ 2,000**	**$ 3,000**
■ Depreciation		320
■ Amortisation		
EBIT	**$ 2,000**	**$ 2,680**
■ Interest		720
■ Taxes	$ 320	$ 314
Net Profit "Bottom Line"	$ 1,680	$ 1,646

Break

Basic Accounting Principles

Guidelines

IASC- *I*nternational *A*ccounting *S*tandards *C*ommittee

IASB- *I*nternational *A*ccounting *S*tandards *B*oard

IAS - *I*nternational *A*ccounting *S*tandards

IFRS- *I*nternational *F*inancial *R*eporting *S*tandards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RICHARD FEARON, CFO OF EATON CORP.

3 Introduction to Finance Lease

IAS 17 Finance Lease Criteria

- Automatic Transfer of Ownership
- Bargain Purchase Option
- Term > Major Portion of Remaining Useful Life
- PV Rent > Substantially all of Fair Market Value
- Special Use Facilities

IAS 17 - Finance Lease

- Treated similar to Purchase with 100% financing:
  - Asset on Balance Sheet, Depreciate over term
  - Finance Lease Obligation – Liability like a loan
  - Payments are Interest and Principal amortisation
  - Interest + depreciation expense on Income Statement

- Substance over Form
  - Document say Lease but,
  - Tenant essentially receives benefits of ownership

Finance Lease Assumptions

- Revenue $10 million
- 50,000 square foot requirement
- 15 year lease
- $20.00psf rent per annum FRI
- Tax 16%
- $1million per annum, PV @ 9% = $8,060,688
- Depreciation $537,379 (15 yrs)
- Interest $725,462 (9%, 15 yr term)

Income Statement Orientation

Income Statement	Lease	Own	Finance
Revenue	$10,000	$10,000	$10,000
Expense			
■ G&A	$ 7,000	$ 7,000	$ 7,000
■ Rent	$ 1,000	$ 0	$ 0
■ Depreciation		320	537
■ Amortisation			
■ Interest		720	725
■ Taxes	$ 320	$ 314	$ 278
Net Profit	$ 1,680	$ 1,646	$ 1,460

Balance Sheet Orientation

Balance Sheet	Lease	Own	Finance
Assets			
Cash	$ 0	$ 0	$ 0
Real Estate (P,P&E)	0	7,850	7,523
Liabilities			
Debt	$ 0	$ 7,941	$ 7,725
Shareholders Equity			

Finance vs. Operating Summary

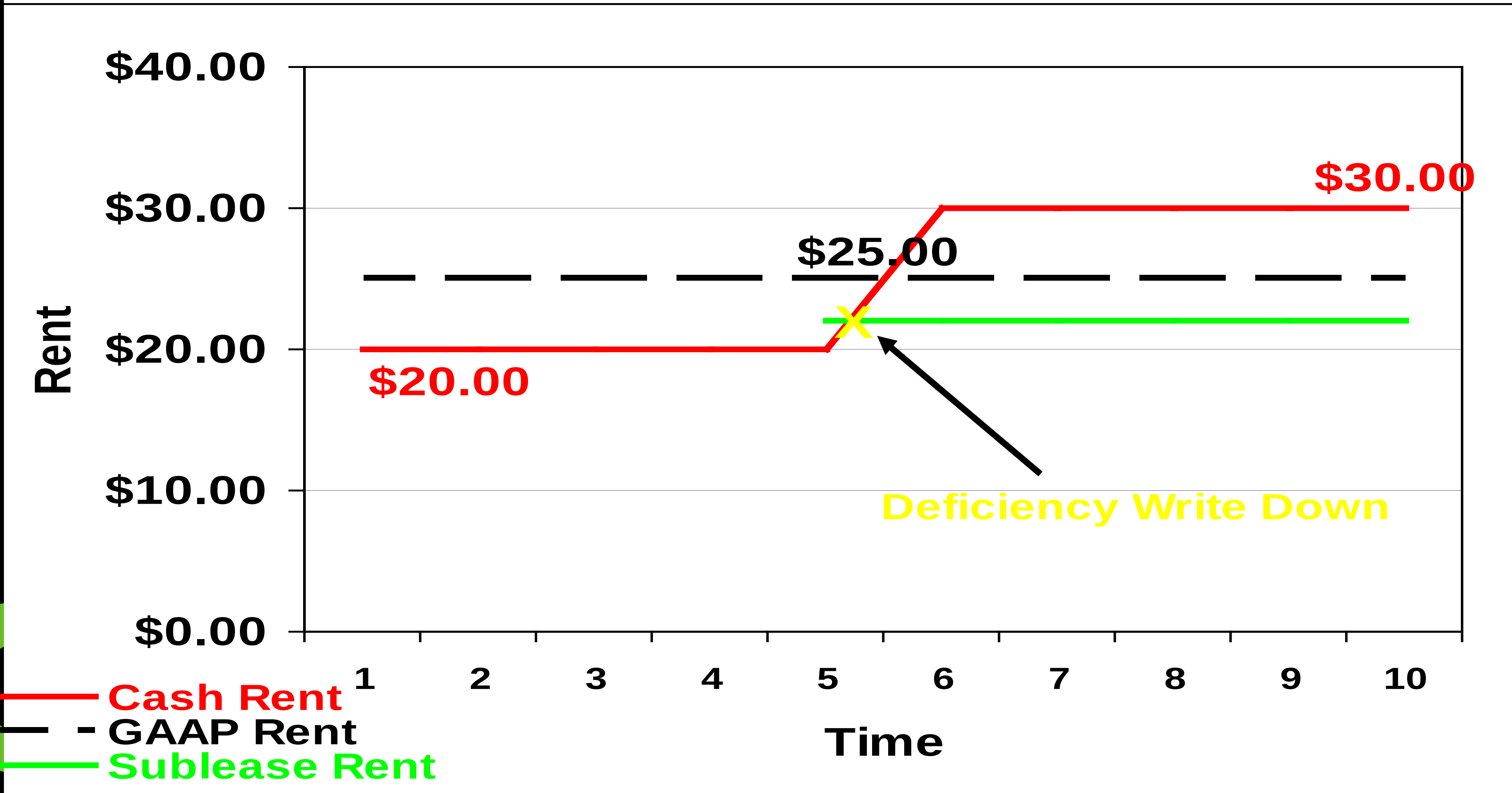
- Finance Lease is on Balance Sheet – think of it as a purchase with 100% financing
- Ratios using assets & liabilities are impacted
  - Current Ratio & Quick Ratio
  - Return on Assets
  - Return on Equity
- Depreciation + interest expense exceed rent
- Generally unfavorable accounting – but…
- ...not good or bad – just shouldn’t be a surprise

4 Introduction to Sublease

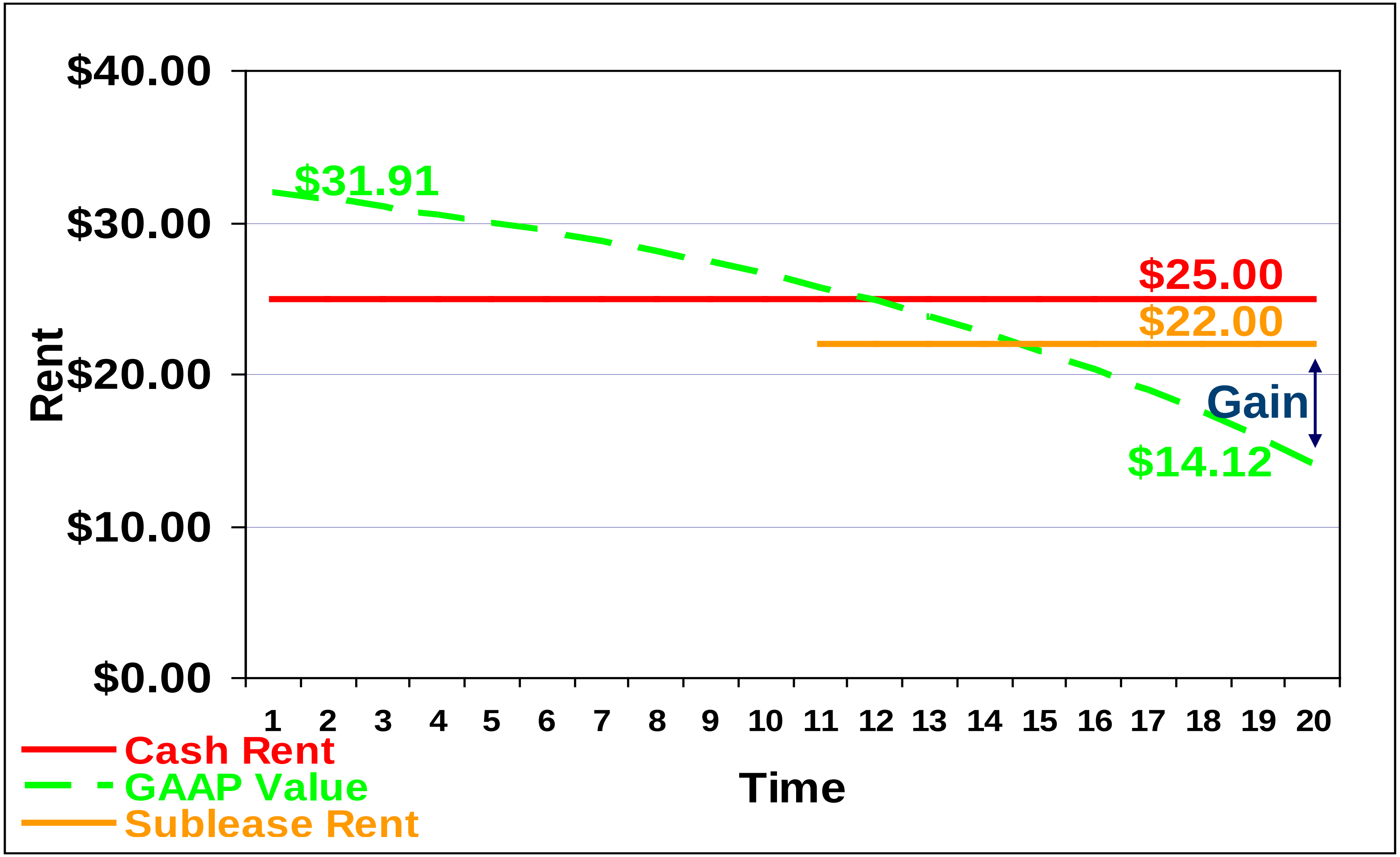
IAS 37 Exit of Disposal Activities

- Recognize when entity ceases using
- Fair value of remaining lease rentals
- Reduced by estimated sublease rentals
- Expense unrealized subrent annually

Operating Lease Disposition
(Sublease)



Finance Lease Disposition (Sublease)



5 Introduction to Financial Ratios

Key Financial Ratios

- CEO
  - Share Price
  - Earnings per Share-EPS

- CFO / Finance Director
  - Debt/Equity Ratio-D/E
  - Return on Equity-ROE
  - Return on Assets-ROA

Financial Ratios

Financial ratios reflect the relationships among certain key numbers in the financial statements.

They are useful for comparing a company's performance:

1. **With industry averages**
2. **With other business in the same industry**
3. **With the company's performance in previous periods.**

Investors and owners often use such ratios to evaluate a company's financial performance and make decisions about the company. Since real estate transactions affect the financial statements, they also affect these ratios. It is therefore useful to consider then in evaluating the impact of transactions.

Market Value Ratios

Market value ratios primarily relate the company’s earnings to its stock price, its share value, and its payment dividends.

Earnings per share- this ratio reflects earnings in the period for each ordinary share

EPS = Net income - preferred dividends/outstanding ordinary shares

$35 million / 50 million = $0.70

Profitability Ratio

Return on Assets - ROA indicates how well the company has used its assets to generate income.

ROA= net income / total assets

$35 million / $835 million = 4.19%

Profitability Ratio

Return on Equity- ROE indicates the rate of return on the investment in shares.

ROE = Net income / shareholder's equity

$35 million / $285 million = 12.28%

Top Line…Bottom Line

Profit Margin

- Revenue $ 100 m
- Costs $ 95 m
- Profit $ 5 m

5% Margin

How do you double profits to $ 10m ?

- Hard way - double sales to $ 200m
- Easy way – reduce costs to $ 90m

Lesson is every $1 saved = $1 of profit

- That's why your customer is managing costs; their ability to increase revenue is limited

CRE Alignment

- **Understand the Corporate Goals**
  - How are CEO and Business Units measured
  - Why do Shareholders invest in your company
  - What drives company "success" on Wall Street

- **Understand your portfolio**
  - Local – Regional – National – Global
  - What does it look like?
  - Does the balance make sense for your business?
  - Which direction should it move?