Real Estate Transactions’ Impact on Corporate Financial Statements

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Global Corporate Services

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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
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.
Corporate Finance

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

- **Income Statement**
- **Balance Sheet**
- **Cash Flow Statement**

*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)

Balance Sheet
- Assets
- Liabilities
- Equity

Cash Flow Statement

Lease
- Rent

Purchase Finance Lease
- Depreciation
- Interest

- Building
- Debt
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
- $20.00 psf rent per annum Net
- Tax 16%
## Income Statement Orientation

### Income Statement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$ 10,000</td>
</tr>
<tr>
<td><strong>Expense</strong></td>
<td></td>
</tr>
<tr>
<td>General &amp; Admin</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Rent</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
</tr>
<tr>
<td>Amortisation</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$ 320</td>
</tr>
<tr>
<td>Taxes</td>
<td></td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
<td>$ 1,680</td>
</tr>
</tbody>
</table>
Balance Sheet Orientation

Balance Sheet

– **Assets**
  - Cash
  - Real Estate (P,P&E)

– **Liabilities**
  - Debt

– **Shareholders Equity**
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

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$10,000</th>
</tr>
</thead>
</table>

**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 Orientation

Balance Sheet

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

- **Liabilities**
  - **Debt**
  - **Shareholders Equity**
    - **$ 7,941**
### Income Statement

<table>
<thead>
<tr>
<th></th>
<th>Lease</th>
<th>Own</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Expense</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G&amp;A</td>
<td>$ 7,000</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Rent</td>
<td>$ 2,000</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortisation</td>
<td>$ 2,000</td>
<td>$ 2,680</td>
</tr>
<tr>
<td>Interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>$ 320</td>
<td>$ 314</td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
<td>“Bottom Line”</td>
<td>$ 1,680</td>
</tr>
</tbody>
</table>

**EBITDA**: $2,000

**EBIT**: $2,680

**“Bottom Line”**: $1,680
Break
Basic Accounting Principles

Guidelines

IASC- *International Accounting Standards Committee*

IASB- *International Accounting Standards Board*

IAS - *International Accounting Standards*

IFRS- *International Financial Reporting Standards*
IT'S TIME TO PREPARE FOR THE ARRIVAL OF INTERNATIONAL ACCOUNTING STANDARDS

Goodbye GAAP

TRIALS & ERRORS
THE RISKS OF DEFENDING A SECURITIES LAWSUIT

THE LOAN DANGER
MANY EMPLOYEES ARE RAIDING THEIR 401(k) PLANS

SUCK IT UP
HOW TO RUN SUPPLY CHAINS ON LESS OR
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
Operating Lease Assumptions

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

Finance Lease Assumptions

15 year lease
## Income Statement Orientation

<table>
<thead>
<tr>
<th>Category</th>
<th>Lease</th>
<th>Own</th>
<th>Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Expense</strong></td>
<td></td>
<td></td>
<td></td>
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<td>G&amp;A</td>
<td>$7,000</td>
<td>$7,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>Rent</td>
<td>$1,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td>320</td>
<td>537</td>
</tr>
<tr>
<td>Amortisation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td></td>
<td>720</td>
<td>725</td>
</tr>
<tr>
<td>Taxes</td>
<td>$320</td>
<td>$314</td>
<td>$278</td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
<td>$1,680</td>
<td>$1,646</td>
<td>$1,460</td>
</tr>
</tbody>
</table>
## Balance Sheet Orientation

<table>
<thead>
<tr>
<th></th>
<th>Lease</th>
<th>Own</th>
<th>Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Real Estate (P,P&amp;E)</td>
<td>0</td>
<td>7,850</td>
<td>7,523</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td>$0</td>
<td>$7,941</td>
<td>$7,725</td>
</tr>
<tr>
<td><strong>Shareholders Equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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
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)

<table>
<thead>
<tr>
<th>Time</th>
<th>Cash Rent</th>
<th>GAAP Rent</th>
<th>Sublease Rent</th>
<th>Deficiency Write Down</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$20.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>$20.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>$20.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>$25.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>$30.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>$30.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>$30.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>$30.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>$30.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>$30.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td></td>
</tr>
</tbody>
</table>
Finance Lease Disposition (Sublease)

- **Cash Rent**: $31.91
- **GAAP Value**: $22.00
- **Sublease Rent**: $25.00

**Gain**: $14.12
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 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 them in evaluating the impact of transactions.
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

$$\text{EPS} = \frac{\text{Net income} - \text{preferred dividends}}{\text{outstanding ordinary shares}}$$

$35 \text{ million} / 50 \text{ million} = 0.70$
Return on Assets - ROA indicates how well the company has used its assets to generate income.

\[ \text{ROA} = \frac{\text{net income}}{\text{total assets}} \]

\[ \frac{\$35 \text{ million}}{\$835 \text{ million}} = 4.19\% \]
**Return on Equity** - ROE indicates the rate of return on the investment in shares.

\[
\text{ROE} = \frac{\text{Net income}}{\text{shareholder’s equity}}
\]

$35 \text{ million} / \$285 \text{ million} = 12.28\%$
Profit Margin
- Revenue: $100m
- Costs: $95m  
- Profit: $5m  

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?