The Lease – An Alternative for Funding Investments in Real Estate

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Summary: This article is dedicated to the use of leases in funding investments in real estate, which still is not very common in Bulgaria, although a growth in the relative share of leasing has already been noticed in the portfolios of Bulgarian companies.

The article places an emphasis on the legal aspect of leasing real estate (a combination of contracts – lease, credit, purchase, construction) and its financial features as a combination of monetary relationships and cash flows.

Attention is paid to the specific types of financial leasing of real estate – leasing of new construction, leasing of the buy-and-lease type, sale and leaseback, leasing through closed-end real estate funds.

The advantages of leasing for the three parties to the real estate lease transaction – lessor, lessee and creditor, are explained, as well as the specifics of some financial conditions – lease payments, the distribution of the various types of expenses, connected to the management of the property, between the lessor and the lessee, etc.

It is noted in the conclusion that the leasing of real estate is a promising form of funding of investments, the development of which would contribute to a more dynamic real estate market.

Key words: leasing, real estate, investments, funding.

JEL: R21, R33.

1. General treatment of the matter

Leasing is a relatively well-known form of acquiring various types of assets like machines, equipment, transport vehicles, etc. Its use in Bulgaria is much more limited when it comes to acquiring various types of real estate. Even so, in the last decade this alternative to funding of investments in real estate has become more popular and the number and volumes of real estate lease transactions are growing.

There are some inaccuracies and inconsistencies in the practical application of leasing in the field of real estate with respect to the science-based theories on the subject. This fact proves the necessity of a better acquaintance with the essence and characteristics of acquiring real estate, funded through a lease. This, in turn, does not mean that the business practice cannot develop its own ideas and forms, and contribute to enrichment of the theory itself.

The term leasing comes from English (to lease = to rent). It can be viewed in two aspects: in terms of civil law it means a contract for transfer of the rights-to-use, and in a financial and economic aspect it is viewed as an alternative for funding the acquisition (investments) of various types of long-term tangible assets, including – in particular, real estate.

Leasing of real estate in Bulgaria is offered by some banks (Raiffeisen Bank, Piraeos Bank, etc), as well as specialized leasing companies (Interlease, Deruick Asset Management – Bulgaria, etc.). Natural persons, as well as enterprises and organizations from various sectors of the economy, can take advantage of the benefits of leasing in their capacity as lessees. For example, in Germany 20 % of the construction of commercial production buildings is funded through leasing. This form is also very suited to acquisition of real property by municipalities and government administration. It should be noted, however, that the subject of leases in the field of real estate are mainly non-residential properties (industrial and administration buildings, office spaces, warehouses, hotels, etc.). As for residential properties, lease transactions could be made with investors, who are acquiring an entire multi-apartment building or a separate housing estate and then, by renting them, (and in specific cases and under certain conditions also by selling separate homes) are forming relatively constant and regular cash flows, thus generally being able to pay their lease installments without difficulty.

During the financial and economic crisis, leasing of machines, equipment, transport vehicles, etc. decreased because of the necessity of businesses to cut down their costs. According to data published in the *Dnevnik* newspaper, the only segment, which has acquired a bigger relative share in the investment portfolios of companies, is that of real estate leasing, with a growth from 8.9 % in 2009 to 13.5 % by the end of 2010.[1] It is also noted that the volume of collectables in connection with lease transactions concluded for real estate by the end of 2010 is BGN 534 million, which is 20 % more compared to 2009.

An important fundamental reason of the relatively strong presence (however, very weak in comparison with other countries) of leasing in the field of real estate is the use of sale and leaseback, which enables companies, selling real estate, to increase their liquidity, observe the terms of payments to other creditors, optimize and make their current payments and, in this way, retain the opportunity to use (through sale and leaseback) the real estate, while also preserving their image and reputation and stabilizing their financial position.

2. Form and types of real estate leases

The leasing of real estate can be defined as a long-term form of assignment of the rights-to-use of a property for a strictly defined time period from the lessor to the lessee in return for payment (by the lessee) of periodic, usually equal in amount, monetary installments (lease payments), with an opportunity for the lessee to prolong the term of use of the asset or to acquire it after expiration of the initially contracted term. Therefore, in this case, the subject of the lease transaction are real investment products (land and its most significant composite part – the buildings), with parties to the deal being developers, industrial and other enterprises, municipalities and organizations from the field of government administration (lessees), leasing companies,

[1] Dnevnik newspaper, 21.02.2011.

affiliates for leasing to bank institutions, etc. (lessors), as well as banks and other credit institutions (creditors).

A lease transaction is regulated through a lease contract. It expresses the legal characteristic of the problem and it has a rather peculiar nature in that it unifies elements of a tenancy agreement, agricultural land lease, purchase contract through deferred payment and a property management contract. In this case, the matter in point is the basic lease contract, concluded between the lessor and the lessee. In a broader aspect, the leasing of real estate can be characterized as a set of separate contracts, with the one between the lessor and the lessee as their core. The other contracts are connected to the nature and the stages of the lease transaction, namely:

- According to the basic contract the lessee undertakes the obligation to purchase or build a certain property (usually at the request of the lessee and meeting its requirements). The lessee is obliged to pay the lease payments and, after expiration of the lease term, to renew it or to purchase the asset (in compliance with the contract). There is also an opportunity (which has to be agreed in advance), after the property is completely ready to be put into use, for the lessee to take on its management;
- Contract between the lessor and a credit institution in connection with the funding for

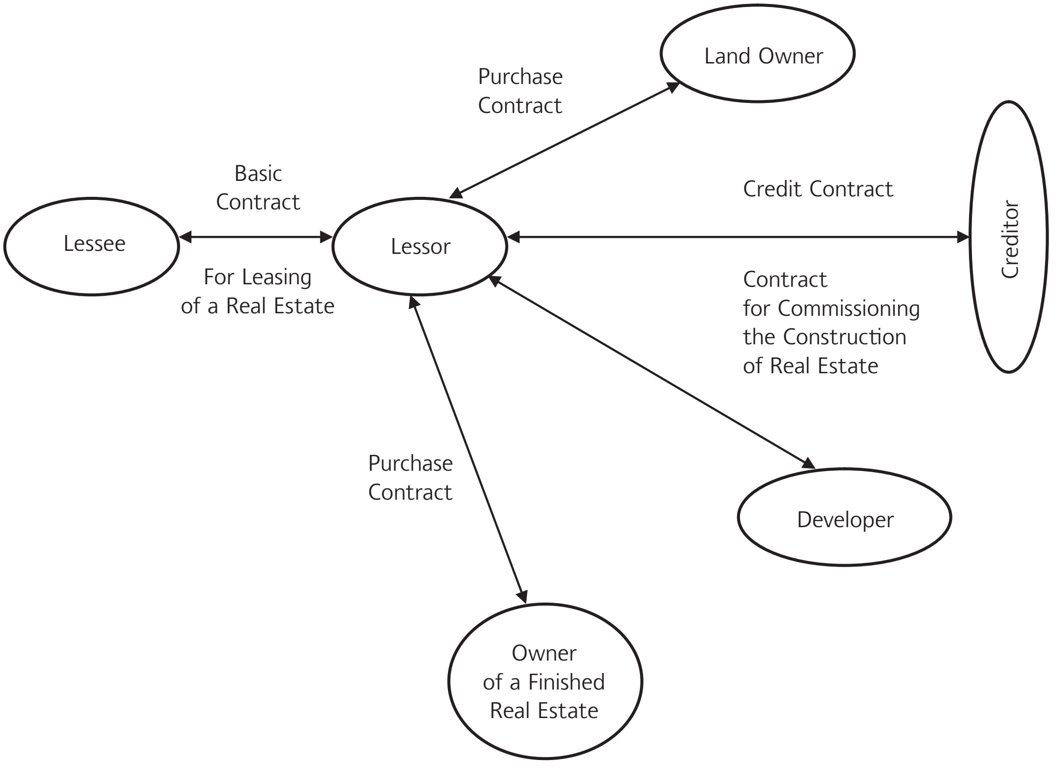

Figure 1. Participants in a real estate lease transaction

acquiring the property, subject of the contract. Depending on the actual case, the credit is directed to one of the following entities, with whom contracts are also concluded:

- Owner of land (respectively, plot to be developed), who sells it to the lessor. A contract for purchase is concluded between the two, funded by the creditor (completely or partially);
- Developer, with whom the lessor concludes a contract for the construction of the building in question. This is also completely or partially funded by the creditor;
- Owner of a building ready to be put into use, who sells it to the lessor. A contract for purchase is concluded between them, completely or partially funded by the creditor.

The relationships described between the participants in the lease transaction for real estate are expressed in the contracts mentioned above, and they can be illustrated as shown in figure 1.

The above diagram shows that from a legal perspective real estate leasing is a combination of contracts, where the lease contract is the main component, and the rest (for credit, purchase and construction) are ancillary, though this does not diminish their significance.

From an economic (respectively financial) perspective, the leasing of real estate can be viewed as a combination of monetary relationships and cash flows between the participants in the lease transaction. The following cash flows can be identified:

- cash flow from the creditor to the lessor in the form of a one-off or repeated allocation of the credit amount;
- regular cash flows from the lessor to the creditor. Most often they are of the annuity payments type (i.e. equal in amount);
- cash flows from the lessor to:
  - the owner of the land;
  - the developer or
  - the owner of the finished building.

These flows can be a one-off or multiple, depending on the method and form of payment agreed in the contract:

- cash flows from the lessee to the lessor in the form of regular (and usually equal in amount) lease payments. Here, both the initial lease payment and the payment after expiration of the lease term must be included, in the event that under the contract the lessee will purchase the asset at its residual value.
- cash flows from the lessor (respectively, a part of them from the lessor to various enterprises and institutions) in the form of payments for normal periodic and occasional services (water, sewage, management of the asset, taxes, fees, etc.). It is very important how these payments are distributed between the lessor and the lessee.

The cash flows and the monetary relationships between the participants in the lease transaction for real estate are presented in Table 1.

An important issue concerning leasing of real estate is the different types of leases. In general, and in the case of real estate, depending on the nature of the obligations of the parties to a lease transaction, the differentiation is between an operating lease and a capital lease. An operating lease, in this case, is characterized by its short term and the ability to be terminated at any time; it is therefore regulated by contracts identical to rental agreements. A capital lease is characterized by its long term and it cannot be terminated for the duration of its term. This type of lease is viewed as an alternative to financing property investments. It can be

Table 1. Cash flows between the participants in the lease transaction for real estate

Participants in the lease transaction			**Name of the cash flows**
Lessor	→ ←	Creditor	Expenses for research and choice of creditor; Expenses for preparation of a credit application; Expenses for repayment of the credit (usually annuities) and other fees and commissions.
Lessor →		Land owner	Expenses for research into the land market[2]; Purchase price of the land; Estate agent's commission; Notary fees; Municipal tax for purchase of property for a consideration Fee for registration of deeds pertaining to the land (respectively, for amendments and deregistration; for registration of mortgages, pledges and other instruments, for waiver of property rights, for registration and cancellation of foreclosures); Fees for making an entry in the cadaster; Other cadaster-related fees; Fees for issue of technical approvals; Fees for amendments made to the cadastral map and cadastral register; Fee for assignment of an identifier; Fee for change of the designation (if necessary) of the land; Fee for issue of permit to use the property; Fee for provision of a copy of the cadastral map.
Lessor →		Developer	Expenses for market research into construction services; Design expenses; Expenses for construction, including coordination and approval of an investment project; issue of planning permission; issue of a building regulations approval; Fees for issue of a permit for appraisal of the compliance of the construction product; Fees for issue of technical approvals; Fees for registration in the property register; Fees for making an entry in the cadaster, for provision of an identifier of the property; Fee for issue of permit to use the property.

[2] In this case, expenses means the outgoing (for the lessor) cash flows, regardless of their recipient, related to the respective transaction.

Participants in the lease transaction			Name of the cash flows
Lessor →		Owner of a finished property (seller)	Expenses for market research;
			Price of the property;
			Estate agent's commissions;
			Notary fees;
			Fees for changes to the lot of the property in the Property register;
			Other fees, connected to services, provided by the Property Register (for registration of mortgages, cancellation of foreclosures, etc.);
			Fees for changes in the cadastral map and the cadastral register.
Lessor	→ ←	Creditor	Expenses for research into the credit market and selection of a creditor;
			Expenses for preparation of the documentation for the credit application;
			Fee for initial examination of the documents;
			Fee for management of the credit;
			Fee for drawing down the credit;
			Commission for engaging the services of the creditor;
			Commission for premature repayment;
			Fee for renegotiation;
			Annuity installments on the credit;
			Amount of the credit.
Lessor and/or Lessee			Current expenses for utilities at the property (water, lighting, heating, etc.);
			Expenses for maintenance of the property in a fit-for-purpose condition (maintenance);
			Expenses for maintenance of the space around the property;
			Other expenses connected to the management of the property and its use.

divided into the following subtypes, depending on the subject of the lease transaction:

- *New construction lease;* The lessor invests in a construction project (usually at the request of the lessee) and later grants the lessee the right to use it via a lease;
- *Buy-and-lease type;* With this type of lease the lessor buys a property (approved by the lessee in advance) from an owner (seller) and grants the lessee the right to use it for a specific period of time in return for payment in the form of lease payments;
- *Sale and leaseback;* In this case, the lessor sells the property it owns to the lessee and the latter grants back the right to use it to the lessee;
- *Leasing via closed-end real estate funds.*

3. Advantages and disadvantages of real estate leasing

3.1. Advantages of real estate leasing

Leasing of real estate has advantages for all three parties to the lease transaction:

- For the lessee:
  - The lease delivers the lessee from problems and costs connected to legal issues (land law, construction law, etc.);
  - The lessor can provide the lessee with various kinds of services during the lease term, which allows the lessee to concentrate on its main business;
  - Depending on the lessee's current financial position and the prospects for cash flows, the lessee has a couple of choices: a) use the lease payments to pay for all costs incurred in acquiring the property (full depreciation); this is rarely used due to the high price and the long term of use of the property; b) use lease payments to pay the larger part of these costs (partial depreciation); here, the remaining part is the residual value of the real estate, as recognized in the financial statements; and c) in the case of partial depreciation, supplement the lease payments with additional payments to the benefit of the lessor with a view to achieving full depreciation at the end of the lease period and the real estate becoming property of the lessee. The additional payments are financed by a creditor of the lessee, while lease payments should be financed by cash flows from the lessee's business activity. This is the so-called model of advance payment at the sale price;
  - Real estate leasing offers a variety of options and forms depending on the different financial positions the lessee may be in and according to the specifics of the property;
  - Having in mind the need for substantial investments in the real estate sector, leasing increases the chances for the lessee to realize its investment targets;
  - The sale and leaseback of property increases the lessee's liquidity, which allows it to realize other projects and ideas, and also improves its image in front of other investors;
  - The permanent nature of lease payments gives the lessee the chance to plan its expenses and to contribute to the greater stability of its business;
  - Leasing helps the lessee to avoid complex, expensive and time-consuming procedures, connected to the lessee's credit-rating and credit use, which in itself is the other opportunity for real estate investment financing;
  - The lessee reports the lease payments as current costs, which decreases its profit and, respectively, the tax on it, without affecting the correlation between fixed capital and debt capital, i.e. without any changes in the lessee's capital structure.
- For the lessor:
  - Leasing of real estate is a business, where the transactions are expected to be of a high value, creating opportunities for realization of good profit and returns for relatively long periods of time;
  - Leasing companies (lessors → independent subsidiary corporations of credit institutions or specialized departments of construction companies) have qualified personnel responsible for the choice of building grounds, planning, construction, financing and management of finished properties. This allows them to offer comprehensive services to lessees, the costs of which are calculated and included in the lease payments. The comprehensiveness and professionalism of the services are a good prerequisite for increase in the lessor's income;
  - Forms are developed in the contemporary conditions, allowing the lessor to minimize the dangers of worsening its own liquidity,

e.g. by betting on the lease payments of the lessee at the credit institution, which has allocated the credit to it. It is also possible for it to sell these installments. In this case, the matter in point is the operation known as forfeiting.

- A real estate lease is usually non-terminable and with a long term, which enables the lessee to reasonably plan its income;
- It should also be emphasized that if the legislation of a given country envisages tax burdens for the lessor, he has the opportunity to transfer them to the lease payments of the lessee;
- Because during the lease term the real estate is property of the lessor, it reflects this fact by reporting it as an asset in its balance sheet, charges depreciation to it, and therefore can take advantage of the tax incentives given for this;

- For the creditor:
  - The main advantage for the creditor is the expansion of the range of products (credits provided by it) with the emergence of a new type of credit applicant (user) → the lessor;
  - Giving loans to lessors is not only bound to an appraisal of their creditworthiness but also to the creditworthiness of the lessees. This to a certain extent reduces the risk of the credit transaction;
  - By giving a loan to the lessee, the credit portfolio of the credit institutions is diversified and opportunities are created for its better management.

3. Specifics of the financial conditions

The basic financial issue of a real estate lease transaction is the determination of the size of the lease payment. It is formed by the following elements:

- Investment expenses (price of the plot and the expenses for construction or the purchase price of the property);
- The interest and the repayments on the credit used by the lessor;
- Taxes, fees and other similar payments of the lessor;
- Profit for the lessor.

The so-formed lease payment is a fixed amount, and it cannot be changed, regardless of any potential change in the factors which determined it, and especially in the interest rate on the credit, which the lessor has used. The only exception to this rule is the case when in the lease contract it is agreed that the payments will gradually increase or decrease, even though their total amount for the whole lease term will always remain fixed. In connection with the elements of the lease payment, it should also be noted that taxes, fees and other similar financial obligations are usually distributed between the lessor and the lessee, which makes the duration of the lease contract a significant factor. For example, if the lease term spans the entire useful life of the property, the tax offices assume that the lessee is the "economic owner" (user), and it pays the tax on the real estate. An important issue is also the one connected to the expenses for maintenance of the property in a fit-for-purpose condition. These expenses are in principle covered by the lessee.

The leasing of real estate is of real significance both for business organizations and for those from the public sector (municipalities, government administration). In this field, leasing could be successfully implemented in the framework of the public-private partnership. Here, the significance of the services, which the lessor can provide to the lessee (management of the use of the assets during the lease term and after its expiration), stands out most clearly.

As it was already pointed out, the nature, types and advantages of the leasing of real estate presented here outline, in our opinion, a relatively new and promising niche in the real estate market, which is gradually being occupied. This form has a development potential, which would contribute to stabilization in the short term and certain growth in the long term, mainly in the real estate market. And, as it is also known, the growth of this market is an indicator and catalyst for the growth of the whole economy.

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