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Financial Watch

Build-to-Suits: More Popular than Ever

by Aimee D. Sweeney

A BUILD-TO-SUIT ARRANGEMENT is one where a lessee works with a developer or builder of either real estate or equipment to design and construct an asset to its exact specifications. Build-to-suits are vehicles employed by lessees to acquire new and customized assets with minimal or no cash outlay. Lessees today are entering into build-to-suit arrangements in record numbers thanks to the historically low financing environment, the off-balance sheet treatment during construction, reduced balance sheet recognition during the lease, and the ability to finance 100% of the project costs. If the transaction is structured as a lease, it will allow a user the use of a new, custom-built asset without strapping themselves with the residual risks associated with ownership.

While build-to-suits have been a successful tool for lessees to lease new core assets, like real estate headquarters and vessels, the previous guidelines under ASC 840 were full of accounting potholes. For example, no hard costs could be incurred by the lessee during construction. If the lessee bought the steel for a build-to-suit project, for example, it would have been deemed to be "involved" in the construction of the asset. Other examples of involvement:

- The lessee had an ownership interest in the lessor.
- The lessee began construction or broke ground.
- The lessee incurred soft costs of greater than 10% of the total expected project cost.
- The lessee took title to the asset.
- The lessee indemnified the lessor for cost overruns or environmental exposure.
- For real estate, the lessee owned the land and did not lease it to the developer prior to construction.

If a lessee was guilty of any of the above statements, it would have caused the construction to be booked on its balance sheet and forced the lessee to have undergone sale and leaseback accounting to de-recognize the asset. Numerous companies disclosed in their financial statements they are violating one of the involvement tests and being required to book the asset under construction. For a transaction to qualify for sale and leaseback accounting treatment, allowing removal of the asset, the leaseback portion could not have contained any items that indicated that the lessee had “continuing involvement” in the asset. Examples were renewal options that could have extended beyond 90% of the remaining life of the asset, a purchase option for the lessee, and having the leaseback be deemed a capital lease.

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The build-to-suit rules under EITF 97-10 and then ASC 840-40-55 have been simplified under ASC 842 thanks to the change from a risk-based standard to a control-based standard. The five control parameters are detailed in ASC 842-40-55-5 and determine if a lessee has obtained control of an asset. If the answer to any of the following five questions below is “yes,” the lessee is deemed to control the asset. The existence of control means the asset will be on the lessee’s books during construction, and, like ASC 840, must undergo sale and leaseback accounting to de-recognize the asset. The leaseback portion of the transaction must qualify as an operating lease, and if it contains a purchase option, it must be at fair market value and a similar asset must be available in the marketplace. A notable exception to the purchase option is for real estate transactions. The FASB believes all real estate is unique, therefore a real estate leaseback cannot contain a purchase option and qualify for sale and leaseback accounting treatment under ASC 842.

ASC 842 control parameters:

1. Does the lessee have the right to obtain the asset during construction?
2. Does the lessor have an enforceable right to payment and does not have another use for the asset?
3. Does the lessee own both the land and improvements or the non-real-estate asset under construction?
4. Does the lessee own the land and improvements and does not enter into a lease for the same?
5. Does the lessee lease the land on which the improvements will be constructed and does not enter into a sublease before construction begins?

It should be noted that the leases in questions 4 and 5 above need to have terms, including renewals, that extend for substantially all the life of the property improvements. Using the same steel example as above, under ASC 842-40-55, if the purchase of steel does not trigger a “yes” to any of the five questions above, “control” of the asset will not vest with the lessee. The result is that this asset will be off balance sheet during construction and avoid sale and leaseback accounting. The new guidance will result in many more assets remaining off balance sheet during construction, thus offering lessees more flexibility in the structuring of their build-to-suit transactions.

Build-to-suits, if they avoid sale and leaseback accounting, have the flexibility to be structured as either operating or finance leases to match the lessees’ accounting objectives. One key change is the timing of the lease classification test, which has shifted from lease inception under ASC 840 to lease commencement under ASC 842. This adds complexity because most build-to-suit leases are executed before construction begins, but final lease classification will now take place when construction ends, and the lease begins. This change in timing of the lease classification may result in a lessee taking interest rate risk during construction. A possible unintended consequence could be a lease that was an operating lease at inception may end up a finance lease at commencement, which likely will not be a good outcome.

In conclusion, the accounting changes that surround build-to-suits, especially when paired with today's historically low interest rate environment and an excess of investor and bank capital, have made these transactions increasingly popular. Lessees revel in the thought of a newly constructed, completely customized asset, and investors and banks are happy to pay top dollar for these assets thanks to the delta between the bank interest rates and the capital yield on an investment in an asset. All this should make for a continued robust build-to-suit market for the foreseeable future.