New rules may make buying lab space better than leasing

By Marisa Manley

Medical laboratories that lease space for their operations will soon be affected by new guidelines from the Financial Accounting Standards Board (FASB) for lease accounting. The proposed changes are momentous. They will almost certainly increase occupancy costs with additional accounting and reporting burdens. The new FASB guidelines may also make leasing substantially less attractive than buying, and they may change the way leases are structured. And be aware, it is likely that these new standards will apply to existing as well as new leases.

The proposed FASB changes to lease accounting include the following:

**Leases will be reported on tenants’ balance sheets.** The right to use space will be recorded as an asset. Primary obligations under each lease will be recorded as a liability. For some companies, liabilities will balloon, and loan covenants may be at risk.

**Rental payments under each lease will be treated as loan payments with an imputed rate of interest.** Like mortgage payments, only the (imputed) interest component will be deductible as a business expense. There is little guidance yet as to how tenants will know the imputed rate a landlord is charging. And, as with a self-amortizing mortgage payment, interest will be front-loaded. This distorts business expenses; the longer your lease, the more distorted the effect. A likely outcome here will be for tenants to seek shorter lease terms. Landlords, in turn, will be less likely to offer substantial “workletter contributions” (the capital needed to build-out or refurbish a space), because they may not have time to amortize and recoup their investment. One can anticipate a negative spiral of disinvestment, and situations where labs are compelled to sink their own capital into real estate rather than higher-value R&D, equipment, or staffing.

**Options become headaches and liabilities.** Under the proposed standards, a tenant must treat each lease as extending for the initial lease term and for any option periods which are “more likely than not” to be exercised. This means that a lab with a 10-year lease and two five-year options may be required to treat its obligation as a 20-year lease — and show this liability on its balance sheet.

Consider that few businesses can confidently predict what space they may need 10 years hence. Even if a tenant is confident it will wish to remain in a certain location, the high degree of speculation involved in determining likely lease rates in the distant future suggests that the exercise will result in distortion rather than clarity.

Today, renewal options are a benefit for any tenant; renewal options provide an element of control without obligating the tenant to commit. Under the proposed guideline, tenants may be better off foregoing renewal options, which may also make them less likely to invest in the premises.

**Need to estimate contingent payments.** Contingent payments due under a lease (e.g., operating expenses, utility costs, real-estate taxes) must be estimated using “expected outcome analysis,” with likely probabilities assigned to different outcomes. Elements to be estimated include changes to asset value based on market conditions. Tenants must re-evaluate these estimates during each reporting period. Tenants will now be taxed with knowledge of real-estate market conditions, building ownership’s management of the asset, and many other issues outside their expertise. Creating new estimates and reconciling previous estimates will become a major accounting task for many labs.
What is the practical effect?

For many lab tenants, buying rather than leasing may become more cost-effective. Shorter lease terms may be more attractive despite the higher costs (i.e., higher rents and increased capital demands) they are likely to impose. Lab companies may wish to give extra consideration to how their leases will affect the assessment of any potential suitor, because the effect on the balance sheet will be significant.

What should labs do?

1. Inventory the portfolio of leases now to understand the extent of existing obligations.
2. Develop systems to estimate future lease costs — rental payments and all contingent obligations — and update these during each reporting period.
3. For any new lease or renewal of an existing lease, assess the optimal lease term based on the new balance-sheet considerations, as well as the business needs.
4. Consider heresy. Foregoing a renewal option when negotiating a lease may now become a preferred approach.
5. Assess whether a purchase — through a condominium arrangement or fee simple — may become a better choice than leasing space for the lab’s needs.

In recent months, after a flurry of public comments — and complaints — it appears that FASB may modify certain elements of the new standards, but the basic outlines of the changes appear likely to remain intact. Currently the projected implementation date is early 2013. The time to start planning is now!

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