TENANT BUYOUT VS SUBLEASING

Lease Accounting Strategies

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As companies grapple with how to best manage a hybrid workforce, real estate professionals are focused on ensuring the best strategies are deployed for each client's unique situation. One common scenario involves the decision to eliminate excess space. In this situation, **there are two common options for commercial tenants: subleasing** or a **lease buyout** – each with cash, balance sheet, and profit and loss impacts that must be understood to achieve an optimal financial outcome.

When a commercial tenant executes a sublease, the tenant rents out a portion or the entire space it has leased to another tenant. The original tenant remains responsible for paying rent to the property owner but collects rent from the subtenant to offset the original rent obligation.

A sublease can have a positive impact on a company's cash flow, as the tenant generates additional income. However, the tenant's lease liability remains unchanged as the sublease is a continuation of the original lease agreement. On the balance sheet, the Right of Use Asset is reduced by the expected loss, which is calculated as the present value of the remaining obligation of the head lease less the present value of the sublease income. Any tenant improvements assets on the balance sheet are written off.

The accounting implications of a sublease on a company's profit and loss statement are more complex but can have considerable benefits when accounting for EBTIDA. A tenant will report a gain or loss on the write-off/impairment at the time of cease use. This gain or loss is calculated by the present value of the remaining obligation of the head lease less the present value of sublease income and expenses. The head lease's existing obligation equates to its straight-line rent expense and its SG&A expense. To account for the sublease impact, the impairment is recognized, and the head lease obligation is netted against the sublease straight line rent expense and the sublease SG&A expense. EBITDA impact is then calculated by adding the sublease impact with the sum of the sublease income and additional rent (shown as a negative on an occupancy basis) to produce a net gain. After the write-off is recognized, the straight-line rent expense of the head lease is less than the sublease income, which produces a net gain and reduction of EBITDA.

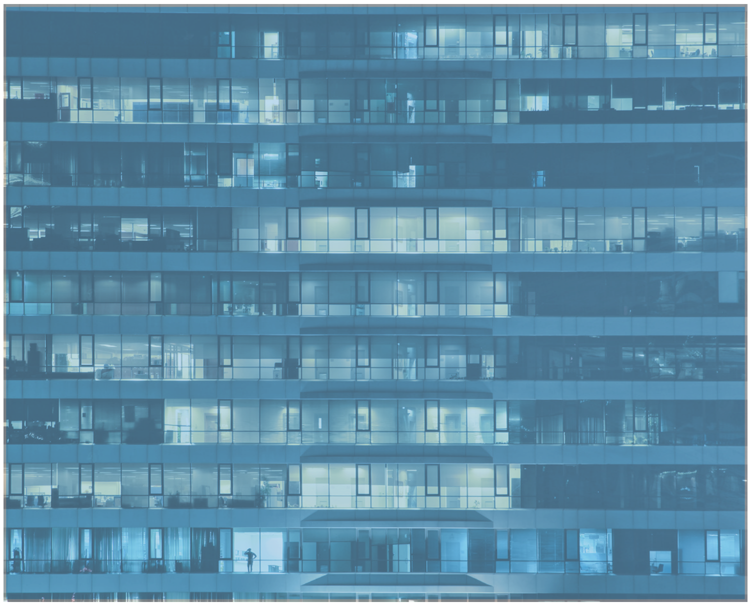
When a buyout is executed, the liability from a tenant's balance sheet is eliminated, the payment is recorded as a one-time expense, and the liability drops to the P&L. A lease buyout requires a lump sum payment to the landlord in exchange for ending the lease early. This payment reduces cash (a current asset) in exchange for eliminating a liability by writing off the Right of Use Asset.

At the time of a buyout, a gain or loss is observed by finding the difference between the Right of Use Asset and the Lease Liability on the balance sheet. Potentially, this could offset buyout costs and the remaining depreciation of tenant improvements. However, this strategy also has the potential to reduce balance sheet strength given cash may be more important for younger companies than an intangible asset. Furthermore, in the case of an owned asset, an additional financial consideration is the impairment, which is calculated as the difference between the asset's book value and its expected sale price, or fair market value. This impairment reflects the loss in value of the asset from its original recorded cost.

Sublease at 0% Recovery vs. Buyout at 100% of Remaining Obligation

In scenarios where subleasing is not viable due to factors like short remaining lease term, high market competition, or the specialized nature of the space, and when a landlord is firm on not accepting a buyout for less than 100% of the remaining lease liability, tenants face a unique decision-making situation. Opting for a buyout that covers 100% of the remaining liability has similar financial implications on the balance sheet and P&L as ceasing use or abandoning the space with a 0% recovery rate – also known as 100% impairment of the right-of-use asset. The key distinction lies in the immediate financial impact: A buyout requires an upfront cash payment to settle the lease liability in full, whereas abandoning the space involves continuing to make the scheduled rent payments until the lease expires. From a financial management perspective, preserving cash by choosing to abandon the space with full impairment can often be more beneficial in the short term. However, there are significant risks and liabilities to consider, especially in triple net (NNN) lease scenarios. In a NNN lease, the tenant may remain responsible for ongoing costs such as capital item replacements (e.g., HVAC systems), which can incur substantial expenses even if the space is not in use. Additionally, the tenant may remain liable for any damages from theft, break-ins or natural disasters, requiring specific security standards as per the lease agreement.

Another situation where a lease buyout might be more favorable is when a company is undergoing significant financial transformation. Simplifying the company's financial statements by reducing liabilities and future financial commitments can significantly influence company valuations during M&A activities and/or positively impact market perception in the lead-up to an IPO. However, this strategy requires a careful evaluation of the immediate cash expenditure against the backdrop of the company's long-term financial stability.



EXAMPLE: SUBLEASE IMPACT

» This analysis assumes a 75% recovery from sublease commencement and 63% recovery from marketing for sublease in 2022. The write off of $1.79M occurs in 2024 when a subtenant is identified as the tenant plans to remain in the space. The ROU asset is reduced by the expected loss (PV of head lease minus PV of sublease income).

» Under old lease accounting, the tenant would wash its hands of the head lease liability. However, under ASC 842 the tenant records straight-line rent expense, which represents the amortization of the impaired ROU asset including interest expense of the head lease liability.

» After the write off, straight-line rental income is greater than the straight-line rental expense on the head lease, resulting in a gain for the remaining lease years, which can help reduce the pain of the write off upon abandonment of the space.

» A write-off/ impairment of the expected loss is recorded at the time of cease use. The expected loss that is booked represents the present value of remaining obligation of the head lease, less the present value of the sublease income and expenses. Also, if there are any tenant improvement assets on the balance sheet when space is abandoned, the tenant can write off this asset.

» A sublease does not erase the liability from the tenant's balance sheet or P&L; however, it can significantly reduce EBITDA impact after an impairment is recognized.

» While a sublease does not use as much cash as a buyout, it does not fully eliminate the liability. The concept of cease use can be used strategically to target a certain period for the write-off to occur.

ANNUAL CASH FLOWS									
Calendar Year (as of 2022)	2022	2023	2024	2025	2026	2027	2028	2029	Totals
Base Rent	$ 441,358	$ 454,599	$ 468,237	$ 482,284	$ 496,752	$ 511,655	$ 527,004	$ 178,264	$ 4,675,938
Operating Expenses	385,177	396,733	408,634	420,894	433,520	446,526	459,922	157,906	4,369,941
Parking	37,200	37,200	37,200	37,200	37,200	37,200	37,200	12,400	372,000
TI Construction	-	-	-	-	-	-	-	-	1,638,560
Security Deposit	-	-	-	-	-	-	-	(193,584)	-
Master Lease Total	863,735	888,531	914,071	940,377	967,473	995,381	1,024,126	154,987	11,056,439
Base Rent	$ -	$ -	$ (300,403)	$ (339,416)	$ (351,120)	$ (362,824)	$ (374,528)	$ (128,744)	$ (1,857,035)
Operating Expenses	-	-	(408,704)	(420,965)	(433,594)	(446,602)	(460,000)	(157,933)	(2,327,797)
Parking	-	-	(37,200)	(37,200)	(37,200)	(37,200)	(37,200)	(12,400)	(198,400)
Costs to Sublease	-	-	289,837	-	-	-	-	-	289,837
Sublease Total	-	-	(456,469)	(797,581)	(821,914)	(846,626)	(871,728)	(299,077)	(4,093,394)
Total	863,735	888,531	457,602	142,796	145,559	148,755	152,399	(144,091)	6,963,045
*Total ($ / Average RSF / Yr.)	36.90	37.96	-	-	-	-	-	-	27.46
BALANCE SHEET (YEARLY ENDING BALANCE)									
Deferred Rent Credit	-	-	-	-	-	-	-	-	
Tenant Improvement Asset	957,927	806,676	-	-	-	-	-	-	
Right of Use Asset	2,201,739	1,914,724	991,710	762,854	533,998	305,142	76,285	-	
Liability for Lease Obligation	(2,586,909)	(2,276,921)	(1,933,726)	(1,554,855)	(1,137,672)	(679,366)	(176,938)	-	
Deferred Rent Asset from Sublease	-	-	47,791	56,569	53,643	39,013	12,679	-	
PROFIT & LOSS (ANNUAL)									
FAS13 / IAS17 / SLE Rent Expense	431,625	431,625	353,898	332,269	308,426	282,205	253,433	77,611	3,981,779
Selling, General & Admin	422,377	433,933	445,834	458,094	470,720	483,726	497,122	170,306	4,741,941
Tenant Improvement Amortization	151,252	151,252	-	-	-	-	-	-	831,884
Sublease Income	-	-	(348,194)	(348,194)	(348,194)	(348,194)	(348,194)	(116,065)	(1,857,035)
Sublease Additional Rent	-	-	(445,904)	(458,165)	(470,794)	(483,802)	(497,200)	(170,333)	(2,526,197)
(Gain) / Loss on Sublease	-	-	1,790,671	-	-	-	-	-	1,790,671
Total	1,005,254	1,016,809	1,796,306	(15,996)	(39,842)	(66,065)	(94,839)	(38,480)	6,963,045
*EBITDA Expenses	854,002	865,558	1,796,306	(15,996)	(39,842)	(66,065)	(94,839)	(38,480)	6,131,161

EXAMPLE: EBITDA-EQUIVELANT BUYOUT

» This analysis assumes a hypothetical $3M buyout at year-end 2022, creating a similar EBITDA expense over the comparison period compared to the hypothetical sublease scenario above.

» A buyout erases the liability from the balance sheet and drops the liability to the P&L.

» Here, tenant is trading cash (a current asset) which reduces strength of balance sheet in return for eliminating a liability in the same amount by writing off the ROU asset (intangible asset). Cash is typically more valuable, particularly for younger companies.

» The buyout payment could be recorded “below the line” under adjusted EBITDA; however, it is shown as an operating expense under straight-line rent in this analysis.

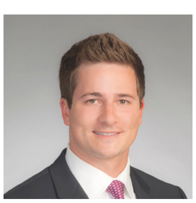
» At the time of buyout, there is a gain of approximately $360k which is the difference between the ROU and lease liability on the balance sheet that offsets buyout costs plus the remaining depreciation of tenant improvements.

» The ROU asset is eliminated from the balance sheet by virtue of the buyout payment. Any remaining Tenant Improvement depreciation is written off, as well.

» The liability is written off in 2022 and for future periods would not appear on the balance sheet or P&L.

ANNUAL CASH FLOWS						
Calendar Year	**2018**	**2019**	**2020**	**2021**	**2022**	**Totals**
Base Rent	$ -	$ 271,260	$ 416,022	$ 428,503	$ 3,404,035	$ 4,519,819
Operating Expenses	171,112	352,492	363,066	373,958	353,079	1,613,708
Parking	-	24,800	37,200	37,200	34,100	133,300
TI Construction (Original)	1,638,560	-	-	-	-	1,638,560
Security Deposit	193,584	-	-	-	-	193,584
Total	2,003,257	648,551	816,289	839,661	3,791,214	8,098,972
*Total ($ / Average RSF / Yr.)	171.16	27.71	34.87	35.87	161.96	76.89
BALANCE SHEET (YEARLY ENDING BALANCE)						
Deferred Rent Credit	(215,813)	(376,178)	(391,781)	(394,903)	-	
Tenant Improvement Asset	1,562,934	1,411,682	1,260,431	1,109,179	-	
Security Deposit	193,584	193,584	193,584	193,584	193,584	
PROFIT & LOSS (ANNUAL)						
FAS13 / IAS17 / SLE Rent Expense	215,813	431,625	431,625	431,625	3,009,132	4,519,819
Selling, General & Admin	171,112	377,292	400,266	411,158	387,179	1,747,008
TI Construction (Original) Amortization	75,626	151,252	151,252	151,252	138,647	668,028
Previous TI Amortization	-	-	-	-	970,532	970,532
Total	462,551	960,168	983,143	994,035	4,505,490	7,905,388
*EBITDA Expenses	386,925	808,917	831,891	842,783	3,396,311	6,266,828

Both subleasing and lease buyouts support lean office strategies and portfolio optimization. It's important to understand the trade-offs and impacts of each in the context of a company's financial goals, equity structure, remaining term and market conditions.



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