Sublease Accounting and Why Tenants Aren't Always Backfilling Space

CRE Sublease Nuances | June 2023

Beginning in January 2023, many of TRA's clients have privately expressed frustration at large publicly traded and private equity backed tenants noting that these tenants put a space up for sublease but do not actively seek to fill that space. These companies continue paying the landlord the contract rent for the duration of the lease, so economically in the short-term, there is no impact to the landlord, but long-term it leaves landlords without a lead on a new direct tenant and could result in greater inventory hitting the market in the coming years.

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Why might a tenant do this?

The simple answer is that U.S. Generally Accepted Accounting Principles (GAAP) allows the tenant to take an upfront non-cash charge and improve its future financial reporting. That's it. It's an accounting trick that impacts the balance sheet and income statement, while netting out in the statement of cash flows. Awareness of this trick may allow landlords to strengthen lease language on future leases to protect against vacancies and lost leads on direct tenants.

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SUBLEASE ACCOUNTING TRICK

KEY POINTS

1. Tenants that have a reduced need for office, industrial, lab, or data center space can account for the space they plan to sublease by writing off the present value of the deferred rent for the remaining lease term once the space is listed.
2. They can further offset the write-down by estimating potential sublease income, even if the tenant has no ability or intention of securing a sublease.
3. Tenants can also write down the value of the furniture, fixtures, and equipment in the space.
4. The financial reporting associated with these transactions gives the appearance of a stronger balance sheet and adjusted operating earnings to potential investors or lenders.

META PLATFORMS' USE OF THE TRICK

In March 2023, social media company Meta Platforms, Inc. (f/k/a Facebook) announced it would be listing hundreds of thousands of square feet of office space for sublease in January 2023. Meta reported that it was seeking tenants for its 435 thousand square foot office tower at 181 Fremont in San Francisco. The company further announced in June 2023 that it will sublease an additional 100 thousand square feet in Austin, Texas at 300 W. Sixth Street, in addition to the more than 550 thousand square feet it put on the sublease market in Austin in late 2022.

We can see some of the impact of some of the company's announced sublease activity in its most recent 10-K under the details regarding its restructuring. While we aren't here to get into a detailed accounting conversation, there are a handful of items on the company's financial statements that highlight the benefits of incurring the charges and the subsequent non-cash adjustments.

EXHIBIT 1
Meta's Sublease Charges

During the year ended December 31, 2022, we recorded impairment losses of $2.22 billion in aggregate for operating lease ROU assets and leasehold improvements under ASC Topic 360 as a part of our facilities consolidation restructuring efforts. The fair values of the impaired assets were estimated using discounted cash flow models (income approach) based on market participant assumptions with Level 3 inputs. The assumptions used in estimating fair value include the expected downtime prior to the commencement of future subleases, projected sublease income over the remaining lease periods, and discount rates that reflect the level of risk associated with receiving future cash flows. For additional information regarding our restructuring efforts, see Note 3 — Restructuring.

The company reported in 2022 that as part of its ongoing restructuring activities, it recorded a charge of $2.2 to $2.3 billion on its operating leases

A summary of our restructuring charges for the year ended December 31, 2022 by major activity type is as follows (in millions):

	Facilities Consolidation (1)	Severance and Other Personnel Costs	Data Center Assets	Total
Cost of revenue	$ 154	$ —	$ 1,341	$ 1,495
Research and development	1,311	408	—	1,719
Marketing and sales	404	234	—	638
General and administrative	426	333	—	759
Total	$ 2,295	$ 975	$ 1,341	$ 4,611

(1) Facilities consolidation includes impairment charges and accelerated expenses related to certain operating lease ROU assets and leasehold improvements.

Source: Meta Platforms, Inc.

The company takes these charges and can even offset the costs based on the anticipated value of unearned sublease income. Therefore, Meta may opt to keep paying its operating leases where it has already taken an impairment charge without expectation of bringing in a subtenant, but it can offset the impact of the impairment charge with the expected cash flows it would generate from the non-existent sublease. If this all sounds a bit convoluted, that's because it is. The Financial Accounting Standards Board (FASB) allows companies to do this so that that company can reasonably assess the market value of its right of use liability.

EXHIBIT 2
Meta's Non-Cash Adjustments

META PLATFORMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)

	Year Ended December 31, 2022	2021	2020
Cash flows from operating activities			
Net income	$ 23,200	$ 39,370	$ 29,146
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	8,686	7,967	6,862
Share-based compensation	11,992	9,164	6,536
Deferred income taxes	(3,286)	609	(1,192)
Impairment charges for leases and leasehold improvements	2,218	—	—
Abandonment charges for data center assets	1,341	—	—
Fair value adjustments for non-marketable securities	463	(232)	33
Other	178	105	85
Changes in assets and liabilities:			
Accounts receivable	231	(3,110)	(1,512)
Prepaid expenses and other current assets	162	(1,750)	135
Other assets	(106)	(349)	(34)
Accounts payable	210	1,436	(17)
Partners payable	90	(12)	178
Accrued expenses and other current liabilities	4,210	3,544	(946)
Other liabilities	886	941	(527)
Net cash provided by operating activities	50,475	57,683	38,747

Source: Meta Platforms, Inc.

In 2023, Meta effectively inflated its operating cash flow calculation by $3.6 billion, or about 7.6%, had it not taken the charge. Free cash flow generation also increased by $3.6 billion as a result of this adjustment.

MITIGATION TACTICS

Existing Leases

- There is little a landlord can do to mitigate against a tenant leaving the space empty. But there is solace in knowing that rent payments will continue from the direct tenant and the space could require less capital to bring to market when the original lease does expire.
- If the tenant has undergone a restructuring event that impacted more than 10% of its workforce, consider amending the early termination penalty downward if there is a good probability to backfill the space with a new tenant at better market rates.

Future Leases

- Landlords could consider including lease language that applies a penalty to vacant space available for sublease to discouraging this behavior. If the goal of a landlord in a sublease is to grow its pipeline of new tenants, the penalty encourages direct tenants to find a subtenant that may ultimately become a direct tenant through a renewal.
- Instead of a stick, the landlord may induce the tenant to giving space back. Consider offering a carve out in the lease to terminate a portion of the lease that would have been sublet for an added fee if the tenant undergoes a restructuring that impacts more than 10% to 15% of its workforce. The additional fee could then be added in as a non-recurring charge to the tenant and it would strengthen its future cash flows by relieving it from a portion of the lease while reducing its right of use asset and liability entries.