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Sale-Leasebacks: Cash Out but Keep Control

Recover capital spent on property purchase and improvements while continuing to occupy and operate the property.

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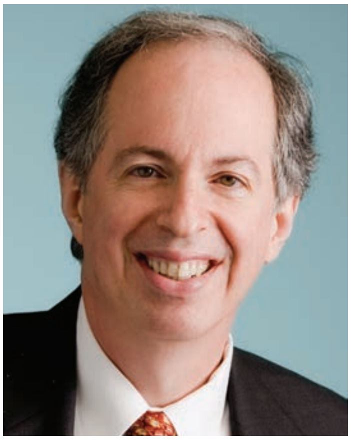

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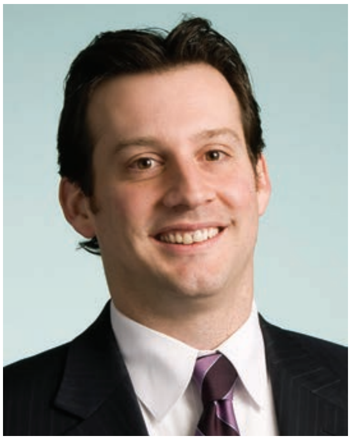

Andrew Dean

Companies that purchase or ground-lease and develop property for their own use may want to consider monetizing those real estate assets through sale-leaseback.

Sale-leasebacks offer a way to recover the capital spent on property purchase and improvements while continuing to occupy and control the property under a long-term lease. They are used as a vehicle to recapitalize, improve balance sheets, and feed expansion efforts.

They are increasing in popularity among companies such as drugstores, retail and restaurant chains, banks, department stores, big-box stores, gas stations, convenience stores, hospitals, medical office buildings, and distribution centers.

When considering sale-leasebacks to raise cash for expansion or other purposes, a company will want to compare the benefits of sale-leaseback with those of conventional financing. The company also should understand the level of control the company will maintain over the property as a lessee, including the ability to assign or sublease the property.

Sale-Leaseback Structure

The basic structure of a sale-leaseback transaction is evident from its name. A seller sells its real property and related improvements and leases them back through a long-term lease. Ground-lease interests also may be sold and subleased back, using a slightly different sale-leaseback structure.

Typical sale-leaseback leases have initial terms of 15 to 25 years with several options to extend the lease; some leases allowing extensions for up to an additional 50 years.

Advantages Over Traditional Financing

There are economic benefits to sale-leaseback not available with traditional lending. A major one is the term. While available debt-financing terms are 10 years or less, sale-leasebacks can have initial terms of 20 years or more, with numerous multi-year extensions.

Fixed rental payments then allow the lessee to lock in operating costs for 20 years or more, and depending on the tenant's creditworthiness, these locked rental payments are structured as net-zero deals where the rent is equal to the amount of debt service paid by the buyer.

Additionally, unlike debt financing, where the loan-to-value ratio is typically 70-80%, in a sale-leaseback the entire amount of the value of property and improvements is monetized so that the seller recovers 100% of its expenses (including soft costs) for acquisition and development.

Recovering all the cash invested

in developed property through a full cash payment from the buyer at the point of sale improves the seller's balance sheet by converting a depreciable asset into cash. Depending on the structure of the sale-leaseback, the seller may reap additional balance-sheet benefits over conventional financing, as the entire rent payment may be deductible rather than only the interest payments made to service traditional debt.

If the seller-lessee is intending to use the proceeds from the transaction to purchase like-kind property and feed expansion efforts, it may be able to take advantage of a capital gain tax deferral through use of IRC Section 1031.

From an operational standpoint, the seller-lessee retains nearly full control over the property. That provides much greater rights related to alterations to the property, operation of its business, and change in use and occupancy. All of those can be heavily regulated within a conventional mortgage requiring lender approval rights and payment of associated third-party fees and costs.

In a conventional mortgage, the borrower (property owner) is also required to make extensive warranties, representations, and mortgage covenants that are not customary in a sale-leaseback transaction. The warranties and representations in sale-leasebacks are more aligned with those expected in a long-term, triple-net ground lease with robust tenant control.

Given the attractiveness of this vehicle to both buyers and lenders/investors, as discussed below, a competitive process ensues when a company decides to do a sale-leaseback.

A seller may put its property (or a portfolio of multiple locations) out to bid through a well-crafted Request for Proposals process. While a property owner could solicit loans through a broker service involving multiple lenders to cash out on existing equity, the RFP process is streamlined, more market driven, and creates robust competition between buyers.

In these transactions it's not unusual to have 10 to 15 potential buyers competing for portfolio deals, which produce a favorable cap rate (i.e., low interest on the money repaid through lease payments) and favorable lease terms for the seller/lessee.

Sellers to date have also benefitted from characterizing sale-leaseback leases as operating leases rather than capital leases, thus keeping them off the balance sheet. But that particular accounting benefit will come to an end when the Financial Accounting Standards Board's new lease-accounting standards, which require inclusion of operating leases on the balance sheet, take effect in 2019.

Many companies, in recognition of the impending change, are already operating under debt instruments whose covenants include lease assets and liabilities coming onto their balance sheets. And in any event, the change in accounting treatment does not affect the other sale-leaseback benefits discussed above.

Sale-leasebacks are most advantageous and result in lower transaction costs when either a number of individual properties are bundled and sold together, or an individual property worth tens or hundreds of millions of dollars is sold and leased back. Such properties include distribution centers, hospitals, corporate campuses, and the like.

Value of Tenant Maintaining Control

The concept of selling property at which a company plans to do business long-term can give sellers pause. However, the sale-leaseback lease structure provides all the practical benefits of ownership via a long-term lease.

The lease is triple-net, where the lessee maintains exclusive control over the property, can make alterations of the improvements, and can sublet or assign the lease, provided that under all circumstances the lessee maintains responsibility for the rental payments during the term of the lease.

There are few restrictions other than acts or omissions that would have a material adverse effect on the value of the property, result in the violation of applicable laws, or create liens on the property. The ability to control the property is the reason companies like Bloomin' Brands, Bob Evans, Circle K, CVS, Darden Restaurants, Global Partners, Walgreens, Wendy's, and others have used sale-leaseback as an effective tool to raise capital while maintaining control over their properties..

What Drives the Sale-Leaseback Market?

Buyers of properties in sale-leaseback deals are primarily interested in deferring capital gains taxes. When a buyer has held property for investment purposes and elects to sell it, capital gains taxes become due, unless the buyer completes a "like-kind exchange" by selling the owned property and purchasing new like-kind investment property in accordance with IRC Section 1031.

There is a robust market of buyers looking for properties in order to take advantage of this aspect of the tax code, and sale-leaseback properties are often "flipped" over time by one owner to another.

Investors who supply the cash for the buyer's purchase are looking for a safe place to invest money: property with a long-term guaranteed rental stream by a highly-rated creditworthy tenant is relatively low-risk.

Prerequisites for Success

Sale-leaseback deals must meet certain investment parameters.

First, because of the lengthy term of the fixed rental payments, the tenant must have a certain level of creditworthiness to attract investors and buyers, which becomes of increasing importance if the deal will be structured as a net-zero deal.

Second, property with older buildings that have not been updated may not be attractive enough for investors looking for valuable assets as this will impact depreciation and may warrant expensive repairs or replacement immediately following the expiration or earlier termination of the lease.

And if the real estate interest is a ground lease that will be assigned, rather than a fee interest sold, certain provisions must already be in the ground lease for it to be eligible for sale-leaseback.

Those provisions include ownership of the building and improvements residing with the ground lessee, liberal assignment rights, liberal change-in-use provisions, and the ability to enter into a leasehold mortgage with robust notice and cure rights in favor of the leasehold mortgagee, including the right to enter into a new lease upon a lessee default.

Finally, to effectively unlock the benefits of a sale-leaseback program, particular attention should be paid up front to the management of any environmental concerns. Indeed, certain buyers and their lenders may view these deals through a real estate lens rather than a credit-tenant lens and have concerns about the inherent environmental legal obligations that come with ownership of real property.

A structured environmental program put in place for property acquisition and development will help ensure smooth subsequent sale-leaseback transactions. Early attention to environmental aspects of a project will reassure buyers and ultimately lead to more efficient transaction execution.

Given all of the foregoing, companies may want to explore the use of sale-leasebacks as a tool to reduce or retire debt, raise capital to reinvest in and expand the business, or simply to improve the balance sheet. Sale-leasebacks are a good way to unlock the long-term value from a company's real estate portfolio to better position the company for growth. CFO

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