

A wise investment

How sale/leasebacks present attractive alternative financing opportunities Interviewed by Meredith McKenzie

Companies are experiencing credit squeezes in every area of today's economy, including real estate. Utilizing a sale/leaseback to raise capital offers an attractive alternative to conventional financing.

In a sale/leaseback, an investor buys property that's owned and occupied by a user, who then leases the property from the investor.

"For an owner-user, sale/leasebacks convert non-liquid real estate assets to cash, while executing a lease that allows the user to stay in its current space," says Michael H. Sell, investment sales manager at Grant Street Associates. "For an investor, it can secure a stable stream of annuity payments with minimal management responsibilities."

Smart Business spoke with Sell to discuss the benefits and drawbacks of sale/leasebacks as well as the key things to keep in mind when considering a sale/leaseback transaction.

Who is a candidate for a sale/leaseback?

Several entities make good candidates. These include, but are not limited to:

- Large companies that could earn a higher return on capital invested in their primary business to facilitate growth, as opposed to having capital invested in its own real estate.

- Companies with squeezed balance sheets in need of raising capital.

- Smaller, closely held corporations that anticipate the retirement of key personnel. Selling the real estate ahead of selling the business can maximize the sale proceeds of both.

- Retailers with large numbers of retail outlets, where a large portfolio can be bundled and sold to institutional investors at a price greater than its cost.

- Health care companies with owner-occupied real estate can free up capital and manpower to be used for expansion or for increasing the efficiency of existing operations.

What are the benefits of the owner-user?

Conventional financing encumbers the real estate asset when it's listed as a primary liability on the balance sheet, but if the sale/leaseback is structured correctly, it can be a footnote on the balance sheet. The asset at current book value is removed from the balance sheet and replaced by the cash raised from the sale/leaseback. This cash value is often higher than the book value.

When the owner-user owns the entire asset but uses only a portion of it, he or she is obligated with the carrying costs of the vacancy. Under the sale/leaseback, the owner-user



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is obligated for only the portion of the asset that he or she anticipates needing during the term of the lease. The responsibility of carrying and disposing of the unutilized portion resides with the investor.

Many owner-users find themselves in this situation today, as organizations downsize operations and right-size occupancy costs. Leasing, with options to expand or contract, gives owner-users scalability as opposed to the static nature of real estate ownership, which lacks flexibility to size the space occupied to current business requirements.

What are the benefits to the investor?

The greatest benefit of a sale/leaseback is the opportunity to secure a stable, long-term income stream. It's a low management intensity investment with a potential for property appreciation, in addition to annuity payments, and it can be a hedge against inflation. Also, you can gain deductibility of cost recovery for tax purposes, and possibly interest, if debt financing is utilized.

What are the drawbacks to the investor and owner-user?

For the investor, the tenant(s) may default and move out of the building, which could

lead to the risk of foreclosure if debt financing is used. In addition, there may be substantial tenant-improvement capital infusions with subsequent leases if the building is specialized. Finally, if the lease is structured at above-market rent and the tenant vacates, it may be difficult to achieve the same investment metrics with a new tenant.

For the owner-user, he or she may see a tax impact at the sale of the real estate, and, depending on the lease, the owner-user may lose the flexibility to renovate or rehab the property. The owner-user may also lose the ability to occupy the building at the end of the lease, not to mention the possibility of a loss of future appreciation of value in the property.

An owner-user must first determine his or her primary motivation for initiating the sale/leaseback to minimize these drawbacks. If the owner-user is primarily looking at a way to raise capital quickly, to increase scalability, or to refocus management resources on his or her core competency, the transaction can be structured in a way to achieve these goals.

The drawbacks for both the investor and the owner-user are never going to go away, but the transaction can be structured and navigated to minimize these problems.

What are key things to remember during a sale/leaseback transaction?

A standard lease agreement is the only document required, but attention should be paid to the term length and extension options. A longer term with more extension options gives the investor a higher modified internal rate of return. However, if the term and extensions are combined to equal a period that is approaching the useful life of the asset, the transaction could come into question.

The transaction is also required to comply with certain points mandated by the Financial Accounting Standards Board, including:

- The lessee cannot automatically obtain ownership at termination of the lease.

- The lease cannot contain a bargain price option to purchase but should include an option to renew and/or purchase at market rate.

- The non-cancellable lease term must be less than 75 percent of the economic life of the property.

- The present value of the rents must be less than 90 percent of the fair market value of the property. <<

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