Are sale-leasebacks the answer to capital freedom?

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National Retailer Utilizes CNL "Split-Funded" Sale-Leaseback Program With Success Fort-Worth, Texas-based retailer Pier 1 Imports is pretty picky about the sites it chooses for new stores, according to the company's real estate vice president Rich Blackwelder.

"When we go into a market, we are not just looking for any available piece of land," says Blackwelder. "What we are seeking is the best location for a Pier 1 store." Whether it be a power center pad site, a freestanding vacant lot, or an existing building, he notes, "it doesn't matter, so long as we feel it is the best location for us."

Most Pier 1 deals are run-of-the-mill leases of existing buildings from owner/landlords, according to Blackwelder. "Even when we need to build our own building," he says, "we usually find that it is the preference of the owner/landlord to build a building and then lease it directly to us."

The only instances in which Pier 1 uses a sale-leaseback vehicle is when a potential site is a vacant parcel for sale, and the owner doesn't wish to build and lease a facility, says Blackwelder. "In those cases, we will call CNL."

Orlando, Fla.-based Commercial Net Lease Realty (CNL) is an equity capital provider that, as a REIT, utilizes its own funds to finance net lease transactions, according to company president Gary Ralston. For retailers, CNL's split-funded, self-development program is a form of sale-leaseback, he explains, that is designed to provide seamless development funding and the most efficient transaction possible.

This program simplifies and compresses the new-site process for retailers and helps avoid the risks and drawbacks of real estate ownership, says Ralston. Typically, a retailer that acquires a site and builds a facility on its own, for eventual sale-leaseback, incurs a variety of closing costs and must invest time in due diligence and marketing.

Under CNL's split-funded, self-development program, the retailer selects its site and negotiates the purchase of the property. "At that point, CNL steps in and buys it - it is never in our name," says Blackwelder. The retailer then builds its facility to its own specifications within a time frame that typically runs up to 12 months, funded by CNL, which assumes the role of lessor to the retailer. In the case of Pier 1, "We already have a contract worked out with CNL," he notes, where the rent Pier 1 pays is based on the cost of the property and building, along with the cap rate return CNL wants to get.

Out of 65 new Pier 1 stores slated to open in 1998, four will utilize CNL's split-funded, self-development program, according to Blackwelder. Two recent projects in the $1.5 million range have closed so far this year in Florida and Tennessee, he reports. CNL's split-funded program fits in well with Pier 1's real estate strategy, he adds. "We own quite a few properties, and are packaging and selling them to get them off the balance sheet," says Blackwelder, "in order to free up capital for other uses."

All you well-entrenched denizens of Corporate America, you fast-growing gazelles, and everyone in between - beware. There are groups amongst us that have their eyes on you - or, more to the point, on the real estate that you own.

They work in a number of ways. Some are focused on your existing facilities, be they office, retail, industrial, or just about anything else. Others will even get their foot in the door by building facilities for your exclusive use. Some have to borrow money to get their jobs done, while others use their own funds. But no matter how they work, their goal is the same - to take control of your company's real estate and have you pay them rent for the right to use it.

Good Deals for Users Not that there's anything wrong with that. If you choose to enter into a sale-leaseback deal with one of these net lease financing groups, you will get paid for your property/properties up front in a sale transaction. In return, the group will agree to lease(back) your property to you for a long term (typically 15 to 20 years) at a negotiated rental rate.

Be prepared to have your credit closely scrutinized in the process of getting this kind of deal done. These transactions "depend on the creditworthiness of the tenant," notes Rich Jacobs, principal of Net Lease Capital LLC, a Baltimore, Md.-based net-lease financier that is wholly owned by Legg Mason Capital Corp. "We are in a binary business - tenants either pay their rent over the term, or they don't," he says. Retailers, historically active participants in sale-leaseback/net lease financing transactions, are especially subject to scrutiny, adds Jacobs. "Retailing is highly susceptible to fluctuations in the economy," he notes, "so we closely examine the position of a retailer with regards to its competition, its debt load outside of the net lease, and a number of other factors."

Making the move from owner to tenant has a number of benefits for companies that currently own real estate, according to Fred Berliner, senior vice president of Miami, Fla.-based United Trust Fund (UTF) an all-cash buyer of sale-leaseback transactions that works in partnership with MetLife. "The biggest benefit is that the company unlocks the funds that they have tied up in real estate, and can then use the funds to help grow their business," he notes.

At the same time, these companies retain more control of their facilities than one might think. "When companies make the shift from owner to tenant, they really don't give anything up," says Berliner. "They retain complete control of the property throughout its useful life." The lease term offered by UTF is typically 15 to 25 years, with options to extend for another 15 to 25 years, he explains. The average useful life of a building is 45 to 50 years, Berliner notes, "and the tenant controls it for that entire period, in many cases knowing exactly what their rent will be for the whole term."

The net lease financing business is one that is continually growing, according to Ethan Nessen, vice president and director of acquisitions for Corporate Realty Investment Co. (CRIC), a Boston, Mass.-based purchaser of net-leased commercial property. "What we are seeing is a fundamental desire on the part of corporations to not want to own real estate," he notes. Today's leasing markets provide the backdrop for the flexible lease terms that allow these corporations to maintain control of their facilities after a sale-leaseback, says Nessen. And at the same time, "Especially in this historically low interest rate environment, it makes sense for companies to match longer-term assets, such as real estate, with long-term funds."

Look for even more growth in the use of this financing vehicle, says Jeff Shell, senior managing director, Financial Services Group, for Cushman & Wakefield. Speaking from his office in Detroit, he notes, "Right around 45% of the real estate in the United States is corporately owned." And at the same time, corporations are increasingly realizing that the real estate they own has a negative impact on value, says Shell. Given the current state of the real estate marketplace as a whole, he adds, "These corporations have a lot to gain by unlocking the capital they have invested in real estate."

Balance-Sheet Boost "Retailers have always done sale-leaseback transactions because they are so real estate intensive," notes Barclay Jones, vice chairman of New York, N.Y.-based W.P. Cary. Other types of companies are climbing on board, he says, because it is an efficient way to raise capital, and it gets real estate off the balance sheet.

"Historically, a lot of companies have maintained ownership of their real estate," according to Chicago, Ill.-based Alter Group vice president & director of national development Kurt Rosene. His company recently used net lease financing to develop a 250,000-sq.-ft. office building for GE Capital in the booming Upper Georgia Highway 400 Corridor of Atlanta. "Today, however, real estate is viewed more as a by-product of doing business - after all, your operations need to be housed somewhere," he says. "Everybody needs real estate," says Rosene, "but they don't need to pay money to own it, and it makes good business sense for a company to move those assets off the balance sheet."

It's not just large corporate concerns that benefit from net lease financing, notes Chris Marabella of the Orange County, Calif.-based Marabella Co., which specializes in single-tenant retail net lease deals. "When a small or mid-cap company is trying to expand," he says, "they can do a sale-leaseback with their existing facilities, which gives them cash to grow and doesn't dilute their earnings."

"The benefits of net lease financing hold for the gazelles of the business world, even more so than for Corporate America," according to Gary Sopko, vice president/acquisitions for Bedminster Capital, based in Bedminster, N.J. "It makes absolutely no sense for small, fast-growing companies, for whom capital is critical, to sink money into the ownership of bricks and mortar," he explains. Through net lease financing, "These companies can enjoy increased liquidity," notes Sopko, "and get a much greater return by investing in their core businesses."

Getting rid of owned real estate is a good move for all types of companies, especially those that are publicly traded, according to Richard Ader, chairman of New York, N.Y.-based U.S. Realty Advisors LLC. "Real estate is not a good asset to be owned by a public company," he says. "Most companies today realize that it is an asset that does nothing for them." On the corporate balance sheet, real estate depreciates, notes Ader, "and earnings per share are decreased by that depreciation."

Even when the value of owned real estate grows, "there is really no way to take into account that increase in value," he says. Indeed, "Value realized through a sale does nothing for a company's stock because it is considered an extraordinary item," says Ader, "that is not reflected in earnings per share."

"In the public marketplace, where stock price and shareholder value are really the most important things on most corporations' minds, a sale-leaseback transaction has many nuances and subtleties that can exert a positive impact on financial reporting," says Gerald Levin, senior managing director of Mesirow Financial, Chicago, Ill.

This company acts as a net lease investor/lessor for its own account, dealing directly with corporations. "We show a company that owning real estate is having an adverse impact on its financial condition as presented to the public," explains Levin. A properly structured sale-leaseback transaction results in "very much improved" financial statistics, he notes. "If you do it right, it is considered off-balance sheet financing - the money we loan to pay for the real estate does not show up on the balance sheet, but is footnoted as a rental obligation."

A sale-leaseback transaction with a net lease financier is an efficient source of capital for companies, according to Levin. "If we can loan money to companies (to be repaid through rent payments) at 6% or 7% interest, and they can employ that money at a 15% investment rate," he says, "it doesn't take them long to figure out that by the sixth year of the lease, they have more than broken even." In Action

Net lease financing is a mechanism that is used for assets that include railroad cars, airplanes, golf courses, auto dealerships, and of course, real estate, notes Charlie Corson, senior vice president and director of retail investment for The Staubach Co., Dallas, Texas. He recently was involved in a transaction where an internal Staubach partnership closed on a $125 million sale-leaseback package of 36 new Rite Aid pharmacy locations nationwide. The partnership purchased the locations, which are corporately guaranteed by Rite Aid via 22-year net leases.

Everyone wins in a deal like this. "This transaction enabled Rite Aid to choose their locations, build facilities as per their specifications, have total control of the facilities, and not carry the real estate on the balance sheet," explains Corson. In return, the Staubach partnership gets whatever appreciation the real estate enjoys over the next 22 years, along with a guaranteed income stream, he notes.

At press time, Dallas, Texas-based Cardinal Capital Partners Inc. was in the process of closing a $255 million sale-leaseback deal with California-based Beckman Coulter Inc., an international clinical diagnostics and bio-research firm. In late 1997, according to Cardinal principal Gil Besing, Beckman Instruments incurred in excess of $1 billion in debt to purchase Coulter Corp., in order to create a new company. "This put a heavy debt load on their balance sheet," he recounts. At the same time, there was also a great deal of real estate on the books, he adds, "which gave Beckman Coulter the opportunity to do a sale-leaseback of the facilities and raise $255 million at a relatively cheap price to pay off the more expensive acquisition debt."

Generally speaking, "A company will take two years deciding whether or not to do a sale-leaseback," says Besing. "And when they decide to move forward, they want to close in 45 days." Companies should indeed take some time for analysis when considering the sale-leaseback scenario, he notes. "From the balance sheet perspective, there is no reason at all not to do a sale-leaseback," according to Besing.

Potential Pitfalls "But at the same time, there are some considerations that corporate real estate people need to think through thoroughly," notes Besing. Sale-leaseback deals are most attractive to users when the leaseback term is long, 15 to 20 years, "because that is how they can achieve the most attractive pricing," he explains. "This means that the user must commit to the properties involved for a long period of time - and if these properties have a chance of becoming obsolete, or eventually becoming unable to accommodate the expansion needs of the future, then a sale-leaseback may not be the way to go."

"A sale-leaseback results in a long-term commitment of a tenant to a property - the longer the lease, the better the terms and the lower the cost of occupancy," says Corson. But over the course of the lease term, the marketplace and the businesses themselves may change, perhaps canceling out the benefits of a long-term deal. "In 15 years, the tenant may find that its business or customer base has changed, or that real estate rents in their market area have declined, or that their facilities are no longer of use," he points out, "but they are still responsible for the rent."

"The only potential pitfalls for tenants are those involved in triple-net lease financing deals," according to Rosene, "where all operating costs and real estate taxes are passed through to the tenant."

Many tenants want these kinds of deals as part of a desire to control the facility with their own maintenance and operational forces, he notes. "But the downfall is that there is no cap - operations costs can rise and taxes can increase," explains Rosene. This has led to an increased popularity on the part of tenants for leases where such expenses are capped, he adds, "and have some limits on the upside for pass-throughs."

The Synthetic Lease According to a recent report from The Alter Group, the synthetic lease, another off-balance sheet real estate tool, is "merely a financing arrangement that is referred to as a lease for financial and accounting purposes." It is used primarily when a special-use individual or group purchases real estate from a third party, and then leases the property to the lessee. Under this scenario, both acquisition and construction costs are financed, with the lessee paying the funds back through rent payments. Properly structured, synthetic leases allow the lessee/borrower to be identified as a lessee under accounting rules, and as an owner and borrower under applicable federal income tax code provisions.

"Synthetic leasing is really bank financing dressed up like a lease," says Levin. It is a short-term form of financing that is cheaper than the long-term financing accomplished through sale-leasebacks, he notes. Under a typical scenario, a public company that wishes to build a $20 million facility utilizing synthetic leasing will approach a bank, usually one with which it has an existing line of credit. The bank creates a five-year synthetic lease with itself as lessor and the company as lessee, loans the company the $20 million for five years at line-of-credit interest, and reduces the company's line of credit by the same amount.

"At the end of the five-year term, if all is well, the bank will renew the lease," explains Levin. "But if the credit of the company, interest rates, the economy, or something else has changed, the lease comes due, and in effect, the company has to repay the $20 million." By way of comparison, for slightly more interest, the sale-leaseback creates a condition where, he notes, "under no circumstance is the company financially obligated for anything but rent."

Outlook With today's strong economy and low interest rates, times are good for the business of net lease financing, according to Berliner. "We are in the middle of a terrific market, and I don't see the end in sight," he notes. A lot of different players are getting into the business, adds Berliner, which has created a lot of competition for deals.

Net lease financing is attracting the attention of Wall Street, according to Jacobs. "The capital markets have seized on net lease financing as an opportunity, and many groups see it as an adjunct to their conduit lending programs."

This is a mistake, says Jacobs. "I don't think that a lot of the people that are looking at this business are capable of assessing and mitigating the inherent risks involved in structuring these transactions." Net lease financing is a "down-and-dirty" business, he notes, "and it requires a true understanding of the corporate side of real estate, the nuances of a lease, and how these nuances can disrupt a cash flow."