The Move to Sale-leasebacks

By Mike Fickes

National Real Estate Investor, Jul 1, 2002

SALE-LEASEBACK PROVIDERS are preparing for a rush of new business. These transactions, already estimated to represent a market of $6 billion per year, are poised to grow in popularity because of their appeal as an alternative source of financing in today's tight lending environment and increasing accounting concerns over synthetic leases.

Synthetic leases — a short-term financing vehicle considered an option to sale-leasebacks — are becoming a less attractive financing method for companies now that the Financial Accounting Standards Board (FASB) is looking into changing the rules that allow off-balance-sheet accounting for the leases. Spurred to action by the collapse of Enron and its use of off-balance-sheet entities, FASB is expected to issue new guidelines in August.

“I think the post-Enron sale-leaseback business will shake loose a lot of transactions,” says Richard Ader, chairman of New York-based U.S. Realty Advisors. “If the [FASB] rules become final, they may make it very difficult to do synthetic leases.”

Sale-leasebacks and their companion financing vehicle, net leases, can be used by companies to raise cash for everything from business expansions to the construction of factories and office headquarters. “By doing net leases and sale-leasebacks with their real estate, companies can provide their own alternative sources of financing,” says Marjorie Palace, a principal at CRIC Capital, a Boston-based joint venture of CRIC and Prudential Real Estate Investors.

CRIC Capital, one of the few companies that tracks synthetic lease transactions, estimates the size of today's net leasing and sale-leaseback market at $5 billion to $7 billion per year. Meanwhile, CRIC executives say

synthetic leases have grown in popularity in recent years and may currently represent a $6 billion to $8 billion annual market.

In addition, Ader estimates the universe of existing synthetic leases may range from $75 billion to $120 billion. “At some point, a portion of those deals is going to break loose and move into the net-lease market,” he predicts.

Off the Balance Sheet

Often referred to interchangeably, the terms net lease and sale-leaseback describe transactions that produce a similar result. In a sale-leaseback, a company owns real estate, sells it to another company and net leases it back. Cash replaces the asset on the company's balance sheet. With a net-lease transaction, a company in need of an asset leases the property from a net-lease provider, which finances the purchase. In both cases, the company receives effective control over an asset it doesn't own under a long-term lease and makes lease payments off the balance sheet.

Accounting rules bar net leases from including a purchase option, allowing both sale-leaseback and straight net-lease transactions to remain off-balance sheet.

In a synthetic lease, a lender typically sets up a special-purpose entity (SPE), which borrows money to help a company finance new construction or the purchase of an existing property. The SPE leases the property to the company, which pays rent in the form of interest payments. Since the transaction is priced as corporate credit, the company typically pays a low interest rate — and it doesn't have to add the real estate asset or associated debt to its balance sheet.

But there is a major drawback — a synthetic lease requires the purchase of the asset at the end of a short five- to 10-year lease-term, unless the company is able to negotiate another synthetic lease. That requirement makes a synthetic lease look like a loan that should appear on company balance sheets. “It is a loan for every purpose other than accounting,” Ader says.

If the synthetic lease accounting changes proposed by FASB take effect, more business will flow from that market into the net-lease and sale-leaseback sectors, says Palace of CRIC Capital. FASB is considering an

increase in the equity requirement from the current minimum of 3% to at least 10%, which would make synthetic leases far less appealing to investors.

The process of switching to sale-leasebacks appears to be under way. “A lot of the deals we're closing today are with companies that did synthetic leases in the past,” says Ethan Nessen, a principal with CRIC Capital.

New Markets for Net Leasing

Net leases and sale-leasebacks are often used to acquire property or cash. But providers are reporting new categories of businesses entering the market.

“We're seeing this use of sale-leaseback transactions by a number of subsidiary companies as well as by divisions of larger companies,” says Palace. “Corporately, [subsidiaries and divisions] would have to fight for dollars.” These divisions can act on their own to receive financing they need via sale-leasebacks and net leases.

For example, Teksid SpA, the metallurgical subsidiary of Torino, Italy-based Fiat SpA, recently built a new foundry in Sylacauga, Ala. Instead of borrowing money for the plant from its parent, Teksid executed a net-lease transaction with CRIC Capital, which provided the $20 million required to build the factory. “The transaction eliminated the need to put debt on the Teksid balance sheet,” says Palace.

Other corporate subsidiaries and divisions also are constructing buildings through net-lease financing and raising cash through sale-leasebacks of owned property. “It's not just Fiat doing this,” she says. “This is a pronounced trend.”

Sale-leasebacks can contribute equity to investment transactions. “Private equity firms are finding that they won't have to contribute as much equity [to a transaction] if they do a simultaneous sale-leaseback,” says Gordon J. Whiting, executive director and deputy director of acquisitions at W.P. Carey.

Consider the management buyout of Eagan, Minn.-based Buffets Inc., one of the largest operators of buffet-style restaurants in the U.S. In 2000, Caxton-Iseman Capital Inc., a New York investment management firm specializing in buyouts, invested in the management buyout of Buffets.

The equity portion of the deal required more cash than Caxton-Iseman was willing to invest. To solve that problem, the firm combined the buyout transaction with a sale-leaseback of Buffets' 100,000 sq. ft. corporate headquarters. W.P. Carey purchased the facility for $21 million and leased it back to the restructured Buffets under a 20-year bond-type net lease. Proceeds from the sale-leaseback provided equity necessary to pay for the management buyout.

“Over the past 12 months, more than half of our acquisitions have been from private equity firms,” says Edward V. LaPuma, an executive director at W.P. Carey.

Emerging interest in net-lease and sale-leaseback deals, combined with the tighter underwriting standards in the capital markets, are providing a boost in business for firms providing these services.

W.P. Carey reported about $400 million in sale-leaseback transactions in each of the past two years. According to Sovak, the company may double that total this year. “The company makes about 20 deals a year, and the average size of its deals with investment-grade companies is growing,” he says.

“We're hoping to get our average deal size up to $40 million,” Sovak says. “With the slowdown in the capital markets, many very good companies need capital to buy new businesses, invest in research and development, and to do basic things like pay down debt.”

U.S. Realty Advisors logged $1 billion in transactions in 2001, up from $700 million the year before, according to Ader, who attributes the strength of the 2001 market to the recession and low interest rates.

Getting out of Real Estate

Other factors may boost the volume of net-lease and sale-leaseback transactions. Once viewed as a last resort for corporations in need of cash, these vehicles have emerged as financial management tools available to healthy as well as struggling companies.

Take Walgreens, for example. The Deerfield, Ill., company recently sold 42 newly built, stand-alone stores in 16 states for $150 million. The company

now operates those stores under 25-year, triple-net leases held by Cornerstone Capital Corp. of Dublin, Ohio.

Proceeds from the deal will help pay down some $650 million in commercial paper debt, a portion of which was accrued through store purchases in recent years. Rick Hans, director of finance for Walgreens, says the company's A+ Standard & Poor's financial rating allowed for interest rates of 2% on these obligations, low enough to support the unorthodox decision to finance a few stores with short-term capital. “It's not something to make a practice of, because you don't know where interest rates will go,” he adds.

Although Walgreens used sale-leaseback cash to pay off short-term debt that had accumulated against long-term real estate assets, Hans says the most important reason for the transaction was to rearrange the company's capital structure. “For us, returns on investments in real estate are not nearly as good as the returns we get from operating drug stores,” he says.

While real estate returns typically range between 5% and 8%, Walgreens' shareholders expect returns of about 18% after taxes, according to Hans. “Real estate ownership would dilute those returns,” he says.

In 2001, about 3,500 Walgreens stores generated revenues of $24.6 billion, up from $21.2 billion in 2000 and $17.8 billion in 1999. By 2010, the company plans to nearly double its size and open 2,500 more stores.

Historically, the company has owned between 15% and 18% of its stores. In recent years, that percentage rose close to 20%. Hans is using sale-leasebacks to drive the percentage back down to historical levels.

Hans will finance new stores with net leases negotiated directly with developers, preferring that technique to selling and then leasing back. He also finds lease negotiations easier with this type of lease. “Sale-leaseback providers usually want a bondable lease,” Hans says. “Our lease is not a bondable lease.”

Bondable leases are referred to as “hell or high-water leases” because the tenant is responsible for condemnation and casualty losses in addition to the typical triple-net lease expenses of rent, maintenance, property taxes and insurance. “Our leases make our landlords responsible for environmental

problems and condemnation," he says. "Under our leases, we also have the right to alter the property without asking the landlord."

Walgreens is one of many companies improving its balance sheet through sale-leasebacks. New synthetic-lease accounting rules are expected to deliver another rationale for this financing alternative to the corporate world.

Contributing Editor Mike Fickes is a Baltimore-based writer.

SALE-LEASEBACKS: NOT FOR EVERYBODY

Sale-leaseback providers have traditionally sold their services by offering corporations hard cash for real estate. But cash is only one of many corporate considerations.

"Corporate finance is a three-dimensional matrix," says Thomas Miller, managing director of the capital markets group of Chicago-based Jones Lang LaSalle. "Looking at a sale-leaseback in one dimension is an injustice to all parties involved on the corporate side."

Whirlpool Corp. of Benton Harbor, Mich., recently asked Jones Lang LaSalle to help identify principles that would make it easier to select among various capital asset financing options that include issuing equities or bonds, drawing down a revolving credit line, taking a term-loan from a bank — or signing sale-leaseback agreements.

Different corporate stakeholders have different ways of looking at financing alternatives, says Bob Dmytryk, senior vice president in Jones Lang LaSalle's capital markets group. For example, a manufacturing operations manager aims to hold down the cost of goods sold, but a factory sale-leaseback that raises cash might also raise the cost of goods sold.

At the same time, a sale-leaseback may appeal to a CEO interested in boosting stock prices by paying down short-term debt. The CFO may believe money invested in other vehicles will generate higher returns than real estate.

Then again, the tax director may argue against booking income from a sale-leaseback that will create tax liabilities.

Who's right?

To answer these questions, Jones Lang LaSalle designed a patent-pending model called Financial Alignment and Optimization (FAO).

In applying this model, corporate officers discuss a host of quantitative financial measures and qualitative factors, including the net present value of cash flow after taxes, the impact of depreciation, the balance-sheet implications of total debt, and the size, age and replacement cost of the asset under review.

Roundtable discussions are held to weigh the factors and assign numerical values to them. The numbers plug into a custom-designed spreadsheet that answers the complex question of what form of financing makes the most sense for a company in light of its current corporate priorities.
— **Mike Fickes**

© 2004, Primedia Business Magazines and Media, a PRIMEDIA company. All rights reserved. This article is protected by United States copyright and other intellectual property laws and may not be reproduced, rewritten, distributed, redisseminated, transmitted, displayed, published or broadcast, directly or indirectly, in any medium without the prior written permission of PRIMEDIA Business Corp.

©2004 Primedia Business Magazines & Media.