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SPECIAL ADVERTISING SECTION

To Sell and Lease Back? Or Not?

When should a corporation raise cash by selling and leasing back real estate?

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Properties like this 210,000-sq.-ft. (19,509-sq.-m.) medical office building are being "re-capitalized" to finance core business operations.

Suppose you sold and leased back your office building 15 years ago and put the cash into your business. Say you received $10 million for a 50,000-sq.-ft. (4,645-sq.-m.) facility. Since you carried out the sale-leaseback in 1988, at the beginning of the economy's descent into the 1990 recession, you might have offset a loss with the income from the transaction and owed no taxes. You might then have put that $10 million into your business during 1989, when your competitors were forced to conserve cash. By 1999, your investment might have tripled, thanks to the booming economy of the mid-1990s. That's a cool $30 million.

Today, while other corporations search frantically for ways to dispose of space, you would actually be able to do it. Your 15-year lease would have ended this year, and you could have walked away from your building. Or you could have reduced your space requirements and negotiated a new lease with lower rent.

Or, suppose that you still own that building today. You could do a sale-leaseback right now. Carried out today, such a transaction might provide seed cash for a business investment that will grow through the next economic expansion.

Then again, it might not.

So how does a company decide whether and when to lease or own real estate? Any number of sale-leaseback companies will tell you to never, never tie up money in real estate. Property historically returns somewhere under 10 percent. A company that earns more than 10 percent on its money would be crazy to sink cash into office buildings, distribution facilities, or stores.

"That's a simplistic answer," says Jonathan L. Winer, a partner in the real estate advisory services group of Ernst & Young. "In theory, you have capital tied up in every asset you own. So should you lease every asset? Of course not."

Sale-Leasebacks To Raise Capital

While there are no textbook reasons to sell and lease back property, continues Winer, there is one reason for a company to sell and lease back real estate: when it is the most sensible option for raising capital necessary to fund corporate undertakings.

Last summer, for example, Ernst & Young advised a large regional not-for-profit healthcare system on a 20-year sale-leaseback of 19 clinics. Stemming from a desire to raise capital, the transaction moved $35 million in cash into the system's coffers.

The healthcare system had built its network of clinics over time with unsecured short-term corporate capital. Even so, the system maintained a 1:1 debt-to-equity ratio on its balance sheet, a reasonable debt level for a non-profit, according to Winer.

The system wanted capital, but did not want to unbalance its debt ratio by using retained earnings or issuing bonds. On the other hand, continuing to own a network of small, 5,000-sq.-ft. (465-sq.-m.) clinics posed risks in the future. The system operated in suburban and rural areas. A demographic analysis suggested that the makeup of the population surrounding the existing facilities would change substantially over 20 years and could require the clinics to move. Even if the demographic analysis proved wrong, the system's executives believed that leasing, buying, or building new facilities in 20 years would pose few problems. Worse risks would stem from owning real estate in the wrong location in 2020.

Selling and leasing back the clinics eliminated that risk, while preserving the system's credit standing with the rating agencies. Whether a company issues debt or enters into a sale-leaseback makes little difference to rating agencies, says Winer. A sale-leaseback is an obligation that increases debt load. In its analysis of the transaction, one rating agency noted that the system's sale-leaseback did indeed affect the company's debt posture. At the same time, the agency applauded the increased liquidity created by moving from real estate into cash. Another benefit stemmed from the fact that the obligation to pay rent didn't appear on the system's balance sheet.

Sale-Leaseback vs. Mortgage

Only the largest and strongest corporations can borrow money for more than 10 years at fixed rates. The rest must borrow short-term LIBOR funds. But when floating LIBOR rates begin to rise, a company that has financed long-term projects with short-term money will eventually find itself seeking long-term refinancing.

Money raised through a sale-leaseback compares well with long-term money, secured by a long-term mortgage, says Michael Dorsch, executive vice president with iStar Financial, a Boston-based sale-leaseback company. Depending on prevailing interest rates, funds raised from a sale-leaseback may even be cheaper than a mortgage.

Michael Dorsch
iStar Financial

For example, says Dorsch, suppose a company enters into a 25-year sale-leaseback and raises $10 million. The sale-lease back company might charge 8 percent, or $800,000 per year, for rent to begin with. Over time, the rent would rise. Perhaps over the life of the deal, the rent would average 9 percent, or $900,000 per year.

Compare that deal with a 6-percent long-term loan on $7.5 million, or 75 percent of the property's value. This transaction would feature a 7.75-percent loan constant and require $581,000 per year in mortgage payments.

Dorsch also notes that the long-term loan requires $2.5 million, or 25 percent of the company's equity, to remain in the property. If the company's return on equity averages 15 percent, the cost of tying that money up in the property will total $375,000 per year. Add that to the mortgage payments, and the mortgage will cost the company $956,000 per year.

While the company can deduct the interest contained within the $956,000, all of the $900,000 sale-leaseback rent is deductible. The sale-leaseback benefit will be at least partly equalized by deductions for depreciation allowed on the mortgage side of the example. But don't forget that the mortgage appears on the balance sheet as a debt obligation, while the lease, as an expense, never touches the balance sheet.

At the end of the mortgage, the company owns the building free and clear and can sell it, but maybe not for very much. Real estate professionals earn their money by selling at the right time in the real estate cycle, when property values are highest. Corporations, on the other hand, usually need space when the economy is humming and property values are peaking. "That's the twist," Dorsch says. "Companies often try to sell real estate when the economy stinks and the property is worth less."

Still, the bricks and mortar will yield some cash value. If corporate executives have the time to manage a real estate sale at that level, the mortgage may prove to be the more economical transaction. The problem is that managing mortgages and sales has nothing to do with a corporation's core business.

Matching Corporate Strategy To Sale-Leaseback Strategy

Recently, Jones Lang LaSalle advised a corporate client working out a five-year operational realignment. A major corporate facility posed a wild card in the process. No one could figure out whether or not the building would be necessary to future operations. The company wanted to put off the decision to keep or dispose of the building for five years. That required making a decision between carrying out a five-year sale-leaseback, an unusual transaction, or simply continuing to own the property.

The building was located in a vibrant sub-market of a metropolitan area. It was adaptable to different uses. It was just the kind of property a sale-leaseback company would want for a long period of time. Although the purchase price would be lower for a five-year lease than a long-term lease, a sale-leaseback company would still pay well for a building as attractive as this.

Next, the company compared the net present value (NPV) of the after-tax cash flows from owning and leasing the building for five years. The benchmark would be an NPV-neutral or NPV-positive comparison. The sale-leaseback would generate a sum of money minus the rents and operating expenses paid over the term of the lease. Continuing to own would include costs of depreciation and operating expenses, adjusted by the residual value of the building at the end of the five years.

As it turned out, the NPVs of the two cash flows were about equal. The comparison led the company to gravitate toward sale-leaseback, but didn't seal the deal.

"Under GAAP, the lower a discounted rental cash flow, the greater the gain you can recognize," says Robert Dmytryk, a senior vice president with Jones Lang LaSalle. "A short five-year lease made it possible to recognize a greater gain than a 10-year lease."

While the five-year sale-leaseback lease would yield lower proceeds, the short-term GAAP gain made the trade-off work. In addition, the company got the real estate flexibility it needed.

"An investor would have paid a ton more for this asset if the company were willing to sign a longer lease," adds Dmytryk.

But the company was more interested in exit flexibility. The real estate deal that produced that flexibility got the nod. A different company with different objectives and different property might have chosen a different path.

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