AREA DEVELOPMENT
SITE AND FACILITY PLANNING
ONLINE

Published August, 2002



FACILITY PLANNING

# Companies Find Cash in Sale-Leasebacks

Real estate makes up a large portion of a company's asset base.
Sale-leasebacks offer an alternative source of financing.

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**TRAK MICROWAVE CORP.**, producer of electronic and microwave components for the telecommunications and defense industries, recently raised $5.5 million from the sale of its 124,000-square-foot office/manufacturing facility in Tampa, Fla. But TRAK is not stocking up on moving boxes and packing peanuts — Aside from some extra cash in the bank, there are no outward signs that a sale even occurred.

TRAK entered into a sale-leaseback in April that allowed the firm to sell its real estate, and at the same time remain in the facility under a long-term lease. TRAK opted to lease rather than own in order to gain access to equity that could be put to better use growing the business.

TRAK was acquired by Veritas Capital, a private equity firm, about two years ago. "The primary mission was to get the capital out of the real estate and redeploy that capital into the business and pay down the debt with the banks that financed the acquisition," says James Cate, a managing principal at Newmark Capital Group in Atlanta. Cate represented TRAK in the transaction.

Companies such as TRAK are exploring sale-leasebacks as an alternative source of financing amid an economic climate where traditional sources of capital have become more expensive and difficult to obtain. "Companies right now, private and public, are very focused on their asset base and cost of capital," Cate says. Real estate is a large part of that capital equation since firms that own real estate tend to have significant money tied up in the property. Firms are asking themselves if they can more effectively lease space and use the capital tied up in real estate for other purposes.

"Interest on sale-leasebacks has definitely heated up," says Lawrence Reed, executive vice president at Colliers Turley Martin Tucker (CTMT) in St. Louis. The reason for the spike in activity is simple – access to capital. Traditional lenders, such as banks and insurance companies, have become more cautious, with loan-to-value ratios dropping as low as 65 to 70 percent in some cases. At the same time, appraisers are assessing properties more conservatively. "The benefit of a sale-leaseback is that you can get 100 percent of the value of the property, compared to 70 to 80 percent in a traditional bank loan," Reed says.

### Viable Option

Several factors have pushed sale-leasebacks onto a company's short list of financing options. "I have seen more and more companies doing sale-leasebacks," says Darrell Betts, senior vice president of investments at Grubb & Ellis Co. in Houston. Last fall, Grubb & Ellis represented Input/Output, Inc. in the sale-leaseback of its 280,000-square-foot corporate campus in Stafford, Texas.

Companies can take a depreciating asset that is on their balance sheet and monetize it at fair market value. Sale-leasebacks provide some of the same advantages of ownership without the depreciation that can dilute earnings. "It continues to be a mechanism that a lot of people are looking at," Betts says.

A sale-leaseback transaction involves the sale of a corporate-owned facility to a third-party buyer, with the former owner then leasing all or part of the facility. Sale-leasebacks have been around since the 1940s when pioneers such as Safeway began leveraging cash from sale-leasebacks to fund store expansion. "It has always been kind of a popular option, going through ebbs and flows depending on market conditions and tax laws," says Jonathan Molin, president of New York-based U.S. Realty Advisors, LLC.

The value of a sale-leaseback is determined by three components: the credit of the tenant, the terms of the lease, and the actual real estate. "All of those factors work together to determine viability of a sale-leaseback," says Keith Sturm, a principal at Minneapolis-based Upland Real Estate Group, Inc. If one component is weaker, another side can compensate by being stronger. For example, a superior real estate location can help to offset a poor credit tenant.

Companies are weighing sale-leasebacks against other options such as synthetic leases, traditional bank financing, or raising equity. Sale-leasebacks are in favor partly because of the turmoil in the stock market and tighter lending in capital markets, which have made it more difficult for companies to raise capital. “We’re finding quite a bit of sale-leaseback activity in the marketplace,” says Ethan Nessen, a principal at Boston-based CRIC Capital.

**Enron Fallout**

Off-balance-sheet financing is one of the big incentives behind sale-leasebacks. Off-balance-sheet financing can be advantageous for public companies trying to give their stock a boost, as well as for firms that are trying to improve their credit rating with banks or other vendors. In addition, lease payments are tax deductible as long as the sale-leaseback transaction is structured as an operating lease by the seller/lessee.

Companies have two primary options in securing off-balance-sheet financing for real estate: sale-leasebacks and synthetic leases. However, increased scrutiny of synthetic lease deals is prompting companies to look more favorably at sale-leasebacks. “The synthetic lease has been turned upside down because of some of the problems with Enron and the accounting procedures associated with that,” Betts says.

In a synthetic lease, the owner takes out a lease from its own special purpose entity, allowing the firm to remove the debt involved in acquisition of the property from its balance sheet while deducting leasing payments for tax purposes. The caveat is that synthetic leases are only applicable to properties that a company has not owned previously, whereas sale-leasebacks can be applied to both new and existing assets.

In light of the Enron crisis, the Financial Accounting Standards Board is expected to introduce tighter regulations regarding the use of those special purpose entities. “So far we are seeing less demand for synthetic leases and subsequently more demand for sale-leasebacks,” Nessen says.

The caution relating to off-balance-sheet financing has also spilled over to impact sale-leaseback deals. “I expect activity to be slow until the SEC rules are clarified, and then there will be a backlog of deals due to the pent-up demand,” Molin says.

**Ideal Candidates**

Industrial properties are ideally suited for sale-leasebacks because facilities such as warehouses and distribution centers can be easily re-tenanted. The less special purpose the property, the more desirable it is for investors. “The best opportunities are the well-located, reusable buildings that have investment grade credit with a 20-year bullet-proof lease with rental increases,” Sturm says.

Sale-leasebacks are as much a function of the credit of the tenant and the rental stream as the real estate. Even if a property has declined, a strong credit tenant can add value to a transaction. “The lower you go down the credit spectrum, the more important the quality of real estate becomes,” Nessen says. That is not to say that firms without investment grade credit can’t get deals done, but lower credit ratings do drag down the overall value of a deal.

The primary driver behind a company’s decision to do a sale-leaseback is a firm’s overall capitalization strategy. Firms need to ask themselves questions such as, “Where is capital best deployed?” and “Does the company really need and want to own real estate?” According to Nessen, “Companies always want to control the real estate, but they do not always need to own it.”

Firms often choose sale-leasebacks after conducting a fundamental analysis to assess return on equity. Most companies can earn a higher return by putting money back into operations. “Typically, every dollar invested in the business returns 20 to 35 percent, while the return on real estate is 8 to 12 percent,” Sturm notes.

One argument against sale-leasebacks is that a company loses control of the real estate when they give up ownership. Companies should be very careful in tying up their real estate in a sale-leaseback if future flexibility is important. However, terms are often negotiated into the lease to give companies leeway in issues such as expansion, contraction, and lease renewals. Typically, sale-leasebacks are structured with long-term leases of 15 to 20 years.

Another negative is that the company no longer owns the asset, so they forfeit future appreciation of the asset. A company would have to sell the building at some point to capture that appreciation. “Most companies are thinking long term about their business and not about selling real estate,” Molin says.

**Deal Structure**

Negotiating the lease deal is a key part of the sale-leaseback. “Just because you want to change the financial structure does not mean you want to change the manner in which you use the real estate every day,” Cate says.

A lease can give a tenant some of the same control as owning the real estate by including such options as expansion, contraction, and lease renewal rights. That control is often critical because real estate can be strategic to business operations, as well as being tied to the corporate identity of a firm. “Companies don’t want disruptions in the way they have previously done business day-to-day,” Cate says. Firms want a seamless transition from owning to leasing where employees and customers won’t even notice the change, he adds.

Another key element of the deal is setting the sale price and corresponding rental rate. Typically, companies pursue sale-leasebacks for one of two reasons — They either want to maximize the amount of cash they can get out of the transaction, or they accept less cash on a sale in return for the ability to lock in a lower occupancy cost.

Higher rents on the long-term lease translate into a higher purchase price. If the rent is lower, the company will receive a lower purchase price. Depending on a company's goals, terms of the sale-leaseback can be structured accordingly. For example, a company may want to structure the sale price lower to reduce their capital gain. In exchange for that lower price they receive a reduced occupancy cost — lower rental rate for the lease term, adds Cate.

In the TRAK case, the firm was facing expensive real estate costs due to its proximity to the Tampa International Airport. However, TRAK structured the lease to reflect a modest occupancy cost at a value of $10 million over the next 15 years — a rate about 30 percent below current market rents. Essentially, TRAK received a lower fixed occupancy cost, and the cash they got out of the deal helped them with some of their financing needs, Cate says.

Sale-leasebacks can be tailored to meet a company's specific objectives. A lease may include escalating rents to boost the sale price, or flat rates may be incorporated to keep occupancy costs stable. Leases also can be structured to place all of the responsibility for items such as repairs and maintenance on the lessee, while other leases can be structured to divide responsibilities between the lessee and lessor. "It depends on what you are trying to accomplish, and what risk and responsibility you are comfortable with," says John Winer, a partner at New York-based Ernst & Young.

Another important consideration in a sale-leaseback is the tax obligation. Most companies want capital to redeploy into the business. At the same time, firms may be facing a large capital gains tax due to the sale. "The big concern is how do I use this capital and not have to pay out a significant amount in capital gains," Cate says. One option is to time the sale when a firm will be experiencing a capital loss on another transaction in order to offset any gain on a real estate sale.

Perhaps the biggest advantage of a sale-leaseback is the flexibility to structure the deal according to a company's own needs. Every firm has a unique set of drivers for doing a particular transaction. "You need to think about goals and match the structure to those goals," Winer says.