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The Corporate Sale/Leaseback Strategy

by Steve Bergsman

Earlier this year, Racal Instruments, Inc., inked a deal with W.P. Carey & Co., LLC, to sell its headquarters building in Irvine, California, and then lease the structure back. The transaction totaled $13.5 million.

What made the deal interesting was the fact that Racal Instruments, a leading international test and measurement systems developer, is owned by two private equity investors, Thomas Weisel Capital Partners and J.F. Lehman & Co.

Private equity firms, more than any other group, are taking advantage of sale / leaseback transactions, says Sean Sovak, managing director and chief acquisitions officer for W.P. Carey, a New York-based real estate investment banking company. "About 60-75 percent of our deal flow is coming from private equity firms, which use the sale / leaseback, in part, because it benefits their portfolio companies by raising capital from an otherwise depreciating asset."

While the weak economy and the stuttering retail sector should have taken some of the wind out of the sale / leaseback market, by most accounts 2002 will end up to be a banner year for companies involved in this busi-ness. The only pause in that statement is that 2002 could actually have been a better year than the one projected.

Sale / leasebacks and all similar commercial net lease transactions (including single-tenant credit deals) continue to gain popularity in the offices of chief financial officers who have scrutinized the company books and realized it would be better for their companies to remove real estate and real estate debt from the balance sheets. In addition, the CFOs figure, such a move would generate more cash than would be garnered through conventional mortgage financing.

A Typical Sale/Leaseback Deal

In a typical deal, the property owner sells real estate at fair market value to an investor, who then leases the property back to the previous owner under a long-term, triple-net lease. Unlike in a typical space lease where rents are based on fair market values, in a sale / leaseback the rent is based on the purchaser's financing costs, creditworthiness of the tenant, and / or a market rate of return on the equity investment.

Three Good Reasons for Sale/Leasebacks

The drive to do sale / leasebacks by corporate America hasn't changed much over the past decade. Why choose a sale / leaseback? Here are three good reasons:

1) property doesn't create revenue;
2) manufacturers and service companies are not experts in real estate deal making and management (and therefore should leave that part of the business to someone else); and
3) ownership of real estate does not maximize assets.

A Big Boost for the Market

For companies such as W.P. Carey that engage in sale / leaseback transactions, a busy private equity market has been beneficial to growing deal volume. However, for most firms, the big change in the market this year has been the decline of the synthetic lease business, a different form of financing that uses an off-balance sheet, special purpose entity (SPE).

In the corporate world, companies can treat corporate-owned real estate that it must occupy in three basic ways:

1) continue to own the property being occupied;
2) sell the property, then lease it back on a long-term basis; or
3) take the property off-balance while maintaining control over it in a synthetic lease format.

Although billions of dollars worth of synthetic leases were done in the '90s, the Enron scandal, with its abuse of SPEs, turned off-balance sheet financing into a horror story. Looking to rectify this problem, the Financial Accounting Standards Board (FASB), is expected to change, or, in the worse case scenario, delete some off-balance-sheet transactions such as synthetic leases. With the prospects of changes ahead, synthetic lease deals have withered away. Eventually, as current synthetic lease contracts come to fruition, it is expected most of those will end up as sale/leasebacks.

"FASB is going to come out with a ruling any time now and give guidelines as to what off-balance sheet really means," says Frederick Wehba, president of The Bentley-Forbes Group, a Los Angeles company that has maintained a specialty in sale/leasebacks for the past 20 years. "What companies are doing right now is taking advantage of LIBOR rates (synthetic leases use LIBOR) as long as they can. Then once they get their hands slapped will go back to sale/leasebacks. That is what we are seeing over and over."

Sale/leaseback firms expected a flood of new business this year from synthetic leases, but the market has been stranded somewhat, as companies have postponed decision making, waiting for FASB to issue new regulations.

This has only meant that 2002 will be a very good year instead of a stupendous year.

Last year, for example, W.P. Carey did $405 million in sale/leaseback transactions, this year it expects to do $700 million to $900 million. "This has turned out to be a very strong year," says Sovak. "A lot of companies are looking to refinance debt."

Sale/leaseback firms work directly with the private equity firms, explains Scott Tracy, a managing principal at Corporate Partners, a subsidiary of CB/Richard Ellis Investors in Los Angeles. 'What generally happens is the private equity firms will take a company private. Then once they own the firm, they will move to sell the real estate in order to free up funds for that investment."

"Part of the reason for the increasing volume of these types of deals," Tracy adds, "is because the debt market has tightened. We do some of these types of deals, but not to a great extent."

Corporate Partners swung about $190 million in sale/leaseback deals in 2001; this year the company expects to do $300 million.

It could be better. "There has been a lull before the storm," says Tracy. "There is a lot of waiting until the final FASB regulations come out. Corporations are waiting to make a final decision regarding real estate."

This isn't to say that there has not been some dealmaking involving companies switching off synthetic leases. At the end of last year, PETsMART, Inc., faced a situation where the synthetic leases on a number of its properties, including a large distribution facility, were coming to an end. The big Phoenix-based, pet supply retailer struck a deal with W.P. Carey, selling the distribution facility and 12 stores for $71 million to W.P. Carey, who then leased back the properties to PETsMART.

Also predicting a good year for 2002 is Gary Ralston, CCIM, CPM, CRE, SIOR, and president of Orlando-based Commerical Net Lease Realty (CNL), a real estate investment trust that invests in freestanding properties subject to long-term, net leases. "There's going to be a lot more business available and the number one reason is there will be accounting rule changes related to special purpose entities and synthetic leases."

Ralston expects CNL to easily top last year's numbers, when it invested $279.6 million in 137 properties.

In 2001, the Bentley-Forbes Group boasted sale/leaseback volume of $230 million. Wehba predicts those numbers will rise to $350 million this year. "This is going to be a very robust year," he says.

However, 2002 has been a different year for Bentley-Forbes in that volume is going to be substantially up, not because it is doing more deals, but because the size of the transactions have been so much bigger. That has not been by accident; the company changed its focus and went looking for more trophy properties. "We enjoy the creditworthiness of the larger companies," Wehba says.

Whatever the reason for the change in tactic, it was a good move for Wehba. "We have not seen as many sale/leasebacks this year as we did a couple of years ago. I don't know why, but I'm assuming people are holding off to see what happens with FASB."

Aligning for the Future

Whether companies are currently using sale/leasebacks or just considering the financial tool instead of synthetic lease, the trend line remains positive. The industry is experiencing a movement to align corporate real estate decisions with corporate capital decisions, says Stephen Tinsley, a senior vice president of corporate finance at Equis Corp., a Chicago-based corporate real estate services firm. This simply means that if the real estate is not performing in a manner that is aligned with the business units, then it is better to sell the real estate and put the capital back into the business.

"We recommend companies look at their real estate assets based on the capital allocation of the business units," says Tinsley. "And it's better to look at a strategy for individual assets depending on the special purpose of the asset. This is really an analysis of the portfolio."

On simple terms, that can mean if a corporation owns a warehouse but is not using the entire building and there exists a strategy to exit the location in five to seven years, the better play might be to do a partial leaseback, where the building is sold and partially leased back by the corporation for a lease of no more than seven years.

One of the major criticisms of a corporate sale / leaseback is that the company no longer controls the property. That is a misconception, Tinsley stresses. For one thing, a sale / leaseback is generally long-term, usually 20 years. Secondly, in some ways the corporation has more control in leasing than in owning because there are more options. The building can be tied up for a long period of time, or, if it is not needed, it is easier to get out and go elsewhere. ❖

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