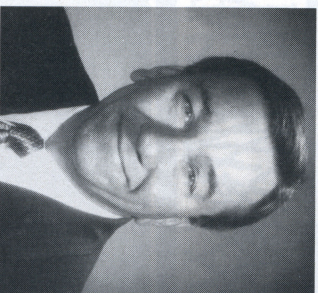


THE SALE-LEASEBACK FACTOR

Various real estate players use tactic to boost cash flow and reduce debt especially with tax-deferred and TIC incentives.

Jeff Young



Young

The "sale-leaseback," already a popular method for companies to increase cash flow and reduce indebtedness, may be set for an even better year in 2005 due to a confluence of factors, not the least of which is the real estate investors' healthy appetite for 1031 tax-deferred exchanges into tenant-in-common (TIC) properties.

In a traditional sale-leaseback, a com-

pany structures the sale of the investment property they own to the buyer, while simultaneously leasing back the property, typically for terms of 15 to 25 years with several 5-year options under a triple net lease. By doing so, it can reap 100 percent of its equity, while traditional financing would net the seller only 60 percent to 80 percent. Other advantages include:

- A cleaner balance sheet, since that debt is no longer a liability to the owner. Furthermore, if the seller uses the proceeds of the sale to pay off debt secured by the property, that too is removed from the seller's financial statement.
- By monetizing its real estate, a company can free itself of property management, which presumably is not its core business. The company can then can free up assets to finance other

business strategies.

- Tax incentives.
- Retaining control of the property. Added benefits to the subsequent tenant-lessee include receiving both favorable rental rates, especially if it is a credit-worthy company, and a premium price for quality property in this seller's market.

One other motivating factor favoring the sale-leaseback is the reluctance of many companies to participate in synthetic leases, which came under fire during the accounting scandals of the past several years. This year has shown a decline in this business approach, which is a hybrid form of financing that uses an off-balance sheet, special purpose entity (SPE).

If all this were not enough to spur the growth of creative financing through the leasebacks, the TIC market has pro-

vided an even greater source of capital from 1031 exchanges. Many real estate investors who formerly were restricted in their choices of "like-kind" property, have, since 2002, had the advantage of participating in these tenant-in-common deals with the issuance of IRS Revenue Procedure 2002-22. Many national sponsor companies — Tax Strategies Group, W.P. Carey & Co. and Macfarlan — to name a few, are seeking quality sale-leaseback properties for their investors. These investors are individuals seeking to defer capital gains and related taxation (depreciation recapture and state taxes) and participate in real estate deals they would not have otherwise been able to. In addition, they are looking to become more "passive" investors while receiving a more steady income stream backed by a hard asset. While most TIC deals utilize mortgage

Tenant-In-Common Investments: The 1031 Exchange Alternative

1031 Exchange into Professionally Managed Commercial Properties

financing, lenders are more willing to lend and offer favorable rates if a long-term lease with a quality credit-rated tenant is in place.

For the seller-lessee in these transactions, there are many creative and flexible strategies that can be employed to support its long-term goals and objec-

CORPORATE AMERICA PUTS BIGGER STAKE IN 1031 EXCHANGES

People will do almost anything to avoid paying taxes. Tax accountants and financial advisors are constantly urged by private and institutional real estate investors to find "safe harbors" so they can continue to play their real-life game of Monopoly, trading less desirable properties for more attractive ones without writing big checks to Uncle Sam.



Ross

And for more than 80 years, these experts have been able to reach into their tax toolkits and recommend the benefits of the Internal Revenue Code Section 1031 tax-deferred exchanges. However, only in the last 4 years, when property values have soared to record levels, has the IRS tax deferral law been so popular among large corporations.

Using the 1031 exchange, individuals who purchased a piece of property 20 years ago for \$1 million can now sell it for \$5 million and roll the profits into a new \$20 million transaction as a 25 percent down payment on the new property — without paying capital gains. The sellers not only improve their tax situation on the property sold, they also now own a \$20 million property, having geometrically increased the value of their real estate portfolio.

By adding a zero or two behind those numbers, that proposition becomes even more important on the institutional side.

Large corporations, especially life insurance companies with growing portfolios of real estate, stocks and bonds, are increasingly turning to the 1031 exchange as a means of avoiding giant federal tax bites resulting from the sale of their properties. Whereas a typical 1031 exchange transaction has been in the \$1 to 5 million range, today high net worth individuals and corporations are trading properties worth \$10 to 75 million. This is a trend that will continue.

In one of the dozens of 1031 exchange transactions I have completed in the last 2 years, Northwestern Mutual Life Insurance acquired an industrial warehouse building in Santa Fe Springs, California, where the tenant was Liz Claiborne. Because Northwestern was in the midst of a 1031 exchange — the property it sold had to be replaced with what the IRS calls a "like-kind" property — the life insurance company's bid for the industrial site was more aggressive and it was able to win the acquisition.

tives. For instance, it could decide to lease back just a portion of the property that was sold if that were to fit the company's model better. Also, if the company had plans to relocate say in 7 or 8 years, the lease could be tailored specifically for that event.

An even modest increase in interest rates within the coming year could accelerate the trend toward sales-leasebacks even greater. A market fueled by demand and lower rates has led to over-building and higher vacancies in many major areas of the country. As the curve flattens, these factors could favor sellers wanting to maximize their real estate value, opting to sell and become a tenant. Concurrently, the demand for TIC properties continues, and the availability of properties leased to credit-worthy tenants will make the properties more attractive to these investors.

These arrangements do not come without risks, however minimal they may be. A close analysis should be completed to insure that the company understands all of the tax ramifications involved. Also, the rent will probably exceed debt service on the old mort-

gage, and financial officers would be well advised to consider all alternatives to drawing capital from their properties, including refinancing.

There are many advantages for corporations converting to tenancy from ownership. Real estate is a non-performing asset and, by liquidating it, the cash can be invested in performing assets, such as stocks. Risks on the side of the buyer-lessor are purchasing a property that does not appreciate as anticipated and assuming responsibility for the management of that property. All in all, the sale-leaseback remains an attractive alternative for owners seeking to put assets toward their core business, pay off debt and move out of the property management business. And should they decide to pursue this course of action, there are plenty of TIC buyers on the sidelines waiting to participate.

Jeff Young is a senior vice president and investment advisor for First Financial Equity Corp. in Scottsdale, Arizona.

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