Today's commercial real estate market adds urgency and profits to sale-leasebacks

BY BEN EDGAR

Do you have a large portion of your balance sheet tied up with your real estate assets, effectively making only a 7.5 percent to 8 percent return on value in today's market? If so, that money invested in bricks and mortar might be better spent elsewhere.

By owning your real estate, you are accepting a rate of return at least half the 15 percent to 30 percent that the most profitable companies aspire to. That's why many business owners and CFOs are looking more carefully than ever at sale-leasebacks, which are transactions wherein the owner of a property sells that property and then leases it back from the buyer.

And with the growing popularity of REITs, there are many large investors ready to make these transactions. So much so that sellers can negotiate very favorable terms right now, including the ability to fix lease costs with little or no adjustments for inflation, lower payments in the early years and wide latitude on required insurance or environmental provisions.

CASE STUDY 1

Our company sold the Convention Data Services' building in Bourne – 20,000 square feet for $3.5 million. CDS is leasing back the entire facility at a below-market lease. CDS' owner wanted to diversify his personal investment portfolio (which was over-weighted in real estate) by taking advantage of peaking valuations. He also wanted to be more flexible for future merger or acquisition opportunities and improve his tax position by expensing the entire property versus having a lot of value in four acres of land that he could not depreciate and did not really need.

TAX BENEFITS

By deducting lease payments, the lessee can write off the full cost of the real estate, including the portion that relates to land. The tax deduction may be accelerated because it is spread over the term of the lease rather than 39 years, the term typically used for depreciating commercial buildings.

That makes sale-leasebacks very attractive from an after-tax viewpoint, because IRS rules do not allow companies to depreciate the value of land under other circumstances.

INCREASING YOUR SHAREHOLDER VALUE

You will want to consult a CPA or business adviser, but consider that in most cases a sale-leaseback capped at 9 percent is the equivalent of selling part of your company at a multiple of 11 times cash flow.

Leasing a property allows the asset to be transferred off the balance sheet. Cash proceeds can be used to pay down existing debt, which would improve a company's balance sheet and debt ratios. In addition, because the fair market value of real estate is typically higher than book value, the sale-leaseback would also increase shareholders' equity on the balance sheet and/or the borrowing capacity of the seller/lessee may be increased.

Consider too that unlike typical bank loans or corporate bonds, sale-leasebacks never need to be refinanced. With renewal options available after the initial lease term, fixed lease rates can be secured for up to 40 years or more.

Sale-leasebacks allow companies to better diversify their financing obligations both in terms of exposure to interest rate risk (fixed vs. floating) and refinancing risk. While a conventional financing package might limit a business owner's borrowing capacity to 80 percent of the property's appraised value, a sale leaseback deal can usually deliver full value.

Many companies are showing a growing appetite to use the capital by investing in core operations or paying down debt. So, as companies, whether they are Fortune 500 size or have assets less than $10 million, are looking at ways to monetize their capital, they are selling real estate – capital that can be cheaper than traditional lines of credit.

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INVESTING

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CASE STUDY 2

We are working with a prominent retailer with 11 locations to sell the first location that it purchased 15 years ago. The property is available for $2,700,000 at 17,800 square feet, or $151 per square feet. The owner is offering to lease the building for $10.85 per square feet, which is below market for this site.

The value of the property has increased fivefold in those 15 years; the owner wants to reinvest the sale proceeds into his core business for expansion. He projects a much larger return on his business expansion than the return on his real estate investment capital.

THE BOTTOM LINE

The biggest benefit of a sale-leaseback transaction is the ability to

increase a company's financial flexibility by selling real estate at attractive long-term rates, while maintaining the availability of bank financing for a future date. By being both the lessee and the seller of the property, a company has greater bargaining power to ensure it maintains uninterrupted control of the facility – including operations, maintenance and alterations. It can negotiate the rights to assign and sublet the facilities, and it enjoys lengthy initial and renewal terms.

Sale-leasebacks don't make sense for all corporate users. Obviously, highly specialized facilities, or buildings with unusual designs or shapes that won't be candidates for an alternative use, may not attract outside investors.

However, selling an 8 percent return to get a 20 percent-plus return is a pretty easy decision. ■

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