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Sale-leasback financing gives owners options

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The benefits of sale-leaseback financing — the strategic conversion of real estate, particularly single-tenant properties, into working capital — is gaining vogue once again as executives scramble to find critical funds to grow their companies.

That "concrete into cash" alternative has increased in appeal in recent months. Reasons include the recent stock market gyrations that displaced investment dollars and downgraded borrowing capabilities, not to mention the economic slowdown and mounting dot-com losses.

Developments in the corridors of capital, on Wall Street and, until recently, at the Federal Reserve have seemingly intersected to restrict access to traditional cash resources, even by mainstream companies. Subsequently, firms finding it increasingly difficult to attract cash for bricks-and-mortar growth, geographical expansion or competitive marketing are rethinking the concept of sale-leaseback transactions and the advantages they afford.

No less than the authoritative National Real Estate Investor has reported, "The sale-leaseback industry has restructured the ownership of trillions of dollars worth of the nation's corporate real estate assets."

According to the *CPA Journal*, "National franchise and chain businesses have led the way in using sale/leaseback to benefit business owners, but the system can work for any business — small or large."

Funds from sale-leaseback financing have fueled leveraged buyouts, mergers and acquisitions; underwritten the cost of maintenance and technology to remain competitive and erased obligations from countless corporate balance sheets nationwide.

The importance of sale-leaseback as a capital resource is reinforced by a February 2000 comment to the Dow Jones Newswire by the SVP-CFO of a national chain of theaters with 458 facilities, 2,848 screens, in 36 states:

"The ability to turn high-performing assets into cash when so much investment capital is flowing into other industries offers us fresh resources to maintain our steady pattern of growth and to improve existing properties."

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> *CPA Journal*

The firm completed the sale and leaseback of $23.5 million in three properties for the theater chain — generating critical cash that helped sustain the firm as the multiscreen cinema industry collapsed this past year.

A more traditional example is Colorado-based Wild Oats Markets Inc., a natural foods supermarket chain in North America, which turned to sale-leaseback financing as an effective technique for "capital recapture" to fuel its growth. Specialty retailers, such as Wild Oats, realize their primary profit potential is in its core business operations, not in the hassles of property ownership.

Industries with single-tenant facilities are ideal for triple-net — NNN — deals. Sale-leaseback financing, net-leased sales and debt-and-equity placements are turning nonperforming as well as high performing assets into available capital for additional growth. That makes sense in an unstable stock market. Such large national tenants as Blockbuster Inc., Eckerd Drug, Kmart Crop., Home Depot Inc., Taco Bell, Wal-Mart Stores Inc. and Walgreen Co. have effectively employed the financing method.

There are several reasons many traditional corporations are finding it increasingly more expensive to borrow money:

- Until spring 2000, technology issues were the darlings of investment bankers, and hungry investors, venture capital firms and "angels" couldn't wait to crown the next dot-com entrepreneur with a garland of greenbacks. Telecom, wireless, biotech and dot-com operations sucked billions of dollars into what was the longest sustained bull market in Wall Street history.
- Until the presidential election was decided, the Federal Reserve Board had raised the key short term interest rates six or seven times since June 1999, setting off a chain reaction as banks ratcheted their own interest charges upward to reflect their new costs. Only the slow consumer spend-

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ing and economic growth, as well as some heart-stopping corrections in the market, seems to have changed Mr. Greenspan's thinking.

Although rates have dropped sharply in the past two quarters, financing spreads continue to widen.

Sale-leaseback financing most commonly involves a company selling one or more single-tenant properties to an investor — individual, company, pension fund or group — usually for fair market value. The investor/landlord provides the seller with a triple-net lease for a negotiated period of 10 to 25 years. The seller/tenant usually pays the investor a negotiated annual rent equal to 8 percent to 15 percent of the contracted sale price. Most often, the lease rate is credit-driven and constant.

Triple net refers to the payment of property taxes, maintenance and insurance. In an NNN lease, the single tenant agrees to pay all the expenses associated with the property use and occupancy, including the cost of insurance, real estate taxes, improvements, on-site property management and maintenance, in exchange for control of the property and a favorable long-term lease.

There also are derivatives of the NNN called bond-lease, absolute NNN and double-net lease. These names invariably change across the United States and with different investors.

Regardless of the moniker, NNN investments are available for all types of existing or build-to-suit real estate, including service centers, fast food establishments, industrial and health care facilities, office and educational buildings, distribution warehouses and retail stores.

Most companies require real estate in order to conduct their businesses; however, few firms profit from owning those properties. The cash and credit they have tied up in facilities and land represent assets that could be employed much more productively in the corporation's core business operations.

Directors and officers are constantly faced with the question of how the company will pay for or finance the cost of the properties without tying up operating dollars, without severely impacting its credit facility and loading up their balance sheet with debt.

The question is fraught with a variety of uncertain variables, including the present and future costs of money, projected tax benefits, maintenance and rental costs, and the accounting treatment. Then there is the guessing game on the expected future value of the real estate in 10, 20 or 30 years.

An NNN leasehold obligation that qualifies as an operating lease under the criteria set by the Financial Accounting Standards Board, however, will not appear on the tenant's balance sheet as either debt or long-term obligation. The corporation pays off the mortgage obligations and/or just receives the unlocked cash from the sale of its depreciated real estate.

The improved debt-to-equity ratio and current ratios can make a corporation/tenant much more attractive to banks and other traditional lenders, as well as investors and shareholders. Short-term borrowing can be avoided and a need for credit lines possibly eliminated.

In addition to expense reduction and the conversion of the corporation/tenant's illiquid real estate assets to capital, a sale-leaseback with a properly structured operating lease can provide the corporation/tenant company with business advantages:

- 100 percent financing based on the assessed value of the property, in contrast to the 50 percent to 85 percent usually provided by mortgage financing;
- Full operating control of the real estate under the tenant's lease provisions;
- Tax deductible lease payments, that is a lower after-tax cost;
- Cash realized from the sale-leaseback transactions can be used to enhance liquidity, expand operations, acquire other businesses, reduce debt, invest in 1031 exchanges, etc.

In the area of acquisitions and leveraged buy-outs, a sale-leaseback can be used as part of the overall transaction. A corporation planning to acquire another firm can use the assets of the acquired company to reduce total acquisition cost. The need for higher-cost debt and lengthening the maturities of the overall financing is reduced.

Taking a long view, many executives express concern about their options when the lease expires. Three choices emerge:

- The tenant can renew the lease at a new negotiated rate.
- If the tenant had a renewal clause in its initial lease, it could exercise its option and re-lease the property from the landlord at the rate specified in the clause.
- The tenant can also move to a new location.

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