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Capital needs turn focus on sale-leaseback

In part one of a two-part series, Dallas consultant JONATHAN HORN *examines the benefits to tenants of sale-leaseback financing. Part two, which examines the advantages to landlords, will appear in our commercial Real Estate Quarterly May 25.*

GREATER METROPLEX — For many years, those promoting the use of corporate property to generate sale-leaseback financing have recommended turning concrete into cash.

In light of current economic conditions, that counsel is gaining vogue with both lessors and investors.

Developments in the capital markets, on Wall Street and at the Federal Reserve have seemed to restrict access to traditional cash resources for mainstream companies. As a result, firms finding increasing difficulty in attracting cash for bricks-and-mortar growth, geographical expansion or competitive marketing are rethinking the concept of sale-leaseback transactions and the benefits they afford.

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 corporate balance sheets nationwide.

Turning non-performing as well as high-performing assets into available capital for additional growth makes sense in an unstable stock market.

The importance of sale-leaseback as a capital resource is reflected in a February 2000 comment to the *Dow Jones Newswire* by a leading executive of a national chain of theaters (458 facilities, 2,848 screens, 36 states), who said: "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."

SALE-LEASEBACK FINANCING
PART 1
BENEFITS TO TENANT

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

The money chase

So, why are many traditional corporations finding it increasingly more expensive to borrow money in 2001?

■ Until last spring, technology issues were the darlings of investment bankers and hungry investors, venture capital firms and "angels," who couldn't wait to crown the next dot-com entrepreneur with a garland of greenbacks. Telecom, wireless, biotech, and dot-com operations — ongoing and aspiring — sucked billions of dollars into what was the longest sustained bull market on Wall Street.

■ 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 upward their own interest charges to reflect their new costs. Only the slow consumer spending and economic growth, as well as some heart-stopping corrections in the market, seem to have changed Mr. Greenspan's thinking.

■ Although rates are dropping, financing spreads continue to widen.

Basic tenets of sale-leaseback and triple net

Sale-leaseback financing most commonly involves a company selling one or more single-tenant properties to an investor, 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% to 15% of the contracted sale price. Most often, the lease rate is credit-driven and constant.

Triple net, or NNN, refers to the payment of property taxes, maintenance and insurance. In a 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 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.

■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.

Corporation/tenant viewpoint

Most companies require real estate to conduct their businesses, however few firms profit from owning those properties. Cash and credit tied up in facilities and land represent assets that could be employed more productively in the corporation's core business operations. Directors and officers are constantly facing the question of how the company will pay for, or finance, the properties without tying up operating dollars, severely impacting its credit facility and loading up the balance sheet with debt.

The question is fraught with uncertain variables, including the present and future costs of money, projected tax benefits, maintenance and rental costs, and accounting treatment. Then there is the guessing game of the expected future value of the real estate.

A 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 receives the cash from the sale of its depreciated real estate.

The improved debt-to-equity ratio and current ratios can make a corporation/tenant more attractive to banks and other traditional lenders, as well as to shareholders, prospective investors and potential acquisition partners. 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 the following business advantages:

■ 100% financing based on the assessed value of the property, in contrast to the 50% to 85% usually provided by mortgage financing.

■ Full operating control of the real estate under the tenant's lease provisions.

■ Operating leases that do not appear on the corporate balance sheet as debt or as a long-term lease obligation.

■ Tax-deductible lease payments, that is, a lower after-tax cost.

■ Effective land depreciation — since the value of the land acquired is factored into the rent, the tenant can effectively depreciate the land by deducting the rent under the lease attributable to the land.

■ 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 utilized as part of the overall transaction. A corporation planning to acquire another firm — or even its own companies — through an LBO 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.

Long term, 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 move to a new location.

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