THE BENEFITS OF A SALE-LEASEBACK

While sale-leaseback transactions may be structured in a variety of ways, a basic sale-leaseback can benefit both the seller/lessee and the buyer/lessor.

The greatest benefit of a sale-leaseback transaction is the ability for the owner/occupier to increase their financial flexibility. By becoming both the lessee and the seller, the owner occupier negotiates from a position of strength to ensure that they maintain uninterrupted control of the facilities; and perhaps, more importantly, they free up capital to invest in their core business. In the context of easing returns from cash and uncertainty surrounding the performance of equity markets, steady and long term yields make this type of transaction an investment just right for the times.

WHAT IS A SALE-LEASEBACK?
A sale-leaseback is typically a commercial real estate transaction in which one party sells its corporate real estate assets to another party. The seller then leases the property back at a rental rate and lease term that is acceptable to the new owner. The lease term and rental rate are based on the new owners financing costs, the lessee’s credit rating and market rates of return.

A sale-leaseback transaction entails the sale of corporate real estate and the simultaneous commitment to a long-term lease of generally 7 to 10 years. This combination allows a company to redeploy the capital that had been invested in real estate back into the core business.

The sale-leaseback may include either or both the land and the improvements. Lease payments typically are fixed to provide for amortization of the purchase price over the term of the lease plus a specified return rate on the buyer’s investment. The typical transaction usually is a triple-net-lease arrangement. Sale-leasebacks often include an option for the seller to renew its lease, and on occasion, repurchase the property.

WHY CONSIDER A SALE & LEASEBACK?
Raising funds through a sale-leaseback transaction offers property owners a number of important business advantages.

Converts Equity into Cash. With a sale-leaseback, the seller regains use of the capital that otherwise would be tied up in property ownership; at the same time, the seller retains possession and continued use of the property for the lease term.

The seller usually receives more cash with a sale-leaseback than through conventional mortgage financing. For example, if the transaction includes both land and improvements, the seller receives 100 percent of the property’s market value (minus any capital gains tax). In comparison, conventional mortgage financing normally funds no more than 70 percent to 80 percent of a property’s value.

Because capital gains tax reduces the cash from the sale, a sale-leaseback where the property is sold at a small gain or at a loss generally is most advantageous.

Companies can utilize the cash for corporate business acquisitions, equipment purchases and debt reductions business expansions.

Alternative to Conventional Financing. The seller usually can structure the initial lease term for a period that meets its needs without the burden of balloon payments, call provisions, refinancing, or the other issues of conventional financing. Moreover, the seller avoids the substantial costs of conventional financing such as points, appraisal fees, and some legal fees.

A sale-leaseback also usually provides the seller with a level of flexibility via renewal options, while conventional mortgage financing has no guarantee for refinancing.

Possibility of Better Financing. Under a sale-leaseback arrangement, a buyer may be able to obtain better mortgage
financing terms than the property owner. Even if the property owner defaults, the buyer is likely to continue payments to protect its equity. Thus, the lender might be willing to charge the buyer a lower interest rate, which could result in lower lease payments to the seller.

**Improves Balance Sheet and Credit Standing.** In a sale-leaseback, the seller replaces a fixed asset (the real estate) with a current asset (the cash proceeds from the sale). **If the lease is classified as an operating lease, the seller’s rent obligation usually is disclosed in a footnote to the balance sheet rather than as a liability.** This results in an increase in the seller’s current ratio, or the ratio of current assets to current liabilities — which often serve as an indicator of a borrower’s ability to service its short-term debt obligations. **Thus, an increased current ratio improves the seller’s position for borrowing future additional funds.**

However, if the lease is classified as a capital lease, the advantages of the sale-leaseback arrangement from an accounting perspective are altered considerably. **Statement of Financial Accounting Standards No. 13 on accounting for leases requires that a capital lease be recorded as an asset and capitalized and requires the obligation to make future lease payments to be shown as a liability.**

**Avoid Debt Restrictions.** Businesses restricted from incurring additional debt by prior loan or bond agreements may be able to circumvent these limits by using a sale-leaseback. Rent payments under a sale-leaseback usually are not considered indebtedness for such purposes, thus a business can meet its cash needs through the sale-leaseback without violating any previous agreements.

**Deterrent to Corporate Takeovers.** Undervalued real estate on a company’s books often serves as a target for corporate raiders. A timely liquidation through a sale-leaseback transaction may serve as a deterrent, providing management with funding to resist the takeover. In addition, a long-term lease is not as inviting to raiders as undervalued real estate.

**Avoids Usury Limitations.** Because a sale-leaseback is not considered a loan, state usury laws do not apply; a buyer in a sale-leaseback can earn a higher rate of return on its investment than if it had made a conventional mortgage loan to the property owner.

**INCOME TAX IMPLICATIONS**

It is important to understand that sale-leaseback arrangements result in income tax implications for both the purchaser/lessor and the vendor/lessee. We recommend consulting your tax advisor for specifics and utilizing Voit’s local market professionals to discuss your specific needs.

**SUMMARY**

In summary, a sale-leaseback could be the right transaction for your business to consider. **The ability to free up capital at a time when the availability of finance is constrained can be of great benefit to a business, allowing the ability to redeploy these funds into core business activities and achieve a better rate of return.** From a seller’s perspective, lease rates lagged behind sales prices so factoring in favorable occupancy costs while maximizing value gives you quite a bit of leverage. In a market where the cash rate is easing and the performance of equity markets remains uncertain, a solid commercial or industrial property with strong covenants and steady long-term yields make this type of investment even more appealing today.

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