



# Sale/Leasebacks: a compelling capital source for corporations

*by Michael L. Cantor*

**IN THE WAKE OF THE HOME MORTGAGE CRISIS**, the capital markets have been tightening up, even for much less risky corporate borrowers. As corporations pursue sources of capital in today's financial environment, sale/leaseback transactions offer some meaningful advantages. A **sale/leaseback** is a transaction structure that involves a company selling a real estate asset to an investor in consideration of "leasing back" the facility for a period of time. The current economic climate presents a compelling opportunity for corporations to utilize sale/leasebacks to access capital through the monetization of real estate assets.

*Why do corporations enter into sale/leasebacks?*

Whether publicly traded or privately held, corporations that own real estate are holding unproductive long-term fixed assets on the balance sheet, which saddles their financial metrics (such as Return on Assets) that are scrutinized by both Wall Street analysts and "Main Street" commercial lenders. Moreover, the book values stated on the balance sheet are often well below market value due to depreciation over the course of ownership. Sale/leasebacks create the ability to extract capital at market value which can be redeployed to productive uses, such as business acquisitions and new equipment. Further, assuming the corporation has a strong credit rating and is willing to commit to a long-term (often longer than 12 or 15 years), triple net lease, this bondable credit lease structure can be used to leverage the capital markets much like a bond instrument.

Beyond these basic financial benefits, sale/leasebacks can also help companies achieve operating efficiencies. By shifting from an ownership to a leasehold interest, the company arguably increases flexibility in its occupancy decisions, especially if the sale/leaseback includes a portfolio of assets where property swapping rights may be arranged. Although sacrificing the bondable nature of a credit lease, a company can also establish an exit strategy by committing: 1) to a shorter term lease; or 2) to only a portion of the space. In the first case, a short-term lease is effectively a sale of the real estate with increased value extracted resulting from the mitigation of

the investor's re-leasing risk. The short-term lease provides the purchaser time to reposition the asset while receiving positive cash flow, which should result in a higher purchase price compared to a sale of vacant property. In the second case, where a company leases back only a portion of the facility, operating efficiencies are captured by immediately transferring the operating costs and risk of re-leasing vacant space to the real estate investor, who should be better positioned to manage and resolve these risks. As contrasted with a credit deal, the flexibility garnered from a real estate deal takes into greater consideration the predicted value of the real estate at lease expiration, resulting in a different set of economic



assumptions and pricing. Due to the risk inherent in the terminal value of the real estate, a real estate deal usually has a higher capitalization rate, resulting in a lower purchase price than would be expected with a credit lease.

#### *A Balancing Act*

An additional balancing of value is based on whether the corporation is trying to achieve maximized sale proceeds versus minimized

rental expense over the lease term. This relationship is illustrated by the equation:  $P = r/C$ . The Purchase Price (P) is the quotient of Annual Rent (r) over a Capitalization Rate (C), which is based on risk factors primarily related to the corporation's credit rating and the value of the real estate. The higher the purchase price is set, the higher the rent payments will be and vice versa. Assuming the company desires to remove the long-term fixed asset from the balance sheet, both the purchase price and the rental rate will need to comply with fair market tests as provided by the Financial Accounting Standards Board (FASB). On the Income Statement, a sale/leaseback transaction often results in a "wash," replacing depreciation and mortgage interest expense items with rental expense. This raises another factor in determining the right balance, whether the company wants its total real estate expenses to increase or decrease, often with an aim to reduce the taxation of net profits. An additional area of consideration relates to capital gains tax treatment of the transaction. Although capital gains issues typically only result in refinement of the structure, in sophisticated portfolio transactions tax deferral strategies should be evaluated. In smaller or single asset transactions, Internal Revenue Code (IRC) §1031 tax deferred exchanges can be structured when appropriate.

*Deciding if a sale/leaseback makes sense and, if so, determining the right structure...*

If benefits of a sale/leaseback align with your corporate objectives—how do you get started? A company should engage a real estate consultant to conduct an objective evaluation that takes into account the corporate objectives, the real estate assets and the market conditions before deciding to go to market. While many conventional real estate

brokers may offer to do the front-end analysis for "free," many times the corporate decision makers question whether they are merely "selling the idea" to set up the opportunity to earn a commission. A real estate consultant working for a fixed fee or hourly rate structure can provide the objectivity desired to evaluate sale/leasebacks compared to other recapitalization strategies. Once evaluating a fully developed comparison of the alternatives, including both projected financial results and qualitative assessments, a com-

pany with support from its financial, accounting and legal resources may decide to go to market. If so, the real estate advisor proceeds with identifying the right universe of investors, which may include institutional investors in the case of credit deals and more traditional real estate investors in real estate deals. Once the marketplace is determined, the real estate advisor manages: seller due diligence activities, marketing and RFP packages, collaboration with the corporation's lawyers and accountants, transaction negotiations, and support of legal counsel through the documentation and closing processes.

While sale/leasebacks are merely complicated by the balancing of considerations in both conventional sale and lease transactions, they can be fairly straightforward alternatives to commercial real estate loans, especially in the current economic climate. While the banks and capital markets sort out the mess of the foreclosure crisis, astute corporations and smart investors will be considering, pursuing and structuring sale/leasebacks. ■

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