Unlocking Capital Bound by Real Estate Ownership

A Barclay Street Real Estate Brief

Sale/leaseback transactions are an option for obtaining maximum equity and accessible working capital from owned real estate. This type of transaction allows the owner of a property to sell it and then lease it back from the buyer at a rental rate and lease term that is acceptable to the new owner, typically on terms consistent with the given market's rates.

The primary purposes of this strategy are to raise money or to free up the owner's equity for other uses, while retaining use of the facility.

POTENTIAL USES OF CAPITAL
Invest in and expand core operations
Finance acquisitions or growth strategy
Pay down debt
Restructure business

A BARCLAY STREET BROKER CASE STUDY

In my previous career in Australia, I worked for a multinational consumer goods distributor and I observed over a two-year period, the commissioning and building of a brand new head office & distribution center customised exactly to the company's specific requirements in Sydney.

Approximately 6 months before occupancy I found out the building had been sold and leased back by my company. I asked one of the directors: 'Why would we sell a building we've just built?'

The response was that our company was in the distribution and marketing business, meaning our capital was better spent on purchasing inventory and marketing dollars for a significant return for our shareholders, as opposed to having equity tied up in a property.

'We are in the distribution business, not the real estate business.'

This made sense and was the first time I had been introduced to the sale/leaseback scenario. The move proved wise and the company thrived for an additional 20 years before being bought by a larger firm competing in the same space.

Advantages of a Sale/Leaseback

Cash is a desired asset because it can aid against uncertainty. Since most companies are not in the real estate ownership business, converting assets into cash to put towards the core business can prove to be very beneficial. Sale/leaseback transactions hold considerable appeal for corporate occupiers and commercial real estate investors alike.

One of the more significant benefits of the sale/leaseback is that it allows businesses to free capital tied up in real estate. A company may own several real estate assets, but the value of these assets remains largely intangible for as long as the business owns the property. As a result, a substantial amount of capital that a company could use more productively to expand or improve its core business remains tied to its real estate.

ADVANTAGES OF A SALE/LEASEBACK

EXTRACT GREATER VALUE VS. MORTGAGE

Provides you with full value of the asset(s) compared to traditional mortgage debt financing

OFF BALANCE SHEET (OBS) ASSET OPERATIONS

Mortgage debt removed from the company balance sheet and operational control of asset is kept.

MIDDLE-GROUND FINANCING ALTERNATIVE

Relocate capital from real estate back into your core business.

ENJOY SIGNIFICANT TAX ADVANTAGES

Core business yields tend to be greater than real estate yields. Lease payments with a sale/leaseback are deductible against your taxable income, versus only the interest portion of a mortgage payment.

RETAIN USE AND CONTROL OF ASSET

You can secure occupancy rights through a long-term lease (often 15-25 years) and multiple renewal options.

Flexibility for Sellers, Stability for Buyers

A sale/leaseback serves both sides of transaction, as it allows the owner to raise capital through the sale of their assets, and the purchaser to secure a long-term tenant on financial terms in-line with the market place. To reiterate: the rationale of a sale/leaseback is to raise money or to free up the owner's equity for other uses, while retaining use of the facility.

Although the type of property involved is usually commercial, sale/leaseback transactions can include almost any property type, ranging from large banks to industrial warehouse/distribution buildings to corporate offices to restaurants. In a typical scenario, a corporation will sell its real estate asset(s) to another party such as a real estate investment trust (REIT) or an institutional or private investor.

Structuring The Deal: Valuation – Two Tactics

Valuing a potential sale/leaseback is a decision with long-term consequences and must be approached with the utmost regard. In traditional real estate transactions, the vendor wants to obtain the highest possible price and the purchaser wants the opposite. Sale/leaseback transactions are slightly more complex. The purchase price earned by the vendor will be a direct result of the annual lease payments agreed to by both parties, which will ultimately reflect the capitalization rate of the deal. Any overachieving in price will be passed through to the vendor via the lease structure. Broadly speaking, there are two approaches in taking a sale/leaseback offering to market.

TACTIC 1 Set only the price expectations and get aggressive.

If the vendor sets a purchase price – often close to or at market value – to ensure all the benefits of a sale/leaseback are achieved while maintaining a lower long-term lease obligation, the vendor may compel the potential purchaser to submit the proposed rental structure early in the negotiation stage, and therefore set the cap rate.

TACTIC 2 Set the price and the lease structure prior to taking the asset to market.

Setting a purchase price and initiating a desired lease structure will assign a market cap rate for presenting the opportunity to the investment community. This will result in a more structured offering but may also potentially create less buyer enthusiasm. The price often becomes the only moving target, typically not in favour of the vendor.

Every potential deal is unique. While there are situations when the first approach should be used, other situations benefit from the second approach. Generally speaking however, with increasing demand from Investors coupled with an overall decrease in available product, we are currently advising clients to approach the investment community using the first tactic. While every deal is ultimately driven by return, the first method has proven effective in driving down cap rates via the competitive atmosphere created.

The Takeaway

For sellers, a sale/leaseback frees up capital. They gain a lump sum of cash quickly and can focus on their core business rather than having funds tied up in passive real estate and allows for substantial control over costs. The long-terms lease provides balance sheet stability and predictability. The benefits to the balance sheet are substantial as well. A sale/leaseback does not add debt to a balance sheet and in so doing, does not affect a company's borrowing capacity. In a sale/leaseback, any existing liabilities for mortgage debt service and management costs disappear when the real estate is sold, replaced only with a lease obligation. Since lease expenses are factored into a company's net income calculation, they do not appear as a liability.

For buyers, equity is invested in a passive, low management-intensive real estate asset where the rent provides constant income. Additionally, low interest rates allow investors to obtain their desired returns at significantly lower rental rates for the vendor/tenant. This adds a further inducement for the previous owner/current tenant to enter into a long-term lease.

For further information or request for Broker's valuation, please contact:

- Darren Abrahamson – Sr. Associate • 403-294-7156 • dabrahamson@barclaystreet.com
- Luke Stiles – Sr. Associate • 587-393-9343 • lstiles@barclaystreet.com

PREPARED BY BARCLAY STREET REAL ESTATE

Anthony B. Scott – Director of Research
403-294-7164 • ascott@barclaystreet.com

L O C A L E X P E R T I S E M A T T E R S

© 2024 Barclay Street Real Estate Limited. All Rights Reserved. E. & O.E.: This publication or any portion thereof may not be reproduced or used in any manner whatsoever without proper citation given to the publisher.