Debunking the Myths: Seven Reasons Companies Pursue Sale-Leaseback Transactions

A sale-leaseback is a financial transaction in which an owner/user of a commercial real estate property sells the property to an unrelated third party, and simultaneously leases the property back from the third party for a mutually agreed upon price, lease term and rent.

Most of the reported sale-leaseback transactions focus on large Fortune 500 corporate users selling essentially trophy-quality real estate. A recent example of this is the announced sale-leaseback of WarnerMedia’s new corporate headquarters in Manhattan, which is expected to raise in excess of $2 billion. However, this type of corporate transaction is not limited to Fortune 500 companies. Sale-leaseback transactions are an alternative capital-raising tool that is frequently utilized by smaller, sophisticated companies who are looking to accomplish similar goals as the largest multi-national corporations.

Historically, companies of all sizes have chosen to execute sale-leaseback transactions for a number of reasons, including but not limited to, utilizing the funds from a sale-leaseback to:

- Buy back corporate stock or make a special dividend
- Finance growth
- Make an acquisition(s)
- Pay down maturing, more expensive or restrictive debt
- Reallocate capital into more productive uses
- Provide capital for expansion or renovation of an existing property

Tying up company capital in a non-earning real estate asset is a potentially limiting use of a company’s finite resources. Buyers of this type of transaction, like ourselves, Mesirow Realty Sale-Leaseback, Inc. (“MRSI”), implicitly value the long-term real estate asset more than the seller company. When we are engaged by a seller corporation, regardless of its size, we look to understand both the company’s short-term and long-term objectives and seek to structure a transaction that meets all of the prospective seller’s needs.

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There are meaningful advantages to utilizing a sale-leaseback as a standalone capital raising transaction compared to conventional corporate or asset-based financing. Some of those advantages are as follows:

1 More efficient use of capital
   Often, even sophisticated companies incorrectly compare or equate the cost of debt financing to the sale-leaseback capitalization rate (the initial annual rent payment as a percentage of the purchase price). In almost every instance, a company’s weighted average cost of capital is greater than the average sale-leaseback capitalization rate. This provides the company with a myriad of opportunities (i.e., financing new opportunities, acquiring a business, stock buy-back, special dividend, etc.). But they all have the same theme: companies can earn more on using the sale-leaseback proceeds than they pay in rent, efficiently generating significant positive leverage.

2 Amount of proceeds
   Whereas a conventional asset-based financing may only lend up to 75 percent of the fair market value of the property, the sale price in a sale-leaseback transaction represents 100 percent of the fair market value, and in many circumstances can be greater than fair market value with the inclusion of tenant improvements and furniture, fixtures and equipment.

3 Term of financing
   Typically, asset-based financings are shorter-term in duration than sale-leaseback financing. Sale-leaseback financing can lock-in a rent rate for up to 20–25 years, and typically include multiple extension options at favorable rates.
4 Reduction of risk to seller
The seller no longer bears the risks associated with property ownership, specifically the risk of the property losing value in the future.

Selling the property shifts all interest rate and market rate risk to the buyer.

The seller no longer has refinancing risk or ancillary refinancing costs associated with the property and as opposed to asset-based financing, the sale-leaseback proceeds need not be repaid.

5 Better tax treatment for seller
Since the sales price can be "set" by the corporate owner, the tax consideration from the sale can be managed.

The Tax Cut and Jobs Act of 2017 made some important changes limiting the benefit of the deductibility of business interest expense for many companies borrowing with conventional financing. Rental expense under a sale-leaseback transaction continues to be fully deductible for tax purposes.

In most cases, a sale-leaseback would provide a tax benefit to a seller when compared to continuous ownership.

6 Avoid debt restrictions
Businesses that are restricted from raising additional debt due to covenants contained in existing loan or bond agreements may be able to avoid these limits by utilizing a sale-leaseback.

Lease agreements created for sale-leaseback transactions are often covenant-free as compared to conventional lending documents.

7 Deterrent to corporate takeovers
Any unencumbered real estate owned by a company serves as a target for corporate raiders.

A timely recapitalization through a sale-leaseback transaction may serve as a deterrent by limiting a corporate raider’s ability to partially fund their prospective takeover with value in the real estate owned by the takeover target.

Sale-Leaseback Myths
Sellers may have concerns when it comes to a sale-leaseback transaction, but perhaps they are rooted in one of these common myths:

Loss of Residual Property Value
The corporation selling an asset may believe that the value of the underlying property is going to be worth more in the future than it is today.

In Reality –
It is just as likely that the future value of the property will be less than the sale price today. Real property depreciates over time to a point of functional obsolescence. For instance, how many people have bought homes believing that they are a great investment, only to lose money after factoring in all improvements and sale costs (not to mention the opportunity costs)?

Even if the value of the property is going to be greater in the future, companies need to understand what the true opportunity costs are of tying up company capital. It is highly unlikely that the expected enterprise rate of return of the real property over time is greater than the weighted average cost of capital of the company. In almost every instance, a sale-leaseback cap rate is less, and at times significantly less, than the weighted average cost of capital of a seller company. That differential between a company's targeted return on capital and sale-leaseback cap rate creates a positive leverage scenario.

If values do increase, the company can still benefit. Fixed rate renewal options past the primary term of the lease would likely be at a rental rate below market, which means that the company could either continue to benefit from below-market rents or realize sublease income.

Loss of Flexibility
The company loses the flexibility associated with property ownership, such as changing or discontinuing the use of the property or modifying the building.

In Reality –
Many of these issues can be negotiated to the benefit of the seller/lessee during the initial lease structuring process. Within tolerable, defined standards, it is not uncommon for the seller to make changes to the use of the property or modify the building so long as the changes do not decrease the value of the implicit value of the property.

In certain transactions, it is not uncommon for a tenant to have substitution or relocation rights in order to provide flexibility in getting out of economically obsolete locations.

Additionally, the lease employed in a sale-leaseback transaction can provide extension options for the benefit of the lessee for as long as the lessee would like. This provides the ultimate optionality and flexibility for the benefit of the lessee.

High Rental Payments
If the rental market softens during the initial term of the lease, the lessee may be paying an above-market rental rate. Rental payments under a lease cannot be adjusted without the consent of the buyer/landlord.

In Reality –
This argument ignores the fact that the initial sale price was predicated on the stated rental rate in the lease. The seller/lessee is still benefiting from the capital raised from the sale. If the market rental rates soften, the diminution of property value has been avoided by the seller and is passed to the buyer. Additionally, if the property is still useful to the seller/lessee, MRSL (acting as a prototypical buyer/landlord) has historically been amenable to reducing the rental rate paid by seller/lessee in exchange for an increase in the term of the lease.

Companies that ultimately enter into a sale-leaseback transaction receive the benefits of an alternative cash raising instrument without affecting the business’ day-to-day operations. Sellers can efficiently raise cash, reduce risk, avoid onerous debt restrictions and deter corporate takeovers, all while receiving fair market value of their property. This type of transaction provides a valuable investment tool that enables sellers and buyers alike to participate in the success of a company.
Market Snapshot: Middle-Market Mergers & Acquisitions

2018 M&A Recap

- Following a frenetic first half of the year, the second half of 2018 saw subdued M&A activity as intensifying trade tensions, political instability and regulatory scrutiny caused hesitation in the marketplace.
- Despite the drop in activity in the second half of the year, 2018 has witnessed the third-highest value on record behind 2007 and 2015, with $3.57 trillion across 19,232 deals announced.
- In 2018, 36 megadeals breached the $10 billion mark, topping the previous year by six deals.

Q1 2019 Recap and 2019 Outlook

- M&A continues to be a core growth driver for strategics and strong backlogs will fuel continued consolidation.
- Record equity markets continue to drive deal flow as high stock prices encourage CEOs and board members to engage in deals.
- Q1 2019 M&A activity trailed Q1 2018. However, Q1 2019 ended above historical Q1 averages.
- Continued high levels of cash and a relatively favorable financing environment are expected to drive an active M&A market for 2019.

Significant Opportunities Exist to Capitalize on the Favorable Financing Environment

- Buyout dry powder levels have continued to increase and are currently at a record high of $724 billion.
- Overall, dry powder has continued to accumulate despite concerns about high asset pricing and competition for deals.
- Compared to 2018’s record year for number of private equity-backed buyout deals announced, Q1 2019 has not maintained this momentum with only 1,100 buyout deals announced globally, worth a combined $100 billion.
- Buyout funds continue to account for the majority of private equity dry powder.

Private Equity Dry Powder by Fund Type

Source: Preqin.
Credit Spreads

- Municipal bonds currently offer less value than taxable instruments, as reflected in the tax-exempt versus Treasury bond ratios. This is a result of strong positive cash flows into municipal bond funds.

- An important secondary effect of strong municipal fund inflows is the compression of credit spreads, most notably in the triple-B category, as illustrated by our chart.

- The municipal yield curve has become modestly flatter over the month of April, relative to Treasuries.

- Most importantly, there is limited value on offer in the current municipal market as a function of extremely strong investor demand.

- High tax states such as New York, California and Massachusetts are richly priced, but may be attractive to some municipal bond investors, given the elimination of other tax reduction strategies by the Tax Cuts and Job Act of 2017. Investors who reside in these states will need to consult their tax advisor in order to make a judgement between the limited value in municipal offerings and the lack of tax advantaged alternatives.
Market Snapshot: Corporate Debt and Infrastructure Finance

Corporate Debt Finance

- Yields on U.S. 10-year Treasuries fell nearly 30 basis points (“bps”) year-over-year from approximately 2.78 percent in April 2018 to 2.51 percent in April 2019, representing a 10 percent drop. 10-year Treasuries peaked in late 2018 at around 3.25 percent and have since dropped nearly 75 bps in the last six months. Corporate credit spreads are following suit, with spreads to Treasuries tightening across credit categories since the beginning of the year. Year-over-year corporate credit spreads across the credit spectrum are roughly on par with April 2018 levels, except for BBB-rated bonds, which have seen yields increase slightly year-over-year.

- Long-term yields are expected to remain low as multinational capital enters the U.S. Treasury market in search of yield, which continues to be relatively high when compared to key international bond markets like Japan and Germany. The Federal Reserve’s indications that it is likely to shelve any further interest rate increases in 2019 supports low rate expectations. In fact, some expect the Federal Reserve could begin cutting rates, partially in response to an inverted yield curve. In late March, the front end of the yield curve inverted for the first time since mid-2007, with the 10-year Treasury yield closing below some short-term government yields.

- Total corporate issuance in the first quarter was approximately $380 billion, which is in line with Q1 2018 levels, thereby continuing the trend of low new bond issuances despite falling long-term borrowing rates. Amid a rising interest rate environment, 2018 showed the lowest amount of corporate bond issuance by volume since 2011.¹

U.S. Infrastructure Market

- The U.S. public-private partnership (“P3”) market, which has been characterized largely by toll road projects, is expanding into new sectors. In 2018, student housing, courthouse and prison projects reached financial close. This trend has continued into 2019, with university-sponsored projects (particularly student housing), airport, high-speed rail and data center projects in the pipeline. The chart demonstrates how social infrastructure projects in North America have been diversifying into new subsectors over time.²

- Mesirow Financial has served as the debt placement agent on several infrastructure deals over the last 12 months. For instance, the developers of the $40 million Digital Crossroads Lake Michigan Data Center in Hammond, Indiana closed funding with Mesirow’s help in the first quarter of this year. Mesirow also acted as placement agent on a $76 million U.S. Department of Veterans Affairs clinic in Puerto Rico in March. Other successful deal executions included a children’s hospital, outpatient clinic, FBI building, correctional training facility and municipal retail building, all of which were developer-driven infrastructure financings.

- Looking forward, Maryland is evaluating a prospective I-495/I-270 Managed Lanes P3 valued at over $7 billion. The Illinois Department of Transportation continues to push for the passage of state legislation that would allow its I-55 Managed Lane P3 to move forward. Rail projects in Honolulu and Texas are also being considered. The University of Illinois at Chicago recently released a Request for Proposal in March for the development of a new Ambulatory Surgery Center P3 on its medical campus. Additionally, the University of Connecticut is looking to build an ice hockey arena and medical center, while Fresno State University might build a central heating and cooling plant modernization P3 project.

¹ SIFMA, US Corporate Bond Issuance, 4.29.19.
² Inframation Deals, 2019.
Featured Mesirow Financial Deals

**Construction-to-Permanent Loan for Puerto Rico Veterans Affairs Clinic**
Mesirow Financial successfully structured and arranged Credit Tenant Lease (“CTL”) construction-to-permanent financing in the amount of approximately $76,777,000 for the development of a soon-to-be-built U.S. Department of Veterans Affairs clinic in the Commonwealth of Puerto Rico. The U.S. Department of Veterans Affairs engaged in a public-private-partnership (P3) with local developer, AJM Management LLC (“AJM”), a division of Arbona Group, to deliver what will be a 134,000 square foot build-to-suit outpatient medical clinic. Upon completion, the facility will be located on a 22-acre parcel of land in Ponce, Puerto Rico. RiskOne Group served as an advisor to AJM on the transaction and assisted with the government application, selection and financing process. This transaction signifies the strength of Mesirow’s CTL Finance and Structured Debt Products business and the firm’s growing government infrastructure initiative.

**M&A Sell-side Advisor to Circle 8 Logistics, Inc.**
Mesirow Financial acted as the exclusive financial advisor to Circle 8 Logistics, Inc. (“Circle 8” or the “Company”) on its sale to GlobalTranz Enterprises, Inc. Headquartered in Lombard, IL, Circle 8 is a non-asset-based third-party logistics and transportation services company that provides multimodal transportation and logistics services throughout North America. The Company’s business model enables customers and carriers to customize their interactions while providing them with access to cutting-edge services and technology. Circle 8’s core services include FTL shipping, a nationwide drop trailer program and private fleet utilization. The Company covers a wide range of industries, including food and beverage, retail, paper and packaging, agribusiness and metals. The transaction represents another successful assignment within the distribution and supply chain sector completed by Mesirow Financial’s Investment Banking group.
Capital Markets

Established broker-dealer offering a suite of innovative financial products and services combined with extensive market expertise to serve the unique liquidity needs of your institution.

- Credit Tenant Lease Finance
- Fixed Income Sales and Trading
- Public Finance
- Sale-Leaseback Capital
- Structured Debt Products

Investment Banking

Boutique M&A advisor serving the middle-market and providing customized solutions to meet the unique needs of our clients.

About Mesirow Financial

Mesirow Financial is an independent, employee-owned firm founded in 1937. As specialists in investment, risk management and advisory services, we are committed to helping our institutional, corporate and individual clients achieve their objectives. Our professionals are inspired by an entrepreneurial desire to develop tailored solutions designed to deliver measurable results. To learn more, please visit mesirowfinancial.com.

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