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

A sale-leaseback is a financial transaction in which an owner/user of 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.

Many sale-leaseback transactions focus on large Fortune 500 corporate users selling essential trophy-quality real estate. An example of this is the recently 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; rather, sale-leaseback transactions are an alternative capital-raising tool that is frequently utilized by smaller, sophisticated companies who are looking to accomplish similar goals.

Historically, companies of all sizes have chosen to execute sale-leaseback transactions for several 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. ("MRSL"), 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, as well as meet all of the prospective seller's needs.

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 the advantages may include:

1 **More efficient use of capital**
Sophisticated companies can incorrectly compare or equate the cost of debt financing to the sale-leaseback capitalization ("sale-leaseback cap") rate (the initial annual rent payment as a percentage of the purchase price). In most instances, a company's weighted average cost of capital is greater than the average sale-leaseback cap 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 cases can be greater than fair market value with the inclusion of tenant improvements and furniture, fixtures and equipment ("FF&E").

3 **Term of financing**
Typically, asset-based financings have a shorter duration than sale-leaseback financings. Sale-leaseback financing can lock-in a rent rate for up to 25 years, and include multiple extension options at favorable rates.

4 **Reduction of risk to seller**
The seller no longer bears the risks associated with property ownership, such as losing property value in the future.

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

Opposed to asset-based financing, the seller no longer has refinancing risk or ancillary refinancing costs associated with the property and 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 important changes limiting the benefit of the deductibility of business interest expense for companies borrowing with conventional financing. Rental expense under a sale-leaseback transaction continues to be fully tax-deductible.

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

6. **Avoid debt restrictions**
   Businesses 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 re-capitalization 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 it is 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, many people have bought homes believing that they are a great investment, only to lose money after factoring in improvement, opportunity and sale costs.

Even if the value of the property is going to be greater in the future, it is highly unlikely that the expected enterprise rate of return of the real property over time is greater than the weighted average costs of capital of the company. In many instances, a sale-leaseback cap rate is much less than the weighted average cost of capital of a seller company. The difference between a company's targeted return on capital and sale-leaseback cap rate creates a positive leverage scenario.

If values 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 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 –
During the initial lease structuring process, and within tolerable, defined standards, it is not uncommon for the seller to make changes to the use of the property or modify the building as long as the changes do not decrease the implicit value of the property.

In certain transactions, it is not uncommon for a tenant to have substitution or relocation rights 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.

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 –
The initial sale price was predicated on the stated rental rate in the lease. The seller/lessee still benefits from the capital raised from 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 been amenable to reducing the rental rate paid by seller/lessee in exchange for an increase in the term of the lease.

Ultimately, companies that 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 to participate in the success of a company.

Featured Mesirow Financial Deals

Since 1991, MRSL has worked with its corporate clients to meet not only their capital needs, but long-term real estate needs as well. A brief description of just a few of our more recent sale-leaseback acquisitions along with our sellers' objectives are below:

Verizon Corporate Headquarters

MRSL successfully acquired the 133 acre, 1.4 million square foot office building in Basking Ridge, NJ directly from Verizon. The property's purchase price was in excess of $650 million and as part of the transaction, Verizon agreed to lease back the entire property for a 20-year term. The building houses approximately 3,900 full-time employees and houses a full range of businesses with Verizon Communications and serves as the headquarters for Verizon Wireless. The net proceeds from the subject transaction allowed the Company to extract "significant value" from the asset while continuing to utilize and benefit from the property. Two months after the sale, Verizon purchased all of the outstanding common stock of AOL for $3.80 billion.

Bob Evans Restaurants

Bob Evans Farms, Inc. ("Bob Evans"), a publicly traded company at the time, was under significant pressure from an activist investor to drastically change the direction of the company. The company was able to stave off a 2015 proxy fight with the activist investor by agreeing to complete a sale-leaseback for roughly 30% of the company's real estate which was approximately $200 million at the time. We were able to successfully lead a 143-property transaction leased back under an absolute triple-net 20-year lease. The net proceeds from the transaction were used to pay down debt under the Company's existing credit agreement and repurchase Company shares.

Verizon Regional Headquarters

A short time after acquiring Verizon's Corporate Headquarters in Basking Ridge, NJ, MRSL was yet again successful in acquiring another Verizon property. The 51.2 acre, 1.15 million square foot regional headquarters campus in Irving, TX was purchased for more than $344 million which Verizon agreed to leaseback the property to MRSL under a new 20-year lease. The net proceeds from the transaction provided Verizon with an immediate financial benefit and assisted the company in providing financial capacity to continue its $1 billion development of the surrounding campus.

Gateway Casinos

MRSL acquired three properties in Vancouver, British Columbia from Gateway Casinos & Entertainment Limited ("Gateway"), one of the largest and most diversified gaming and entertainment companies in Canada, for a purchase price of more than CAD$500 million. Upon the sale of the property to MRSL, Gateway entered into a 20-year lease. Gateway used the proceeds from the sale-leaseback to recapitalize its outstanding debt, invest in specific corporate developments, and make a special dividend to its shareholders.

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