Sale Leaseback Transactions Provide Benefits to Operating Companies and Real Estate Investors

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A sale-leaseback transaction is a type of transaction in which an operating company that owns its own real estate, either directly or through a related entity, sells the underlying real estate to a third party real estate investor and enters into a triple-net lease with the investor. This transaction often occurs in the context of the sale of an operating company to a third party, but it can take place independent of any sale of the operating company.

Typically, real estate acts as a store of value in which the only way to monetize that value is to either sell or mortgage the real estate, both of which have drawbacks, including temporarily ceasing operations to facilitate a move or being subject to principal and interest payments on a mortgage loan. The sale-leaseback can mitigate these drawbacks.

By entering into a sale-leaseback transaction, the operating company is able to unlock the value of its real estate and put that money into its operations. Moreover, this can be an attractive investment opportunity for real estate investors and purchasers of the operating company alike.

Benefits of Sale Lease-Back Transactions

In addition to monetizing the value of the real estate with minimal interruptions to the operating company's operations, the other benefits of a sale-leaseback transaction to the operating company include the following:

1. Retain Practical Control of Property. The operating company is in a position to maintain possession and practical control of the real estate when entering into a sale-leaseback transaction because the operating company is in a favorable position to negotiate favorable lease terms.
2. More Favorable Lease Terms. The operating company can refuse to sell the real estate unless it gets lease terms that it finds acceptable. Since the operating company can use the real estate whether it sells or not, this shifts much of the advantage in negotiating the lease to the operating company as the proposed tenant.

3. <u>Tax Benefits</u>. A real estate owner is permitted deductions for interest payments and depreciation, which is spread out over 39 years. Conversely, as a tenant, the operating company is able to deduct the entirety of the lease payment each year. This typically allows for a much greater deduction of actual costs of operating on the real estate than the depreciation method and other benefits as well.

As noted above, a sale-leaseback transaction also offers advantages to real estate investors. Those benefits include:

1. <u>Financially Stable Tenancy</u>. The real estate investor purchases the real estate with an established tenant in place that has a track record in that location. This allows the investor, and its tenant, to be more confident in the expected rate of return. A stable tenant may also make obtaining a loan or raising equity in connection with the purchase of the real estate easier to accomplish. The primary risk to owning commercial real estate is vacancy because a vacant building does not generate revenue to the owner. With a tenant in place that has succeeded for years prior to the real estate investor's acquisition, such risk is mitigated making the acquisition more attractive to lenders and equity investors.
2. <u>Reduced Contract Risk and Transaction Costs</u>. The real estate investor has a tenant immediately at the closing of the sale-leaseback transaction, and such tenant is subject to a lease negotiated between the two parties during the transaction. Thus, the real estate investor is able to contract out several risk areas, and place potential financial burdens (such as taxes, utilities, maintenance, and property insurance) upon the operating company on the date of purchase. Further, there are no costs associated in marketing the real estate and fewer rent and other concessions are necessary to entice new tenants to lease the real estate.

Finally, the sale-leaseback transaction can be particularly beneficial to companies and private equity firms purchasing the operating company because the value of the property may be tied into the purchase in an efficient manner. The sale-leaseback transaction is often used as a component of financing the acquisition of an operating company.

Sale-leaseback transactions work as a form of financing because the real estate can be leveraged in such manner that he purchaser of the operating company is able to obtain a portion of the funds necessary for the purchase of the operating company from the real estate investor. This again, may make the financing of the remaining acquisition easier by allowing the operating company purchaser to take on less debt to acquire the operating company or may make the transaction more appealing to equity investors. At the same time, the real estate investor is able to finance its acquisition of the real estate. This can allow for more leverage since there are two separate borrowers financing different aspects of the same overall transaction. With the ability to obtain more debt, the amount of cash, or equity, that the purchaser of the operating company and the real estate investor need to pay can be greatly reduced.

Drawbacks of Sale-Leaseback Transactions

While a sale-leaseback transaction offers many advantages to the operating company, purchaser of operating company, and the real estate investor, there are some drawbacks to this type of transaction. Such drawbacks include:

1. Loss of Control. An operating company, under a sale-leaseback transaction, no longer maintains an ownership interest in the real estate and thus, no longer maintains control of the real estate. This subjects the operating company to the terms of the lease, which often reflect the real estate investor's intention with the real estate, rather than what may be best for the operating company. For instance, the operating company may be prohibited from making beneficial capital improvements or alterations under the lease. Additionally, at the end of the lease, the operating company is forced to either negotiate a lease extension, repurchase the real estate, or move.
2. Loss of Flexibility. As the operating company, a long term lease can be problematic if the triple net lease terms are real estate investor friendly and restrict the operating company's usual operations within the real estate. Practically speaking, it may be difficult for the operating company to relish ownership and be subject to the restrictions of a lease, especially if the lease terms regarding use of the real estate, including default, termination and assignment or subletting terms are severely restricted by the real estate investor. Finally, if the operating company is not performing well the choices for relocation or dissolution are limited by the terms of the lease.

A sale-leaseback transaction results in drawbacks for the real estate investor as well:

1. Loss of Flexibility. The real estate investor enters into the purchase contingent upon the execution of a long term lease with the operating company. While real estate investor can negotiate favorable lease terms, if the operating company fails or is a poor tenant the real estate investor's investment goals might not be reached.
2. Less Favorable Lease Terms. When purchasing the real estate, the real estate investor may need to make concessions to the operating company that it may not typically make to other tenants. This is due to the fact that the proposed tenant owns and controls the real estate, and can prevent the real estate investor from purchasing the real estate unless such terms are included in the lease. This can make the lease more expensive to the real estate investor if the operating company demands significant improvements be made or financed by the real estate investor or if other similar concessions are demanded in the lease.
3. Real Estate Restrictions. The real estate investor is entering into a lease with the operating company, which formerly owned the real estate, and as such

may have made improvements that do not translate to other future tenants, which may increase the costs of owning the real estate.

Finally, a sale-leaseback transaction presents the following drawbacks for the purchaser of the operating company:

1. Increased Cost. The primary drawback to a sale-leaseback transaction as a component to a merger or acquisition of an operating company is the increased time and transaction costs in connection with such a transaction. In such instances, there are typically two additional parties that are not present in a standard merger and acquisition transaction, the real estate investor and its lender. With additional parties involved the transaction, the cost to coordinate these parties increases.
2. Transaction Risks. Since sale-leaseback transactions in mergers and acquisitions are typically a component of the financing of the overall acquisition of the operating company, both transactions need to be contingent upon one another. That may result in a situation in which either the purchaser of the operating company or the real estate investor can independently prevent the other party from closing on its respective transaction.