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CAPITAL PARTNERS

Valitas Insights: Unlocking your Company's Real Estate Value

There are creative ways to provide financing to your business beyond traditional bank loans and real estate mortgages. In owning real estate, many business owners are sitting on a potentially undervalued asset that could provide much-needed liquidity to their companies. With the significant increase in value of commercial and industrial real estate over the past decade, the value of these assets is often much higher in the hands of specialized real estate investors than in the hands of business owners. The ins and outs of real estate ownership are complex, and so to an outsider, the value and versatility of this unique asset class can often be overlooked. For instance, some business owners may be led to believe that it is imperative to maintain full ownership of the real estate asset their company occupies in order to ensure smooth business operations. While this is often true, there are certain situations wherein many businesses could leverage their real estate in a sale-leaseback transaction to unlock value.

As the name implies, a sale-leaseback transaction involves a business selling their property to a real estate investor while retaining the use of that property through a long-term lease usually lasting 10 to 20 years. The typical sale-leaseback transaction involves a company in need of growth capital and in possession of a real estate asset. To obtain said growth capital, this company can exchange an undervalued value real estate asset for cash and subsequently lease the same asset back, effectively providing the company with immediate liquidity while preserving normal business operations.

Advantages and Disadvantages of Sale-Leaseback Transactions

Sale-leaseback transactions have numerous advantages that can substantially outweigh the disadvantages, as summarised below:

Seller Advantages

- ***Optimal Use of Capital:*** The seller can likely generate higher returns by redeploying the capital to growing operations than it can through real estate ownership. Alternatively, transaction proceeds can be used to pay back debt or issue a dividend for shareholders
- ***Control of Property:*** Retain full use of integral sites for business operations with the ability to negotiate a 10-20 year lease allowing extensions or early terminations
- ***Purchaser Expertise:*** Leverage the benefit of the purchaser's real estate expertise including solving future property issues and obtaining favourable mortgage financing rates
- ***Tax Structuring:*** Ability to deduct total lease payments instead of only interest and depreciation
- ***Healthier Balance Sheet:*** The seller can exchange a below-market value fixed asset for cash or more productive assets
- ***Better Financing Alternative:*** Can finance up to 100% of the real estate versus 70-80% as in a mortgage. Sale-leasebacks have better implied financing rates than other options such as mezzanine financing

Seller Disadvantages

- ***Loss of Property Value:*** The seller will forgo any additional property appreciation. Some investors would be willing to include a repurchase option which could mitigate this risk
- ***Lease Agreement Risk:*** A well-structured legal agreement is necessary to avoid potential relocation risks or the loss of operating flexibility. This risk can be mitigated with proper legal representation
- ***Higher Payments:*** Lease payments may be higher relative to interest payments on a conventional mortgage
- ***Less Certainty:*** Carry less certainty of success and will take longer to execute in comparison to a conventional mortgage

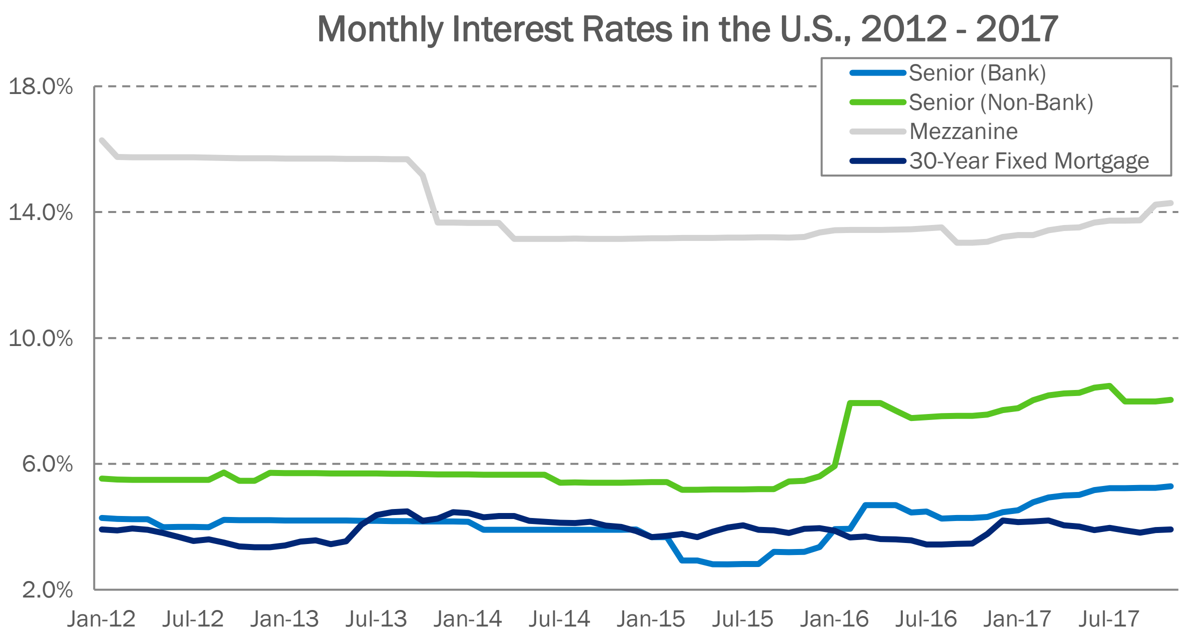
Sale Leaseback Market Factors

As with any financing alternative, a sale-leaseback transaction is influenced by the strength of the market. The current low-interest rate environment has caused traditional fixed income investors to look at alternative investments, such as sale-leaseback transactions, to achieve returns which has driven higher yields. In low interest rate environments, real estate values tend to increase faster than rents thereby creating an opportunity for businesses to lock in high property values and relatively attractive rental rates. Real estate investors, such as pension funds and insurance companies, are looking for long-term, low volatility and stable return assets such as real estate to match their liabilities, and are prepared to accept much lower rates of return on their capital than operating businesses. This creates an arbitrage that is beneficial for both the investor and business.

In addition, the growing popularity of real estate investment trusts (REITs), which generate passive income, has increased the demand for sale-leaseback transactions. These factors have combined to create a favorable market for sale leaseback transactions.

Furthermore, traditional bank financing has remained relatively expensive post-financial crisis for non-investment grade companies. As a result, lower middle market companies have found it difficult to access financing at reasonable terms. Typically, when a business has exhausted traditional financing options, it will explore mezzanine financing. Mezzanine funds usually require an 11 to 13% interest rate along with some form of equity warrants resulting in total returns of 18 to 22%. Many of these funds will also demand restrictive negative covenants that hamper strategic growth decisions.

The graph below illustrates monthly U.S interest rates for senior, mezzanine and mortgage financing. Sale leaseback transactions will usually have interest rates slightly above mortgage rates, which are roughly equivalent to senior bank financing rates. In contrast, both mezzanine financing and non-bank senior lenders will charge significantly higher interest rates than a real estate investor, highlighting the cost advantage of sale leaseback transactions in comparison. Interest rates don’t account for other aspects of mezzanine deals such as equity warrants.



Note: Senior and Mezzanine spreads were sourced from SPP Capital Partners for companies with less than US $7.5 million EBITDA. Mortgage data sourced from the Federal Reserve Economic Data

Ideal Sale Leaseback Situations

Moreover, it can be difficult for a business to determine if a sale-leaseback transaction is the right fit for its situation. A few common scenarios are a business seeking additional capital that has capped out its senior lending capacity, a business seeking to improve the health of its balance sheet by reducing debt in exchange for an undervalued asset and preparing for a sale to a private equity buyer.

The potential value of a sale-leaseback transaction is illustrated below by analyzing a situation where the business is preparing to sell to a private equity buyer. Most private equity funds are not interested in the real estate market and prefer to limit their exposure to markets where they aren't specialists. Due to this preference, real estate is seldom captured in the EBITDA multiple and assigned its full value in a private equity sale. In contrast, a real estate investor will do an appraisal of the property and building, an extensive market study, due diligence and a review of market lease rates for a sale-leaseback transaction. These steps inform a value to a business' real estate greater than that assigned by a private equity fund. The following example shows the total value to the seller in two scenarios:

Scenario 1: Sale Value	
Company Value	
EBITDA	$5,000,000
EBITDA Multiple	5.0x
Company Purchase Price	$25,000,000

Scenario 2: Value Post Sale-Leaseback	
Company Value	
EBITDA	$5,000,000
Rent	500,000
EBITDA (after rent)	$4,500,000
EBITDA Multiple	5.0x
Company Purchase Price	$22,500,000
Real Estate Value	
Rent	$500,000
Cap Rate on Rent	5%
Effective Multiple on Rent	20.0x
Real Estate Purchase Price	$10,000,000
Total Value	$32,500,000
Increase in Value Post Sale Leaseback	$7,500,000
Effective EBITDA Multiple	6.5x

In Scenario 2, the business undergoes a sale-leaseback transaction before the private equity sale which drives a lower company purchase price while simultaneously creating a dividend from the proceeds of the sale-leaseback transaction. The combination of the company's purchase price and dividend create an additional $7.5 million of value or 1.5x higher effective EBITDA multiple. The sale-leaseback transaction allows the business to maximize sale proceeds by selling its real estate and company separately to the most suitable buyers.

Sale-leaseback transactions can be complex to execute without prior knowledge of the real estate market. It is important to retain experienced advisors to run a clean auction process and negotiate with investors. A strong advisory team can have a drastic impact on the outcome of the transaction. Overall, sale-leaseback transactions are a worthwhile financing alternative for businesses to explore. When structured properly, sale-leasebacks can deliver a significant increase to shareholder value while retaining flexibility for the business, resulting in a win-win situation for both the business and the real estate investor.