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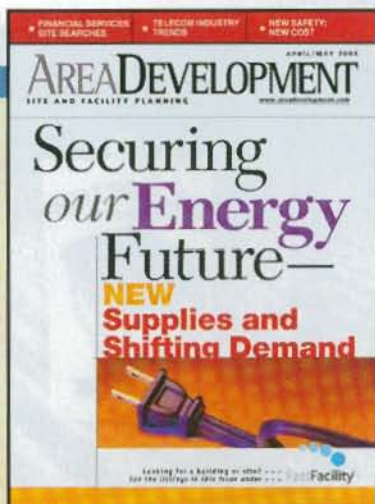


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Sale/Leasebacks: The Key to Funding Your Expansion

A sale/leaseback strategy can be an important tool in your company's growth.

By Chad Adams, Director of Project Development, Century Equities, Inc.

WHAT IS YOUR corporate real estate strategy? Do you have an answer? Too many companies never even ask the question, assuming that companies should always own their real estate in order to maintain complete control of their property. This is a fine (albeit archaic) way to think, except that it can limit rapid

expansion and can hamper the growth of your operations — and, ultimately, your bottom line. Suppose someone created a program that allowed companies to tap into the millions of dollars locked up in “bricks and mortar” in their facilities while maintaining complete control of their property, all while enjoying numerous tax and financial advantages? Look no further; the program is here, and it is thriving. Firms around the country are using sale/leasebacks to compete, grow, and prosper. Is yours?

The Basics

A sale/leaseback is a financial strategy that gives you an opportunity to raise cash and improve your balance sheet. A sale/leaseback takes place when a business sells real estate it already owns to a third party for fair market value (the “sale”), and then immediately enters into a long-term net lease and continues to occupy the property (the “leaseback”). If the transaction is structured as a triple net lease,

the tenant continues to be responsible for maintenance, utilities, and insurance, therefore retaining control of the property. In entering into a sale/leaseback agreement, you are paid fair market value for your property, which provides cash to expand operations, pay down existing debt, create liquidity, and/or substantially improve your balance sheet and financial ratios.

A sale/leaseback essentially provides 100 percent financing to the business owner. A company looking to build a new facility does not have to tie up cash in the form of the 25 percent or more “down payment” typically required by commercial banks. Further, the entire lease payment is tax deductible, as compared to a tradi-



tional mortgage where only the interest portion of the loan payment is deductible. If a company already owns its real estate, it can "unlock" the equity in the property and turn that equity into cash. The original purchase price of a building, its cost, net of accumulated depreciation, is shown on the balance sheet. A property that was purchased for \$3 million 10 years ago is shown at a net book value of \$2.25 mil-

purchase option less than fair market value?

- 3) Does the beginning of the lease term fall within the last 25 percent of the total estimated economic life of the real estate?
- 4) Is the lease term, excluding renewal options, greater than 75 percent of the estimated economic life of the real estate?
- 5) Is the present value of the minimum

variable rents to meet tenant cash flow needs, forwarding purchase commitments or development participation for new construction, using lease structures to maximize tax results, and establishing nonstandard lease periods to meet a tenant's need to use a building for a limited time.

In family-owned businesses, the real estate is often viewed as a crucial part of the business because it has been passed down from generation to generation. Families find it very difficult to consider selling their real estate to an "outsider." Century Equities, Inc., a real estate investment firm, has structured a method to have continued family ownership in the property to help achieve estate-planning goals, while allowing the company to realize the benefit of unlocking the capital in their real estate. The family should be able to make more money investing dollars into its core business than it would make on the appreciation of its real estate.

If a company already owns its real estate, a sale/leaseback can "unlock" the equity in the property and turn it into cash.

lion on the balance sheet, but may have a current market value of \$7 million. A sale/leaseback on that property would replace the \$2.25 million asset on the balance sheet with an asset of \$7 million in cash.

Operating vs. Capital Lease

When structuring a sale/leaseback transaction, most financial professionals prefer that the transaction be treated in the financial statements as an "operating lease" as opposed to a "capital lease." Seasoned real estate investment firms should be able to walk you through the maze of accounting requirements in order to ensure that the transaction qualifies and takes advantage of the favorable tax treatment associated with an operating lease. The distinction between these two types of leases is governed by Generally Accepted Accounting Principles (GAAP) as outlined in FASB statement No. 13, as amended.

There are five basic tests that a sale/leaseback transaction must pass in order to qualify as an operating lease. The following questions are answered by examining the terms of the lease agreement. In order for the lease to be treated as an operating lease, these questions must be answered in the negative.

- 1) Does the lease transfer ownership of the real estate from the landlord to the tenant?
- 2) Does the lease provide for a bargain

lease payments greater than or equal to 90 percent of the fair market value of the real estate?

When a sale/leaseback is structured as a capital lease, both the real estate asset and the associated debt are added to the balance sheet. Only the building portion (not land) of the real estate asset is depreciated, usually over 40 years, and deducted as an expense from the income statement. Also, only the interest portion of cash payments to the lender are treated as an expense on the income statement.

However, when the transaction is structured as an operating lease, the real estate asset and the associated debt are omitted from the balance sheet. Footnote disclosure of future minimum rental payments in the aggregate and for each of the five succeeding fiscal years is required. The full rental payments are treated as an expense throughout the term of the lease.

Custom Structure

Some firms that specialize in sale/leasebacks can not only handle typical deals, but can structure transactions in a customized manner to meet the particular needs of their clients. These firms are experienced in these transactions and work to maximize the client's benefits by understanding the company's goals and using creative solutions to meet them. Some ways to customize a transaction include: using

Case Study I: Rapid Industrial Expansion

A regional manufacturing company was quickly gaining traction in its market but needed to grow nationally to achieve its financial goals. Faced with the challenge of building multiple industrial facilities without a war chest of cash, this company turned to a real estate investment firm for help. The real estate investment firm acquired 12 locations in five states over four years through sale/leaseback transactions. At the end of each calendar year, this company would sell and leaseback the facilities they had developed that year. These dollars were then used the following year to develop the next round of facilities. For four years, this company used this financing method to grow its business, which enabled it to compete on a national level.

This important relationship with the real estate investment firm allowed the company to keep the real estate and its associated long-term debt off of its balance sheet by structuring the transactions as operating leases. By doing so, they were relegated to disclosure in the footnotes of the audited financial statements. The sale/leaseback transactions provided this regional business with

the tools to grow its business and established it as a prime acquisition candidate.

Case Study II: Build to Suit with a Spin

A publicly traded textile giant wanted a custom-built facility on the Mexican border but did not want to tie up capital in construction. After identifying the site where they wanted to locate, the company partnered with a real estate investment firm to make it happen with a "build-to-suit with a spin" strategy. The real estate investment firm funded construction with the security of having an executed long-term lease in place with the textile company.

The textile company did not have to invest any money or go through the arduous process of finding construction funding. It was able to dictate the specifications for its new facility and enjoy the comfort of being in control of the property by signing a long-term net lease. Although this transaction was not a pure sale/leaseback, the concept and the result was essentially the same, in that the textile company

realized the value of having a lease payment versus increased debt.

Case Study III: Creation of Much-Needed Capital

A privately owned logistics company currently leases the majority of the 70 or more facilities it operates; it only owns a handful of properties. In order to accommodate a customer's demand, the logistics company had to build a facility for this customer with short lead time. It did not have time to locate and partner with a real estate investment firm, because it had to get the facility up and operating. Understanding that they had millions of dollars tied up in the building after construction, and needing to "free up" that capital, the company completed a sale/leaseback with Century Equities, Inc. To minimize risk, the logistics company leased the facility back on a seven-year net lease to match the seven-year contract it had with this customer. If the customer renews the contract, the logistics company will also renew its lease. This provided much-needed capital that allowed the

company to better leverage its corporate strengths and minimize debt.

Self Evaluation

Do you have a strategy for your real estate? Are you making your real estate work for you? Does it make more sense to sell and leaseback some of your properties and deploy that capital into more productive areas of your core business? Can you improve your critical financial ratios and thereby put yourself in a stronger position with your banks?

More and more companies are using sale/leasebacks as a cost-effective and efficient alternative to traditional debt in funding the costs of expansion, acquisition, and construction of new facilities. Evaluate your core business goals and the direction of your company. Decide whether owning real estate is of primary importance or whether the dollars tied up in "bricks and mortar" could be better spent elsewhere. Prepare a summary of your current situation, including preliminary information on your company and your current real estate holdings, and contact an experienced real estate investment company for a review. Explain your goals, and these professionals might help custom-structure a program for you.

In tight economic times, companies need to be flexible and find ways to continue their financial growth and physical expansion. A sale/leaseback can be an important tool in your company's growth and help you to stay ahead of your competition.

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