



Real estate as a source of financing

Once all traditional sources of financing have been exhausted, many companies turn to subordinated debt to bridge their capital needs. In other cases, equity offerings may be considered, but this dilutes existing shareholders' equity. In either scenario, these types of financing can be expensive and can involve restrictive covenants (financial ratios to adhere to, veto rights on certain company transactions, board seat, etc.). One alternative often overlooked by companies possessing one or several real estate properties is the "Sale and Leaseback".

The value of commercial and industrial properties has substantially increased over the past several years; however this appreciation in value is usually not reflected or leveraged on the company's balance sheet. A sale and leaseback enables the company to immediately take advantage of this additional value while enjoying all the advantages of property ownership. This financing structure frees up the "equity" locked in a company's real estate.

The mechanics

The mechanics of a sale and leaseback are relatively simple and involve selling the property to a third party who will, immediately upon acquisition, lease it back to the vendor. The lease terms will often include an option to repurchase the property upon expiry of the lease at a pre-determined price. In most cases, the lease term will be for a minimum of 10 years with options to renew.

Contrary to traditional mortgage financing which provides the borrower with between 2/3 and 3/4 of a property's market value, a sale and leaseback provides almost 100% of the property's value. In many cases property financings may already be in place. Assuming the value of the property to be more than the balance of the debt, then recourse to a sale and leaseback will provide the vendor with the liquidity remaining between the actual market value and the balance of financing. Supplementary cash resulting from this type of transaction could indirectly be considered as a form of capital injection since the resulting gain will find its way onto the company's balance sheet at closing. The tax implications of this transaction, however, should be thoroughly analyzed since there could be tax liabilities upon recovery of depreciation as well as on any capital gains. Should the taxes be too high, then a sale and leaseback transaction would not be justified.

From an accounting point of view a sales and leaseback is treated as an off-balance sheet item which has an immediate positive impact on the company's financial statements (the company will no longer have any real estate asset or related debt on its books). If the company owns other tangible assets the sale and leaseback transaction will actually increase its borrowing abilities.

Advantages and disadvantages of a sale and leaseback transaction:

Advantages

- Frees up working capital for other purposes
- Less expensive than other financing sources
- Off-balance sheet financing resulting in reduction of debt on the balance sheet
- Indirect capital injection
- Tax deductible rent

For the buyer:

- Loss of depreciation
- Loss of appreciation in value
- Possible tax implications



Real estate as a source of financing (suite)

As previously mentioned, it is possible to structure a sale and leaseback in order to allow the tenant to repurchase the property upon expiry of the lease at a pre-determined price. Should the property appreciate over time, the tenant will have lost none of the advantages of property ownership. Conversely, should the property's value decrease, the tenant would be under no obligation to exercise his option to repurchase.

The changes that have occurred in the real estate industry over the past few years with the proliferation of Real Estate Investment Trusts have demonstrated the importance of properly managing real estate on a company's balance sheet. Moreover, given the existence of today's dynamic real estate industry, this might be an appropriate time to maximize the hidden value of your real estate with a sale and leaseback transaction.

Having completed several sale and leaseback transactions, it would be our pleasure to assist you if you are interested in looking into such a transaction to finance your capital needs.

A sale and leaseback transaction can generally be concluded within a relatively short period of time.