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Hunt Corp. Commercial Real Estate Q&A: Generating cash with a sale-leaseback - by David Hunt

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David Hunt

Q: Our business has owned and occupied a small office building for over 15 years and we are considering refinancing. Would there be an advantage to a sale-leaseback over refinancing?

A: Each method, refinancing and a sale-leaseback, have different advantages and disadvantages and neither is the “right” decision without a close examination of your company. Since I don’t know enough about your business to recommend one over the other, let me discuss the advantages of a sale-leaseback and how it works.

What is a sale-leaseback? You sell your building to an investor, who in turn, leases the building back to your operat-ing company. One advantage to a sale-leaseback is that you are accessing 100% of the property value, as opposed to refinancing which will allow only an agreed-upon loan to value ratio, e.g. 70% of the property value. Another advantage is a much stronger balance sheet if the operating company owns the real estate. The depreciated building will be replaced with a healthy influx of cash, as well as an improved debt-to-equity ratio, and a reduc-tion in interest and depreciation expenses.

Two more advantages are utilized by most of Fortune 500 America. A sale-leaseback frees up capital tied up in “bricks and mortar”, and allows it to be spent on the core business activity of the company. Leasing has become the pre-ferred method of occupying real estate as companies intensify their efforts to con-centrate on core business and outsource non-core functions. In addition, leasing provides a company with an easy and known exit strategy. In a fast-changing business environment, flexible real estate terms are often the key to managing real estate costs. For these reasons, most of Fortune 500 America have divested them-selves of their real estate holdings and prefer to lease. This may apply to your company as well.

The price you can achieve on the sale is a function of three major variables: The appraised value of the real estate, the return on the investment to the investor (“cap rate”) and your credit. Ultimately the property value to an investor is a func-tion of the cash stream that the property will generate. In other words, a higher sale price requires higher rent from your operating company. As a general rule, the appraised value of the property, without income, is the starting point for negotia-tions, with the location and condition of the property, as well as the credit-worthi-ness of the tenant, key variables in deter-mining the final price and leaseback rate.

We are seeing a very healthy demand today from the investment community for sale-leasebacks for all kinds of commercial real estate. Long Island commercial real estate values have reached new highs in many areas, so from a seller’s perspective, this is an ideal time to be considering a sale-leaseback. I recommend a decision-making process with a pre-sale and post-sale financial analysis. If the deal looks good on paper, I suggest that you examine the more subjective business decisions to see if the concept still works.

A sale-leaseback is a wonderful way to unlock equity in a “frozen” asset, and may be an ideal way for your company to raise capital to reduce debt, and to improve or expand operations.

Do you have a question regarding commercial real estate? Email your question to Commercial Real Estate Q & A, at email@huntcorp.com for possible inclusion in a future column.

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