

# TRANSMERCIAL COMMERCIAL REAL ESTATE INVESTMENTS

SALES – LOANS – PROPERTY MANAGEMENT – LEASING

WWW.TRANSMERCIAL.COM

NEWSLETTER – JULY 2012

## Sale & Leaseback – What Investors Should Know

By David V. Tran

### What Is a Sale & Leaseback?

Sale & leaseback is a commercial real estate transaction in which the owner sells his property and signs a long term lease with the buyer to become the tenant at close of escrow. The seller retains the building for his business and receives the proceeds of the sale. While restaurants are common sale & leaseback properties, almost any owner-occupied single-tenant properties, e.g. car repair shops, medical office building, etc. can become sale & lease back properties. When you see the phrase “new lease to be signed at close of escrow” in the listing or property’s brochure, it’s likely to be a sale & leaseback.

### Why Sale & Leaseback?

As an investor, one can speculate if the sale & leaseback is a sign that the business owner is in financial trouble and thus has to sell his/her most valuable asset. It’s a valid concern because a financially-strapped tenant may not be able to pay the rent down the road and you end up with a vacant property. However, there are many good reasons why the owner of the property wants to sell the property and lease back:

1. **Finance business expansion.** For example, Joe, a restaurant operator, has constructed 5 build-to-suit restaurants. All 5 restaurants are now open and have been running smoothly for the last 2-3 years. He now wants to build 3 more new restaurants. However, Joe will need capital for construction as the restaurant chain has its own unique building design such that he cannot lease just any building. He can apply for a construction loan which may take up to 12 months from application to funding, a very time consuming process which requires lots of document from architectural drawings, permits, detailed construction bids, worker compensation insurance proof, to business plans. In addition, if lucky, he can obtain 70% financing of the total construction costs (not including land acquisition cost) of the projects if he can overcome the loan application hurdle. Alternatively, he can sell some or all of the existing restaurants at market value and sign 20 years NNN leases to the buyers. That way, he can cash out 100% of his equities in the 5 restaurants. So, sale & leaseback is a very quick, smart and effective way for Joe to raise capital so he can focus on his business expansion. He may even be able to sell the property for more than his cost and thus make a profit!
2. **Pay down debts & improve balance sheet.** Real estate owned by a company is a depreciable asset which means it has lower & lower book value in the balance sheet. The IRS does not allow the company to adjust the balance sheet to higher market value. By selling its real estate at higher market value, it can cash out all the equities. The money can be used to pay down debt to make the balance sheet stronger, or to expand business or to be used for research & development. This may have positive impact on the stock value. On a lean year, some public companies may sell its real estate assets to meet projected performance expected by analysts. Sometimes major shareholders may demand a company to sell its real estate assets to make the company more profitable in a short term.
3. **Cut down income taxes.** Walmart sells and leases back many stores from a real estate investment trust owned by Walmart as a way to reduce its income taxes.



**David V. Tran, ext-201**  
Chief Investment Advisor  
CA DRE# 00969014



**Maria-Jose Martinez**  
Property Manager  
CA DRE# 01729060



**Eric Zhang**  
Investment Advisor  
CA DRE# 01459848

### What is important to investors?

Besides location and various other factors, there are other financial aspects you should look at to determine how risky your investment to this sale & leaseback property is. In general, the higher the risk, the higher the returns you should demand or expect from the seller.

1. **Tenant's financial statements:** The seller may provide you with 2 to 3 years of past income tax returns. Ideally you want a tenant with a profitable business after paying rent and other occupancy expenses, e.g. property taxes, insurance and maintenance expenses. You also want to see higher & higher profits year after year. This will minimize the risk that the tenant may not have money to pay the rent. However, this may not be possible for a business, e.g. restaurant especially in a new location to be instantly profitable in the first few years. In this case, the risk is higher.
2. **Tenant's business track records:** You want to find out how long the tenant has been in the business, and how many locations he currently has. Business experience really counts. As a general guideline, the few locations the operator has, the higher cap rate he has to offer to you.
3. **Lease guaranty:** The tenant often provides some kind of lease guarantee that if the tenant defaults the lease, then you can go after the guarantor's assets to recover lost rental income. The long term lease is only good if the entity that guarantees rental payments has strong assets and/or good credit rating. A seller with multiple locations may structure his company such that each location is owned by a single entity, e.g. Limited Liability Company (LLC) to limit his liabilities exposure. All the single entity LLC's are then owned by the parent company. In this case, the guaranty from the parent company is better than the guarantee of the single entity LLC. Sometimes you can also get the personal guaranty from the principals from the company. If the guarantor is a public company, then its S&P credit rating is a good indication that you will likely receive the rent checks in the future.
4. **Ability to get favorable financing.** It does not make sense to get a good deal on a property and have to pay an excessive amount for financing. Of course, if you buy a property in a tiny city at the middle of nowhere, acquiring a loan would be challenging and would include a very high interest rate. If you buy a property with a non-franchised tenant with weak or unavailable financial statements, then you will have a tough time borrowing money. Please refer to *"What Investors Should Know about Commercial Loans"* written by the same author.
5. **Lease terms:** In a sale & lease back transaction, the lease terms are negotiable and could be different from what's stated in the marketing brochure. You normally want to get:
  - A reasonably long-term lease, e.g. 10-20 years so you don't have to worry about finding a new tenant for a while. In addition, longer lease makes financing of the purchase

easier.

- Triple net lease in which the tenant pays for all operating expenses. This will minimize your investment risks as you don't have much control over the property taxes, insurance and especially maintenance expenses. Ideally, you don't want any landlord responsibilities or have to take care of anything, e.g. roof, HVACs, or parking lot replacement.
- Some kind of periodic rent increase, preferably 2% annually or 10% every 5 years to keep up with inflation. Besides, the rent increase also ensures the property will go up in value when you sell it.
- Rent at or below market. This motivates the tenant to stay there for a long time since he will pay higher rents somewhere else. Should the tenant vacate the property, it's always easier to find a new tenant for the property when the rent is below market.
- Some level of approval over possible construction or remodel of the property in the future. Franchised restaurants are required to remodel the restaurant to a new format to reflect changing consumers' taste. And so the lease should be flexible to allow this to a certain level. For example, the lease should state that any structural changes will require landlord's approval.
- Tenant's financial statements, if needed, especially for the location you buy. When you need to refinance or sell the property later on, a tenant's financial information, e.g. sales revenue, profit and loss statement will be very crucial for lenders to provide favorable financing and potential buyers for making the strongest offers.

Preferably, you don't want to have these in the lease:

- Right of first refusal (ROFR): This gives the tenant an option to buy the property each time you receive the offer by matching the same price. The ROFR makes the property less desirable when you need to sell it later on. The buyer, after making an offer, has to wait for the tenant to decide whether it wants to exercise the option. This discourages some buyers to make an offer as they are hesitant to spend time to negotiate and find out later they cannot buy it because the tenant exercises the option. In addition, if you have an all-cash offer from a buyer, you still give the tenant an option to buy it and time to apply for the loan which may be turned down later.
- Option to purchase: This gives the tenant to purchase the property whether you want to sell it or not. The purchase price is stated in lease, either at a certain fixed value or at market value as determined by an appraisal. There is a risk that this value could be lower than the price you paid for it. And so, this option makes the property less desir-

able and consequently has a negative impact on the price when you want to sell the property.

- **Early termination rights or kick out clause:** This allows the tenant to terminate the lease when the property is partially damaged, e.g. 20% by fires other perils or if the sales revenue does not reach a certain figure. As a landlord, you want a property that will continuously generate income. And so, you don't like a lease with early termination clause. You want the tenant to make every effort to repair, rebuild the property and re-open the business quickly. If you cannot remove this right from the lease, then try to keep the damage percentage threshold as high as possible, e.g. 50%.
- **Landlord's responsibilities to environment matters.** This is mainly because you are just a passive investor and have nothing to do with these issues.

ies, schools, governmental office buildings cannot be structured as sale & leaseback transactions. This can be a way for cities, counties, states and even federal government to raise money for critical projects or to address the budget deficits without raising taxes. After all, government is a major tenant everywhere in the US.

### Do's & Don'ts

1. **Hire a CPA to review financial documents.** Some of the financial information may be very complex. The tenant may have a very good accountant to prepare its tax returns to show to the IRS that its taxable income is low so it does not have to pay lots of taxes. The revenue of a franchised tenant is probably more accurate due to contractual obligation to the franchise for royalty collection purposes. For non-franchised tenant, the reported income could be lower than actual income as the tenant might not report cash income. The CPA should be able to give you an opinion about the tenant's financial strength.
2. **Hire a commercial real estate attorney to work on the lease.** You want to make sure the lease addresses all the potential legal issues that might arise in the next 10-20 years. The lease may be revised several times between seller and buyer during the negotiation process. And so, you may want to work with an attorney who has a flat fee, e.g. \$2500 instead of one that charges per hour.
3. **Have a broker with experience in sale & leaseback representing you.** Sale and lease back is a very complex transaction that requires an experienced broker, together with the CPA and attorney to guide you through.
4. **Look at tenant/seller's background.** Since you will have a fairly long term business relationship with someone you don't know much about, it's probably prudent to do a back ground check on the owner for business and even criminal records to see if there are any red flags. A simple Google search should be the minimal.

### Out-of-the-box Thinking

Currently most, if not all, of the sale & leaseback transactions involve with properties owned by individuals, private and public companies. However, there are no good reasons why public properties, e.g. librar-