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Unlocking Value Through a Sale Leaseback

The sum of the parts may be greater than the value of the whole.

by Brian Bergsagel

All cash flows are not created equal. This adage is particularly relevant when considering the combined value of business cash flows and real estate cash flows. When business owners sell both an operating business and the real estate that supports that business, they may be leaving money on the table if the situation is not handled appropriately.

Over the past three decades we have encountered countless private businesses that own real property or properties within the same entity as the operating business itself or where business owners own both the real estate and the operating company. The prevalence of this strategy stems from the fact that owning their real estate provides business owners:

- An opportunity to re-invest in the business through a long-term asset;
- A sense of security, as there is no risk of eviction or lease renegotiations;
- Additional annual income via lease rentals;
- Ability to amplify equity returns via higher leverage associated with real property; and
- Upside potential through property value appreciation.

The logic is not dissimilar from a consumer's rent versus buy analysis for their homes: If they are going to pay a monthly amount to a landlord, they would prefer to make those payments to a lender so that at least some portion of their payments accrues to themselves via increased equity.

Despite these reasons, institutional investors and large corporate buyers typically prefer not to own operating properties, given the differing risk profiles between the operating business and real estate and the resulting impact of those risk profiles on relative valuation and returns. There are, of course, institutional investors who focus on real estate investments, but these investors typically have different investment mandates, hold periods, and return targets than do acquirers of operating businesses.

In order to maximize the value of all related assets, acquirers of a business will commonly pursue a sale leaseback transaction post-closing. Prudent private business owners should be aware of this strategy and may benefit from deploying it themselves.

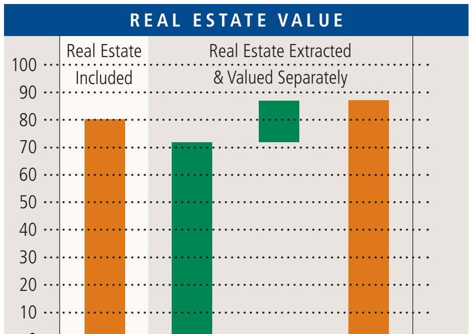
DEFINING A SALE LEASEBACK

A sale leaseback transaction involves the simultaneous sale of a property and establishment of a lease arrangement with the new owner. This process requires agreeing upon the fair market value of the property as well as the future lease rate and terms. Sale leasebacks are typically structured with long-term leases – as long as twenty years – with a few additional five-year lessee renewal options. This longer term gives stability to the tenant and eases the investor's concern that they may ever have to find a new tenant.

ARBITRAGE OPPORTUNITY

Owners of both an operating company and the related real estate are indifferent to the source of the cash flows from the two assets, and may not appreciate that these cash flows are valued differently. The differing risk profiles, or costs of capital, between an operating business and the related real estate typically create an opportunity for value arbitrage. This arbitrage opportunity exists when a capitalization (cap) rate for the property is lower than the weighted average cost of capital (WACC) of the operating business.

REAL ESTATE VALUE



Value A	OpCo	RE	Total Value B
EBITDA: $10 million	**EBITDA:** $9 million	**EBITDA:** $1million	**EBITDA:** $10million
Multiple: 8x	**Multiple:** 8x	**Cap Rate:** 8x	**EV:** $86.3mm
EV: $80mm	**EV:** $72mm	**EV:** $14.3mm	**Implied Multiple:** 8.6x

Cap rates can be thought of as the inverse of an EBITDA multiple: a 7% cap rate on a property implies a multiple of one divided by seven percent, or 14.3x, on the annual net operating income (NOI). In this example, so long as the operating business is valued at less than 14.3x EBITDA, there is value to be gained or lost depending on the lease rate because a dollar of lease income is valued more highly than a dollar of EBITDA at the company level.

Although "removing" the go-forward rental amount from the EBITDA of the operating business results in a lower enterprise value (EV) for the business, the value is more than made up for through the sale of the real property.

TACTICAL CONSIDERATIONS

While sale leaseback transactions are not structurally complex, the timing and sequence of events require careful coordination. Sale leaseback transactions involve three principal parties: the seller of the operating company and real estate, the buyer of the operating company, and the buyer of the real estate. At the appropriate time, each party needs to be made aware of the other parties and their financial capacity in order to fully understand the pro forma capitalization structure and credit profile of the tenant.

There is always a risk that the sale of the operating business does not go through, in which case a business owner may wish to retain ownership of the real estate. To mitigate this risk, sellers can solicit sale leaseback proposals on the property that would only be executed in the event of a sale of the operating business. At that point, the new property owner will need to know who the owner of the business will be and may need to provide landlord consent for the transaction, but the bulk of the due diligence and underwriting will already have been done. This all requires synchronization of timing between the business sale process and the sale leaseback process, but can be the optimal way to preserve optionality and avoid unwanted outcomes.

Given the extensive coordination required, this effort may benefit from a sale leaseback expert. We have worked with a number of spe-

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cialists in this field over the years. A sale leaseback specialist can work alongside the other transaction advisors to tee-up the sale leaseback transaction for an eventual closing simultaneous with the closing of the business sale.

Sale leasebacks can also be a useful strategy to consider outside of a business sale. The proceeds from a sale leaseback can be used to de-leverage a business by paying down debt or can be re-invested in higher-return segments of the business.

CONCLUSION

When considering a sale, business owners should understand the different components of value that they are selling, and the strategies that will allow them to maximize the value of each of those components. At the end of the day, acquirers of an operating business with real estate are likely to enter into a sale leaseback transaction almost immediately after closing to obtain the value arbitrage for themselves. Fully evaluating the opportunity for a sale leaseback prior to completing a sale of a business can allow this value to instead accrue to a seller. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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