

WHY SALE-AND-LEASEBACK WORKS FOR BUSINESSES LARGE AND SMALL

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Despite recent legislation, releasing capital through such transactions remains valid for many, says Arvi Luoma, managing director, head of European investments, W P Carey.

Sale-and-leaseback is a popular choice for yield-focused investors and although recent legislation in the form of IFRS 16 has convinced some corporate property owners that the strategy may lose some of its lustre, market evidence suggests otherwise.

In a sale-and-leaseback transaction an investor buys a company's operationally critical real estate and leases that property back to them. It is an attractive alternative to other forms of financing for companies looking to avoid debt or selling shares in their business to raise capital.

Historically, private equity investors have enjoyed the arbitrage opportunity of sale-and-leaseback allowing them to generate higher immediate equity returns without tripping financing covenants.

Two years ago the IFRS (International Financial Reporting Standards) Foundation introduced an accounting rule called IFRS 16 to ensure companies' operational leverages are clearly visible on their balance sheets where, from 1 January 2019, they will be obliged to declare all leases.

Although one of the key benefits for corporate sellers will end when IFRS 16 becomes effective, it remains an underutilised and attractive form of financing. Goldman Sachs, for example, recently announced it is seeking £1.3bn (€1.48 bn) for the sale-and-leaseback of its London headquarters (pictured above). KPMG, Lloyds Banking Group, and DHL have also undertaken sale-and-leasebacks recently.

While sale-and-leaseback is an established form of financing in the US it is yet to mature in Europe, even though 70% of companies own their own property, compared to approximately 30% in the US.

One effect of IFRS 16 will be the increase in balance sheets reflecting all leases, while EBITDA will rise as the operating cost of leases is no longer present. It is expected that lenders will use IFRS 16 to enforce loan covenants, although lenders have always been aware of operational leverage.

More likely is that IFRS 16 will cause shorter lease terms as tenants seek to reduce balance sheet fluctuations. Renewal, buy-back, assignment and subletting rights will also become more relevant as they no longer have a potential impact on accounting treatment.

Despite IFRS 16, there are many reasons why sale-and-leaseback remains valid to companies of all sizes.

Sale-and-leasebacks can enable SMEs to release capital tied up in otherwise illiquid real estate while retaining full operational control of their property. Family-owned businesses are increasingly using sale-and-leaseback as a source of capital that does not compromise shareholdings in the company. Some deals even give the company the right to buy back the property at the end of the lease.

Sale-and-leasebacks appeal to larger companies with more financing options because they allow stock prices to increase when the company realises value on its balance sheet. Using capital to delever or invest in growth initiatives with higher equity returns than if it remained tied to real estate assets can signal the future potential of a company to shareholders.

Sale-and-leasebacks also avoid risks associated with debt financing, particularly refinancing. And at the end of the lease, renewal options give the tenant the choice to remain in a facility or to move to somewhere more appropriate. Sale-and-leaseback also relieves corporates of the risk of property devaluation.

Key to the success of a sale-and-leaseback arrangement is finding an investor able to provide an agreement that meets the vendor's needs. High rents can over-leverage the tenant in poorly structured deals, for example.

The investor should be an experienced landlord that has got to know the company's business and culture and is willing to provide the ability to expand and upgrade premises through further investment and who is a stable long-term partner who will not immediately trade the asset.

Industrial companies are the traditional champions of sale-and-leaseback deals because they typically have large portfolios of operationally critical real estate in the form of factories and warehouses. However, a sale-and-leaseback deal can be valuable for any company looking to release the capital without compromising a shareholding.

Eastern Europe in particular remains an attractive region with substantial growth potential for sale-and-leaseback investors. The market drivers of highly-skilled, low-cost labour forces continue to enhance the business prospects of the region, especially for companies in the manufacturing, distribution and back-office sectors.

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