Using Real Estate for Cash

The favorable economic climate for most SME in Switzerland and the need for capital to finance organic growth or growth by acquisition has brought the sale and leaseback of commercial property into the picture as a practical and increasingly popular corporate finance tool.

Recent dynamics in the financial and property markets have reinforced sale and leaseback transactions as attractive vehicles for users, investors and lenders to achieve their respective real estate and investment objectives. In particular, the demand for debt and equity investment in real estate and the willingness of suppliers of capital to be more flexible in the structures they will offer have never been higher. The markets for sale and leaseback transactions are proliferating and creating a fluid market adaptable to a diversity of conditions that provide an important investment and financing instrument.

Seller and purchaser perspectives

Sellers/lessees are, typically, in control of the assets initially and can structure the transaction in a manner to satisfy their occupancy needs while not saddling themselves in later years with unwanted locations as their business evolves. These transactions can be strategically timed to get the most out of the following potential benefits:

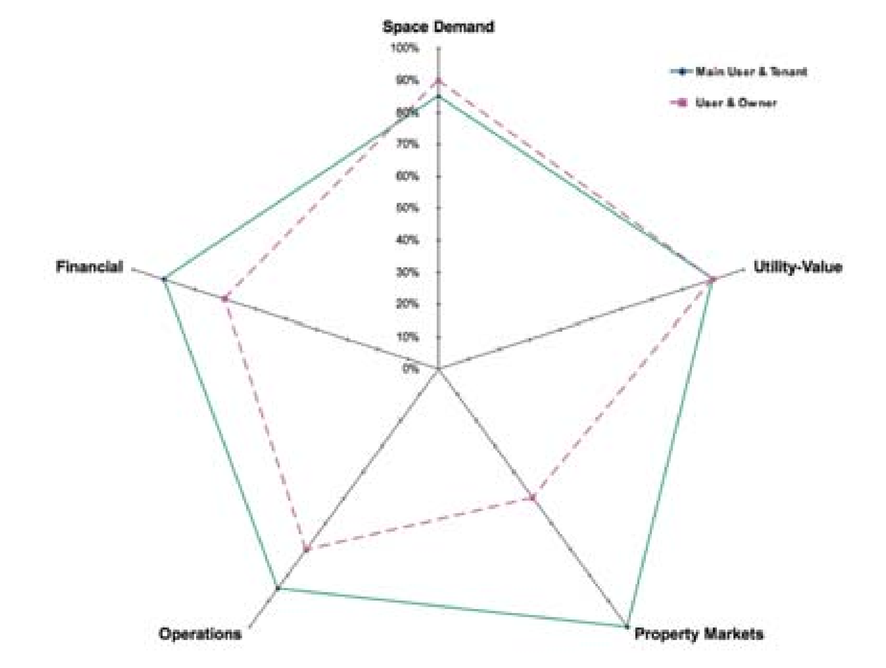
- Freed up capital to fund core business developments, mergers & acquisitions, and capex
- Increased company image by showing contemporary financial engineering to the shareholders and public markets
- Continued control over the use of the facility while optimizing the management of vacant space
- One-off profit and loss account benefit reflecting profit realized over book value
- Tax benefits by offsetting lease costs as an operating expense
- Transfer of (non-controllable) real estate value risk to a third party on a transparent basis.

For public companies, a sale and leaseback transaction removes non-cash charges such as depreciation from their balance sheets and thereby increases reported earnings per share. The other side of the depreciation coin benefits the private purchaser/lessor, serving to increase its after-tax return and creating an additional incentive for these transactions between public companies and private investors. This helps to offset the phantom income created by the non-deductibility of mortgage principal amortization, which affects all property owners alike.

From the purchaser/lessor perspective, sale and leasebacks provide a secure income stream, often from a single tenant with quality rating. In the current environment with ever increasing demand for real estate investments and drying-up of potential investment product supply, buying corporate real estate has become an attractive alternative to core property investments offering a host of potential benefits:

- Developing and implementing favorable lease conditions for both parties together with the main user from the beginning
- Closing long-term leases with an investment grade rated or good quality credit tenant is attractive to mortgage lenders and achieves higher loan-to-value ratios
- Property and asset management can be focused on the main user providing higher service quality and fostering good relationship with the lessee partner
- Fully occupied properties offer an initial yield equal to the potential yield, hence facilitating financial planning
- Opportunity to develop additional space together with the corporate user, should his business grow.

Corporate sale and leaseback evaluation



The potential for income loss due to vacancy is often minimized or deferred until the expiration of the lease. The secure income stream of a usually "net" lease provides the real estate investor with an ability to compute his projected internal rate of return (IRR) with confidence. At the expiration of the term of the lease, it is the investor exposed to market risk relative to the marketability and value of the property. Timing and circumstances under which this will occur are relatively predictable, especially when compared with multi-tenanted operating properties.

Corporate decision-making

As with all important strategic decisions, the outsourcing of property ownership by selling and renting back has to be carefully evaluated by management. It all starts by reporting the most important parameters to the corporate stakeholders. Ideally, the pros and cons of the following five "value drivers" should be evaluated and eventually be visualized in order to get board level buy-in and agreement: space demand, utility value, real estate markets, operations and financial.

The diagram on the previous page shows the results of a sample corporate sale and leaseback evaluation. In this particular case, the advantage of becoming a main user and tenant over remaining user and owner was 100:82 in favor of outsourcing property ownership. Besides the obvious advantages of avoiding (non-core business) property markets exposure, substantial advantages were also on the financial (growth, restructuring, exit, capex) and operations side (facility and building management, property value conservation).

Sale and leaseback transaction needs

The economics of the sale and leaseback transaction and purchase of a net leased asset may contain fewer variables than the purchase/sale of a multi-tenanted operating property. Nevertheless, the seller and future lessee should take the following parameters into account when entering into a sale and leaseback venture:

- "Difficult" starting point and complex contractual situations should not prevent the implementation of the transaction
- The corporate real estate to be outsourced should also be (a) usable for third-party occupiers in terms of property location and site infrastructure, and (b) re-positionable by means of capex for modernizing the buildings
- Core facilities, part-core facilities, and non-core facilities/properties should be viewed as parts of an integrated disinvestment solution
- The company's rating is important to the purchaser and future lessor to structure its debt financing
- Performance and track record of the purchaser and future lessor is crucial for preparing a successful deal structure and implementing a smooth transaction.

Last but not least, only constructive and transparent deal structures lead to a promising long-term relationship between the seller and the purchaser. The reliance placed on the above factors requires that the seller investigate them carefully and address them together with the potential purchaser in an informed and intelligent fashion. The details of the lease and loan documents can have a significant impact on the pricing and yield to be achieved. Each party must carefully examine the particulars of their respective obligations and appropriately match them with their objectives and priorities. ▪

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