OAK INVESTMENT MANAGEMENT GROUP

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Real Estate Sale and Leasebacks

A 'sale and leaseback' is when the real estate of a company is sold to another entity and rented back on a secure basis. This is an attractive way to raise money for a company that uses real estate. From an economic point of view, if security of use can be assured for the foreseeable future then it is not needed to tie up working capital in the physical ownership of a real estate asset. Doing so would divert resources from the central competency of a company to one which it might or might not be good at but which is not its central focus.

It is attractive to the capital markets to own in a secure and passive way a piece of real estate in which there is a secure tenant. Additional to this, there is often a value to owning the real estate of a company that has a great growth story. The leases of successful and thriving companies can be more readily traded in the market and at a noticeably better yield than less successful peers.

Real estate meets the capital markets in a seemingly perfect way: Return metrics used by analysts mean that the return on equity increases, so that if the company in question is publically traded then 'buy' recommendations increase and the market rewards the company accordingly. From an accounting point of view the real estate is moved off the balance sheet onto the profit and loss account – focusing the mind of management on profiting over properly accounted costs for the period in question. From a risk point of view a sale and lease back almost always means a less concentrated amount of risk on a degradable, capital intensive and tax heavy real estate.

Yet sale and leaseback is still borrowing. And borrowing of any description magnifies for better and for worse underlying economic performance of a business. For every well-run business with sensible and well calibrated uses of the cash raised from a sale and leaseback there are plenty that use the one off proceeds for vanity or net present value negative projects. Worse still, if the dynamics of the profit and loss account are going the wrong way then managers might create a windfall opportunity from a sale a lease back to disguise the deteriorating state of their operational performance. Even with the best intentions in the world revenues can still fluctuate and bring into question assumptions made on the affordability and suitability of rent arrangements.

Therefore, entities funding a sale and lease back need to do so with their eyes wide open to the embedded risk that they are taking on. Of course, the value of the underlying real estate might be such that they wish to get vacant possession i.e. that they wish for the current tenant to default in order to use the real estate for something even more valuable. But a sustainable model is one where all benefit from the operational performance of a business and that is one where there needs to be a fair return relative to the risk being taken on. There are companies that will always regard the notion of sale and leaseback as selling the family silver, but sale and leaseback has an important role to play in balancing the nature, tenure and suitability of the overall liabilities of a company.

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