

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 & lease back properties, almost any owner-occupied properties, e.g. Jiffy Lube, car repair shops, banks, dental office, 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 Sell & Leaseback.?

As an investor, you might wonder if the sale & leaseback is a sign that the owner is in financial trouble and thus he has to sell his 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 in the next 12 months. However, Joe will need capital for construction as the restaurant chain has its own unique building design such that he cannot lease just any buildings. He can apply for construction loans at 9% interest (or Prime plus one) in which if lucky he can obtain 70% financing of the total costs of the projects. 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 smart way for Joe to raise capital. In the best case he may be even able to sell the property for more than what he spends for construction costs and thus makes 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. 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 state income taxes:** Walmart sells to and leases back many stores from a real estate investment trust owned by Walmart (it’s not a misprint!) as a way to reduce its income taxes.

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. As a rule of thumb, 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 previous 2 or 3 years of income tax returns. Ideally you want a tenant with a profitable business after paying rent and other rental expenses. You also want to see



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higher & higher revenue 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. **Lease terms:** In a sale & lease back transaction, the lease terms are negotiable. You normally want to get

- A reasonably long term lease, e.g. 10-25 years so you don't have to worry about finding a new tenant for a while.
- Triple net lease in which the tenant pays for all operating expenses. This will minimize your investment risks as you don't have control over the property taxes, insurance and maintenance expenses.
- Some kind of periodic rent increase, preferably 2-4% annually 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. Should the tenant vacate the property, it's always easier to find a new tenant for the property when the rent is below market.

3. **Tenant's business track records:** you want to find out how long the tenant has been in the business, and how many locations he has so far. So business experience really counts.

4. **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 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 exposure to lawsuits. 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. If the guarantor is a public company then its S&P credit rating is a good indication how likely you will receive the rent checks in the future.

5. **Ability to get favorable financing:** it does not make sense to get a good deal on a property and have to pay an arm and a leg for financing. Of course if you buy a property in Detroit or in a tiny city at the middle of nowhere, you will have problem finding a bank to loan you money and/or have to pay very high interest rate. If you buy a property with a non-franchised tenant with weak or unavailable financial statements then you will have tough time borrowing money. Please refer to "*What Investors Should Know about Commercial Loans*" written by the same author.

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 may be lower than actual income as the tenant may not report cash income. Your CPA should be able to give you an opinion about the tenant's financial strength.

2. **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. You can find out a lot more about a person for less than \$100 on the Internet.

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. libraries, schools, governmental office buildings cannot be structured as sale & leaseback transactions. This can be a way for cities, counties and states to get money for critical projects without raising taxes.

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