New Lease on Life (and the Balance Sheet)

Why Sale-leaseback Arrangements Make Sense for Many Business Owners

By GEORGE O'BRIEN

Jeff Fialky weighs in below

It's not exactly a recent phenomenon, but a transaction known as the sale-leaseback is becoming an increasingly popular option for businesses looking to raise capital. As the name suggests, the transaction involves sale of a commercial asset and then leasing it back. There are benefits for both sides of a deal, but also myriad factors that must be considered before one decides to go down this route.

Attorney Jeff Fialky says the sale-leaseback is an often-prudent course, but there is a laundry list of matters to consider before moving forward.

At first glance, it looked like a fire sale spawning questions about the future of the company and its presence in Western Mass.

Upon further examination, however, it was part of well-thought-out, balance-sheet-altering business strategy designed to free up capital for the new owners of Friendly Ice Cream Corp., enabling them to focus on core operations and essentially get out of the real-estate business — thus ensuring the company's continued presence in the Pioneer Valley.

'It' is a broad series of so-called sale-leaseback arrangements involving Friendly's properties ranging from the corporate headquarters building in Wilbraham (sale price: $27.5 million) to individual restaurants in Chicopee ($2.2 million), Holyoke ($1.6 million), Springfield ($1.3 million), and other area communities.

In all, more than 160 properties have been sold and then leased back, mirroring a trend nationwide involving restaurant chains, but also businesses across several sectors. The sale-leaseback is hardly a new concept, but it is gaining greater acceptance as a vehicle for raising needed capital or helping companies weather difficult financial times.

"It's not a new concept at all, but it's one that more people are looking at, and for good reason," said Bob Greeley, president of the R.J. Greeley Co., noting that there can be benefits for both parties in these transactions. The seller can raise capital that can be applied for expansion efforts, equipment purchases, new-product launches, and other purposes, while the buyers, ranging from individuals to real-estate investment trusts (REITS), gain solid revenue streams that come with the added security of hard assets behind the investment.

There have been several sale-leaseback transactions in Western Mass. over the past several years, most involving large regional or national concerns such as Friendly's, C&S Wholesale Grocers, which sold facilities in Hatfield and Westfield, and Western Mass. Electric Co. Meanwhile, many national retail chains, including CVS, Walgreens, and others, sell and lease back their facilities in this region. But the strategy can — and has been — an effective tool for many smaller ventures, said Greeley, who described it as an often-overlooked capital-raising (or investment) strategy.

But there are many factors that must be considered before a party enters into such an arrangement, said Jeff Fialky, a business law specialist with the firm Bacon & Wilson. "Laundry list" was the term he used to describe the sum of the matters to be weighed before entering a sale-leaseback deal.

These include tax considerations — the seller can deduct some or all lease payments as operating expenses, for example, but, in the case of a conventional mortgage loan, can deduct only interest and depreciation, he said. And there are many other financial and logistical considerations, including everything from lease rates (not too high for the seller or too low for the buyer) to language regarding which party will be responsible for managing and maintaining the property after the sale.

"A sale-leaseback is advantageous in circumstances where it is attractive for the seller to retain or obtain the use of funds that are tied up in a non-earning asset such as real property or a large piece of equipment," he said. "But there are many considerations to take into account regarding both the transaction itself, and ongoing costs after a sale is completed."

Building a Case

James Sullivan, vice president of franchising and development

at Friendly's, couldn't get into too many specifics about the corporation's sale-leaseback transactions, especially with regard to how the hundreds of millions of dollars raised would be put to work.

But, in general terms, he said the series of transactions — negotiated between the corporation's new owner, O. Ice LLC, a wholly owned subsidiary of Sun Capital Partners, and Realty Income Corp., a California-based company that specializes in sale-leasebacks — effectively maneuvers Friendly's out of the business of managing real estate and enables it to focus all of its time and energy on its core businesses of making ice cream products and operating family restaurants.

This strategy mirrors a trend within the restaurant industry, said Sullivan, noting that the transactions dramatically reshape the company's balance sheet.

"The restaurant business is all about liquidity," he said, "and tying up cash in real estate is not a liquidity driver. When companies that own real estate want to raise liquidity, they're able to divest that real estate and enter into long-term leases and free up that capital to accelerate growth, for development, or to reinvest in the base business."

This, in essence, is what sale-leasebacks are all about, said John Williamson, owner of Williamson Commercial Properties in Springfield. He told *BusinessWest* that it's become increasingly difficult for many businesses to make a case that they need to own their own real estate.

"It just doesn't make sense to own in a lot of situations," he said, adding that businesses across sectors ranging from hospitality to financial services, from health care to manufacturing, are opting to sell and lease back their space.

Greeley agreed. "There are a lot of Fortune 500 companies that have believed that, as a strategy from day one, they should not invest in their own real estate, but invest instead in their own business model and to go rent real estate from those who are real-estate professionals."

Most sale-leasebacks are fairly straightforward transactions — terms and conditions vary slightly with each deal — that are appropriate under various circumstances for both the seller and buyer, Greeley continued. The strategy might be a good option for a company facing financial hardship, he said, noting that a sale-leaseback could help reduce or eliminate debt, and usually puts more money in the seller's hands than refinancing a mortgage.

"The company doesn't necessarily have to be in trouble," Greeley said of the potential seller, "but they clearly have to be someone willing to give up the conservative real estate investment for the capital to be used in another place."

Meanwhile, on the buyers' side of the equation, there are many investors who consider real estate to be a better option than the stock market, said Greeley, and sale-leasebacks can be an effective strategy for such groups and individuals.

"There's incredible demand for real-estate investments today," he explained. "Because of the performance of the stock market for quite a while now, there are a lot of people with a lot of money who would rather invest in real estate than the equities markets."

Taxing Situation

But each deal must be considered carefully, said Jim Barrett, a partner with the Holyoke-based accounting firm Meyers Brothers Kalicka, who, like Fialky, noted that there are potential benefits for both parties in sale-leaseback transactions — if the circumstances are right.

He said he's handled a few sale-leaseback deals over the years, some undertaken strictly for strategic purposes — getting a company out of the real estate management business and back to its specific niche — but others for purely tax considerations (such as a desire not to relinquish loss carry-forwards set to expire) and some involving companies that were in some form of fiscal trouble and needed an effective vehicle for raising cash.

One deal in that last category involved a small Westfield manufacturer that owned an historic building in the downtown area. The company operated on upper floors of the building, while leasing space to retailers on the ground floor. By selling the building to one of those tenants and leasing it back, the company reversed roles, going from landlord to tenant, but, in the process, gained a much-needed infusion of capital to stay in business.

That deal is typical of sale-leasebacks, and points to the many factors that must be considered in such transactions, Barrett said, noting that they need to work for both parties.

For starters, a sale-leaseback is often an attractive option to conventional mortgage refinancing, said Fialky, because the seller would likely obtain 100% of the property's value, as opposed to 80% in a typical refinancing. "Meanwhile, there would be no appraisal costs, points, or other traditional financing costs," he continued, "and there would be no financial covenants, and a sale-leaseback does not draw on existing lines of credit or other pending loan facilities with the seller's institutional lender."

One disadvantage to the seller is that it is relinquishing an asset that could, and probably would, appreciate over time, said Barrett, adding that potential sellers have to weigh the cash they would gain today against what their property might be worth down the road, especially if it is in a high-growth area such as Route 9 in Hadley.

Both parties have to be careful about lease rates and other conditions, said Fialky, noting that if a seller isn't diligent, it might get locked into a high rental rate for a substantial period of time, in an arrangement that may not be subject to renegotiation in a softening real estate market, when that rate may be well above market value.

Another consideration is management and maintenance of the property. The buyer may incur these landlord obligations, said Fialky, or stipulate that the seller continue to absorb those duties — and costs.

From a tax standpoint, deductions for lease payments that are gained by the seller are pretty much offset by other deductions that can be taken by property owners, said Barrett.

"It's essentially a wash," he explained. "If you own real estate, you are able to capitalize the cost of that real estate and depreciate it over a certain number of years. In addition to that, you can deduct interest payments. If you lease it, you can't capitalize it because you don't own it, and you don't get to depreciate it."

Meanwhile, there are capital gains taxes to be weighed, he continued, adding that in some cases, especially when the property is heavily leveraged, those taxes can be significant enough to make a sale-leaseback impractical.

Running the Numbers

Generally speaking, a sale-leaseback is simply a tool, said Greeley, to be used by companies that want to take cash tied up in real estate and put it to different, more effective uses.

Such transactions don't work in all circumstances, he continued, but they are certainly worth considering for those looking to raise some capital and move their business forward.

And also looking to get out of something that *isn't* their business — managing commercial real estate.❖

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