

Demand increases for sale/leaseback transactions

By John Lecky



Partly attributed to a slower economy and today's stricter lending environment, the Canadian and British Columbia commercial real estate markets continue to witness solid demand for sale/leaseback transactions as a means for obtaining maximum equity from owned real estate.

A sale/leaseback is a transaction wherein the owner of a property sells that property and then leases it back from the buyer at a rental rate and lease term that is acceptable to the new owner (and typically on financial terms that are consistent with the marketplace).

The primary purpose of a sale/leaseback is to raise money or to free up the owner's equity (that is invested in the property) for other uses, while retaining use of the facility. Although the type of property involved is usually commercial, sale/leasebacks can also apply to equipment, vehicles or aircraft. In commercial real estate, sale/leaseback transactions can include almost any property type, ranging from large banks to industrial warehouse/distribution buildings to corporate offices to restaurants.

Blake, Cassels & Graydon LLP (Blakes), one of Canada's leading business law firms, reports in its "Commercial Real Estate Trends—2008 Perspective" that "as credit markets

tighten, owners who are occupants of office buildings, manufacturing facilities and industrial warehouse facilities will look to other sources of financing. Sale leasebacks have seen an upsurge in Canada among owners, with strong covenants capitalizing on the tax, balance sheet and cost of funds advantages to be had from selling and leasing back the premises they occupy."

In a typical scenario, a corporation will sell its real estate asset(s) to another party, such as a real estate investment trust (REIT) or an institutional or private investor, and then lease the property back at a rental rate based on current market rents.

Another scenario may involve a company that has acquired or built several manufacturing facilities across Canada over the years and is now a successful manufacturer with real estate assets. However, because its core business and expertise is in manufacturing and not in real estate investing, it decides to maximize the use of its capital with a sale/leaseback transaction. The owner sells the property to an investor and maintains the benefits of the location and the building(s) by signing a long-term lease.

To illustrate, in August 2008, **Canadian Tire Corp.** reached an agreement for the sale/

**AVISON
YOUNG**

Intelligent
Real Estate Solution

leaseback of 12 properties across Canada, generating proceeds of \$174 million. The company expects to realize a pre-tax gain on the sale of approximately \$70 million, which will be amortized over the initial 15-year term of the leases. Toronto-based **Canadian Real Estate Investment Trust (CanReit)** acquired eight of the properties for \$137.3 million. Each of the 12 properties in the portfolio, totaling 996,000 square feet (sq. ft.), includes a recently constructed or expanded Canadian Tire store and six of the sites feature a **Mark's Work Warehouse**.

"While we continue to see real value in owning the majority of our real estate assets, carefully selected sale/leasebacks enable us to monetize the value of select properties creating financial flexibility while maintaining our overall operating flexibility," said CEO **Tom Gauld** in the company's news release. "The properties included in this transaction are locations featuring stores that are either new or recently expanded so we do not see a need to relocate these stores in the foreseeable future. This enables us to monetize these sites at attractive rates while creating financial flexibility."

Demand for sale/leasebacks is also brisk from companies with below-investment-grade credit. Owners who are facing rising debt and are unable to obtain financing can reinvest the sale proceeds in their core business and use the cash to fund improvements at their existing facilities.

According to **Real Capital Analytics (RCA)**, an independent New York-based research firm, in 2007 corporate users capitalized on investor demand for property globally with \$88 billion worth of asset sales— including \$56 billion of sale-leaseback transactions. Many market experts expect the trend to continue.

Given the volatility in today's global financial markets, cash is a preferred asset because it can provide a hedge against uncertainty. Most businesses are not in the real estate business, and commercial real estate properties owned by businesses are assets that can be converted into cash by disposing of real estate that is not required and then renting back real estate that is required.

There are benefits to both buyer and seller. For the seller, a sale/leaseback frees up capital; he/she gains a lump sum of cash quickly and can focus on his/her core business rather than having these funds tied up in passive real estate. For the buyer, equity is invested in a passive, low management intensive real es-

tate asset, where the rent provides constant income.

Examples of BC-based companies that have engaged in sale/leaseback transactions in recent years include **Pacific Blue Cross**, which sold and leased back its 120,000-sq.-ft. building in Burnaby, BC.

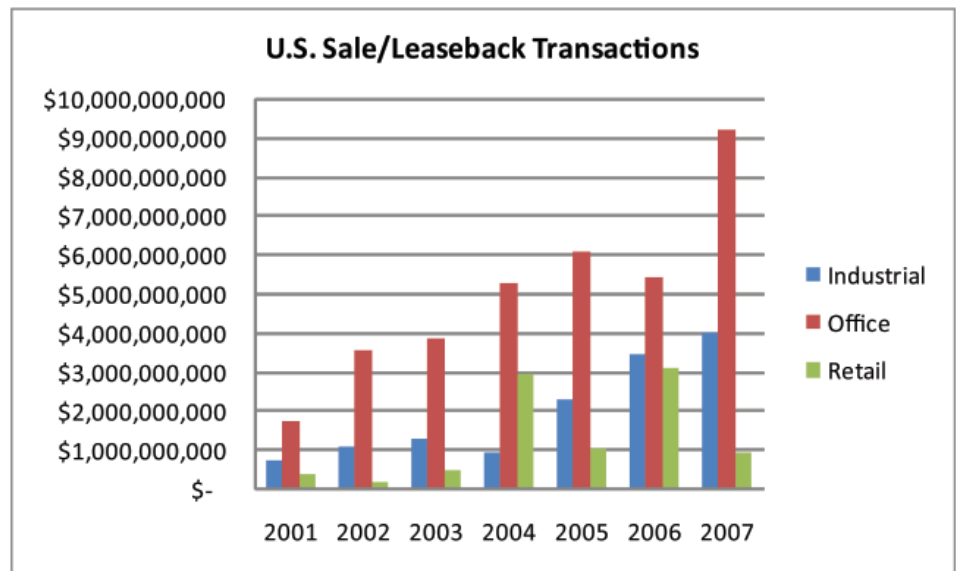
John Crawford, Pacific Blue Cross' Senior VP, Finance, comments: "The rationale behind Pacific Blue Cross executing a sale/leaseback of its office building was "to free up capital in order to diversify into other corporate investments, thus providing a better return than realized on its corporate real estate. Also, the transaction allowed us to eliminate unbudgeted capital expenditures associated with building ownership."

structure for our new head office building in Burnaby because we are in the business of conducting unreserved equipment auctions; we're not in the business of owning and managing commercial real estate," points out COO **Bob Armstrong**.

He adds: "We own most of our auction sites around the world because they are critical to our ability to conduct business. We are willing to allocate capital to these strategic assets, but not to our office buildings."

Advantages of a sale/leaseback for the seller/eventual tenant include:

- Provides 100% of the value of the assets compared to traditional mortgage debt financing, which rarely exceeds 70%



Source: Real Capital Analytics
Tracking real estate assets \$5 million and greater

In September 2008, global biopharmaceutical company **QLT Inc.** sold its 163,897-square-foot corporate headquarters at 887 Great Northern Way (and an adjacent undeveloped parcel of land) in Vancouver to **Discovery Parks Holdings Ltd.** for \$65.5 million. In conjunction with the sale, QLT entered into a five-year leaseback with Discovery Parks for approximately 30 per cent of the facility.

"This now marks the completion of another non-core asset transaction," said CEO **Bob Butchofsky** in the company's news release. "We are very pleased with the progress we have made in our efforts to restructure the company."

Ritchie Bros. Auctioneers Inc. is another example of a BC company that recently completed a sale/leaseback transaction: "Ritchie Bros. Auctioneers is using a sale/leaseback

- Debt that was associated with the real estate is removed from the balance sheet
- Ability to redeploy the capital into the core focus of the corporation
- Extra cash for business expansion, new equipment or technology, other developments or acquisitions
- Provides equity to distribute to shareholders
- Continued operational control of facility, without responsibility for facility management
- Equity reinvested in core business in many instances yields greater returns than are generated from the real estate
- Complete rental deductibility: rental pay-

ments under a sale/leaseback structure are 100% deductible against company's taxable income, versus only the interest portion of a mortgage payment

- Flexible lease terms: the term of the operating lease is designed to coincide with the needs of the user and the asset. Lease terms under a sale/leaseback structure are usually 10 to 20 years with built-in renewal options of five years each.

"...the transaction allowed us to eliminate unbudgeted capital expenditures associated with building ownership"

— John Crawford
Senior VP, Finance, Pacific Blue Cross

Advantages of a sale/leaseback for the investor/new landlord include:

- Ownership of a fully-leased, trouble-free asset
- Potential for appreciation in value of the newly acquired asset
- A return on the investment from rental revenue is often leveraged by obtaining debt that is lower priced than the asset yield (or capitalization rate), which serves to enhance the return
- A prequalified, reliable tenant who likes the property/location and has signed a long-term lease
- A hedge against inflation depending on lease term and rental rate adjustments
- Relatively low management due to single tenancy
- Tax efficient income stream due to capital cost allowance deductibility

What to look for in a real estate advisor:

When considering the disposition and lease-back of a property or real estate portfolio, the seller should retain a qualified commercial real estate investment advisor to formulate and execute the transaction.

The real estate advisor should be mindful of the following considerations:

- Inquire about and understand the client's objectives for the occupied real estate and the equity generated from the sale

- Prepare a financial model, predicated on a firm understanding of the current market fundamentals, to review with the client, including:

- potential proceeds realized
- potential returns realized on proceeds redeployed in other core areas of the company
- various ongoing rental rate obligations
- optimum lease term i.e. 10,15 or 20 years and required renewal terms
- whether the tenant should assume capital expenses for long-term leases, such as roof and structural repair items
- termination or retraction options

- Conduct proper due diligence of the property, and liaise with third-party (i.e. environmental) consultants

- Liaise with client and legal counsel to generate a lease document incorporating lease terms consistent with the client's objectives

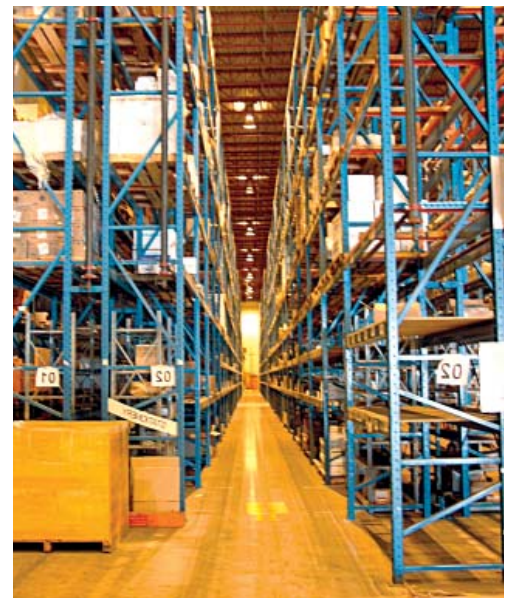
- Upon receiving approval to introduce the property to the marketplace, provide the client with periodic progress reports to ensure the client is fully apprised of the unfolding disposition process

- Generate broad exposure of the investment offering to private and institutional investors

- Upon receiving offers to purchase, review and analyze the terms of each offer with the client, provide background information on the financial strength, reputation and experience of the potential investor (eventual landlord), and advise accordingly



Overall, the real estate advisor will manage the two salient components of the sale/leaseback transaction: the generation of the lease document and the execution of the disposition process. As with any investment, there are associated risks. Should the seller/tenant choose to vacate prior to cancellation provisions, the property will have to be subleased. There may also be capital gains



or recapture tax liabilities to the seller. Some sale/leaseback arrangements allow the seller the option to buy back the property at a later date.

And of course, the credit of the tenant is crucial in a sale/leaseback transaction. The higher the credit rating, the lower the risk of rental default, which may allow the seller to offer a lower yield to prospective purchasers. An experienced real estate advisor will be able to address these and any other issues that may arise.

Given today's more conservative lending practices, resulting from the current turbulence in credit markets worldwide, sale/leaseback transactions are anticipated to remain popular in the foreseeable future. For companies wishing to monetize their real estate assets and invest the capital in their core business or use it for other strategic purposes, a sale/leaseback is an attractive financing alternative. Similarly, well-located properties with a good-credit tenant will continue to attract all real estate investor-types seeking the long-term benefits of real estate ownership. ■

John Lecky is a principal at Avison Young (Canada) Inc. in Vancouver, British Columbia. He has successfully completed numerous sale/leaseback assignments in BC and across Canada. He can be reached at 604-687-7331 or jlecky@ay-bc.com, www.avisonyoung.com