SALE AND LEASEBACK OFFERS BUSINESS

FLEXIBILITY

A SUCCESSFUL FUNDING APPLICATION IS KEY TO MOST NEW DEVELOPMENTS OR INVESTMENTS IN COMMERCIAL AND INDUSTRIAL REAL ESTATE. A PROPERTY FINANCE VETERAN WHO HAS VIEWED HUNDREDS OF APPLICATIONS REVEALS WHAT LENDERS ARE LOOKING FOR AND HOW YOU CAN MAXIMISE YOUR CHANCES OF SECURING A LOAN.

THE WIDESPREAD ECONOMIC impacts of the global COVID-19 outbreak are starting to hit home with many New Zealand businesses now experiencing pinch-points and cash flow problems as the realities of the changed market sink in.

As a consequence, many businesses that own real estate are considering sale and leaseback transactions to free up capital, reduce debt and/or focus on their core activities which can include research and development, new product lines, acquisitions, customer retention and staff training.

Bayleys national director real estate advisory sales, Stephen Rendall, says creative thinking is required for businesses experiencing interim cash flow constraints due to restrictions on trade and the multiple handbrakes that were being applied throughout the economy due to the pandemic.

"Selling core real estate assets to release equity, which in turn can be channelled into the business's day-to-day operations, stacks up for a range of business sectors – even in the best of economic times," he says.

"It's certainly not to be viewed as a failure but rather, as an astute realignment of priorities and finances with the aim of improving balance sheets and fuelling business growth."

The sale and leaseback model had been gaining traction pre-pandemic and for many Bayleys' clients, the decision to proceed with the process now is a case of an existing business strategy path coming to fruition.

"But for others, interest in these transactions has been accelerated by the post-pandemic environment we find ourselves in," says Rendall.

"Businesses need to ensure that they have adequate capital directed towards growth and bottom-line damage control to enable business continuity – albeit in some cases, in a very different form to just several months ago.

"The more mature and agile the business is, the more open they seem to be to sale and leaseback transactions that free them from property ownership ties given the more pressing need to evolve and pivot their operations to remain competitive and liquid."

DEALING WITH THE DETAILS

The flexibility to grow or shrink a business becomes more viable when a large chunk of capital is released from property ownership and many businesses find the move from owner to tenant to be liberating.

Rendall says many business executives prefer not to own real estate for the very reason that it enables them to direct equity into core entrepreneurial activities.

"For many high-performing businesses, leaving the ownership of real estate to expert property investors and managers who have very different risk-return parameters, makes sound business sense.

"And investors and lenders are looking for good tenant covenant to underpin any investment property proposition."

"SELLING CORE REAL ESTATE ASSETS TO RELEASE EQUITY, STACKS UP FOR A RANGE OF BUSINESS SECTORS – EVEN IN THE BEST OF ECONOMIC TIMES."

STEPHEN RENDALL, BAYLEYS NATIONAL DIRECTOR REAL ESTATE ADVISORY SALES

Rendall says given the inherent uncertainties in the current market, a real estate sale and leaseback transaction could free up capital to be redeployed to deal with immediate, business-threatening circumstances.

"This could include requirements imposed by banks to reduce debt exposure, or to avoid a breach of banking covenants in the short-term, or bank conditions that make further lending contingent on the sale," he explains.

"Equally, businesses may need the cash to be sure of meeting payment obligations to suppliers or staff."

EXPERT ADVICE ESSENTIAL

Executing a real estate sale and leaseback transaction is a multi-layered process involving a range of professionals.

Rendall says having a team of trusted legal, accounting, valuation and tax advisers on hand to support the process, in addition to a real estate agency and advisory team, is invaluable and will help to make the process robust and with more chance of achieving an optimal outcome.

"We can't stress this enough – a sale and leaseback proposal should be navigated from a foundation of sound information, due diligence, proven process and transparency so that all parties are up with the play," he says.

In a typical sale and leaseback, a business that owns real estate enters into a sale and purchase agreement with a purchaser. On settlement, the purchaser acquires ownership of the land, buildings and other improvements on that land, and simultaneously, the business leases some or all of the land, buildings and improvements back from the purchaser for an agreed period of time.

"So, the business owner converts capital that had previously been tied up in real estate into liquid form, for better use within the business, while retaining occupation and economic use of the real estate," says Rendall.

"The purchaser becomes the owner of the real estate and is entitled to receive the rent and other payments that the business is now obliged to make under the terms of the lease."

Rendall says as with all business operational and ownership structures, there are pros and cons, but it is hoped that in freeing themselves of property ownership, the business itself takes centre stage.

"To illustrate the benefit with a simple example, imagine that a business – that owns the real estate it occupies – determines that it expects a return on equity of 5-7-percent per annum from its property asset.

"However, in doing the numbers, the business expected a return on equity of 12-14-percent per annum across the same horizon from the business's core area of expertise (for example, the manufacture and distribution of farm irrigation systems).

"All other things being equal (including the relative risk of the two ventures), the business could derive significant additional return for its investors by converting the equity held in the real estate into investment in the business's core business, thereby generating higher returns for investors."

Although the real estate is now owned by a third-party investor, the lease back to the business will grant the business exclusive occupation and use of the real estate for the term of the lease, potentially on terms which are more favourable for that business by comparison with ownership.

"For example, a lease can – and often will – allocate certain maintenance and replacement obligations to the landlord," says Rendall.

"THE BUSINESS COULD DERIVE SIGNIFICANT ADDITIONAL RETURN FOR ITS INVESTORS BY CONVERTING THE EQUITY HELD IN THE REAL ESTATE INTO INVESTMENT IN THE BUSINESS'S CORE BUSINESS."

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"The minutiae of property ownership can often take focus away from core business so in a lot of instances, being a tenant is preferable."

BUSINESS CONTINUITY

As to the potential downsides to a business, losing long-term control of the physical real estate is the main one and for some business owners, there's a reluctance to sell property because its seen as a 'safe' part of the business equation.

"However, in taking a step back and looking at the health of the business and the potential for change or growth, owners realise that they do not necessarily need to own the property itself to be successful," he says.

"By securing lease terms that confidently give them occupation rights for an agreed length of time – and therefore business continuity – the business can step away from ownership without disruption to day-to-day activity.

Another potential negative is the relinquishing of control over the physical space.

"Leases do not usually grant full rights of exploitation, meaning a tenant must use the premises as they are constructed, and for a specific use," points out Rendall.

"While modifications with landlord consent can often be negotiated, in simple terms, the tenant can no longer treat the property as if it was the owner."

The way leases are structured can also impose obligations and there are transactional costs and tax implications to be managed.

Bayleys has structured and executed sale and leaseback transactions for a wide range of businesses in recent years including ANZ, Fonterra, MediaWorks, Woolworths New Zealand, Foodstuffs, New Zealand Post and KiwiBank.

Rendall says Bayleys' multi-disciplined, full-service agency team has market-leading experience in negotiating lease terms specific to sale and leaseback deals and can propose a number of solutions to address or mitigate any perceived "cons" to becoming a tenant under such an arrangement.

NZX-listed carpet manufacturer Cavalier Bremworth is selling three of its manufacturing facilities via a sale and leaseback offering through Bayleys. Its Papatoetoe manufacturing facility is located in the heart of the town's industrial precinct.

Billed as a trophy asset, this property owned by Woolworths New Zealand and occupied by Countdown Aotea, is for sale with a long-term lease in place.