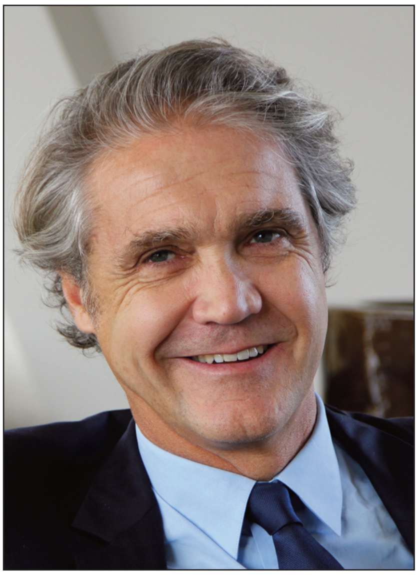
SALE-AND-LEASEBACK : HERE TO STAY!



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Sale-and-leaseback transactions (often referred to simply as leasebacks) saw exponential development in the early 2000s. Initially serving as an arrangement to allow struggling companies to unlock capital, the concept has since found a broader appeal, particularly on the back of a number of high-profile and highly profitable transactions involving financially stable companies and private equity funds keen to separate their real estate from the corresponding business assets. Nowadays, leasebacks are commonplace for office properties, hotels, logistics and retail facilities, fast food outlets and retirement/care homes, as well as in other sectors.

But despite its popularity, the leaseback is said to be on the way out practically every year. First, it was predicted that it wouldn't survive the financial crisis and the ensuing credit crunch. Then it was said that the repeal, as from 1 January 2012, of the 'Section 210 E' preferential tax regime would spell its end. Next, it was thought that the Pinel Act would wipe out the appeal of such transactions for investors, by preventing buyer-lessors from on-charging major repair work to their seller-lessees as from 2014. And most recently, the IFRS reform was expected to finish off the leaseback for good. The new IFRS 16 ('Leases'), effective since 1 January 2019, has harmonised the accounting treatment of leases. Now, regardless of whether the lease in question is an operating lease or a finance lease, lessees are required to recognise in their balance sheet all right-of-use assets granted over the entire lease term in consideration of future payments, as well as a lease liability corresponding to all future rent payments owed.

Yet here we are in 2020, and the sale-and-leaseback is still going strong in all sectors. Given that leasebacks no longer offer any particular tax or accounting advantages and must now be treated in the same way as any other operating lease, it is interesting to take a look at the basics of a concept that is still proving its worth for many companies.

Financing: the key factor behind every leaseback

By unlocking the significant financial value of fixed assets accounted for at their historical cost, leasebacks are a relatively obvious option for CFOs looking to boost their financial ratios or fund a strategic project that requires substantial equity.

In some cases, leasebacks are even used purely as a financing mechanism. A company with frequent new property needs may set up 'back-to-back' leasebacks: the funds released from the first transaction are immediately reinvested in new assets, which in turn become the object of further leasebacks a few years down the line. In the meantime, the seller-lessee will have been able to fund modernisation work at a relatively low financing cost and accordingly derives a development capital gain.

These financial aspects can sometimes overshadow the other benefits of a leaseback transaction, however. A truly successful leaseback shall also meet certain clear industrial needs. The most obvious of these are the need for increased operational flexibility and the transfer of the risks of building ownership and obsolescence (especially in terms of compliance and structural work) to an external real estate professional.

Limitations: the strategic value of a property

The benefits to be gained in terms of financial resources and flexibility are such that very few companies go back to an asset-heavy business model once they have tried leasebacks. Nonetheless, a number of recent transactions, primarily in the hotel sector, seem to suggest that some operators are choosing to return to the more traditional set-up of combined property and business assets to avoid some of the negative consequences of leasebacks on strategic assets.

Take the following example: after one or two renewals, a hotel operated under a sale-and-leaseback arrangement starts to show its age and the renovations required extend somewhat beyond a fresh coat of paint. In such a situation, the lessor may not wish to grant the lessee's request for investment, and the lessee will most likely not be willing to tie up significant funds in an asset it does not actually own. Variable rents – an increasingly common feature of hotel leases – offer only a partial response. As a result, we are now seeing a number of 'repositioning' transactions: franchisors and managers are pushing for the real estate and business assets of their most strategic hotels to be combined once again, so that they can talk capital expenditure and profitability with a single party empowered to take the necessary decisions.

This example illustrates both the benefits and potential pitfalls of the leaseback. A contradiction lies at the heart of the most successful transactions: the seller-lessee is selling assets that are highly valuable for it. This utility value is key to reassuring the investor and allowing the seller-lessee to leverage the resulting liquidity, capital gains and greater flexibility. In such respect:

- if the seller-lessee only requires use of the asset over a relatively short period (a decade or so in real-estate terms), then the transaction will most likely be a success;
- if, on the other hand, the transaction involves a strategic asset that will ultimately demand hefty investment, then the seller-lessee should prepare for tough negotiations in the future.

In view of the appeal of leasebacks, heightened by the current cap rate compression and the high-quality and diversified management services offered by investment professionals – now active in virtually all sectors, the key aspect for prospective seller-lessees to consider is their long-term strategic requirements.

Leasebacks make perfect financial sense for a company that owns numerous properties, especially if it can divest itself of entire portfolios of low-value, high-cost assets. In delivering more flexibility, the arrangement can also be of strategic advantage in sectors where technological advances are turning existing property models on their heads (witness the current battle between online and high-street retailers, for example). But when a property is in a fantastic location, has been granted a valuable permit or licence or boasts exceptional features, making it a key asset, its owner should think long and hard before putting it on the leaseback market. Although the proposal will necessarily attract keen interest from investors, such properties are not easy to come by ...

How the M&A toolbox can serve leasebacks

Leasebacks organised as straightforward property transfers and lease agreements quickly run up against certain obstacles in terms of the associated expense and their limitations: high costs, considerable mandatory paperwork, potential issues associated with pre-emption, etc. When the transaction involves an entire logistics network or a portfolio comprising dozens of hotels, stores, restaurants or retirement homes spread across a number of countries, M&A professionals and their toolbox can prove useful. The seller-lessee will need to engage the services of a corporate bank to work on the transaction's equity story and ensure the ideal asset selection for the leaseback. It may then contribute the assets to a joint venture in which it holds a minority interest; this serves as a guarantee of the transaction's interest for the investor. The chain of legal and financial transactions involved in such cases are detailed in a shareholders' agreement and a memorandum of understanding, and actually have more in common with a spin-off than a typical property sale. By ultimately reducing the process to the acquisition of an equity interest, the application of tried-and-tested M&A techniques to leasebacks enables a swift transfer of entire portfolios comprising dozens or even hundreds of properties located in various different countries. Only through the use of this type of efficient structuring can these complex and preparation-intensive transactions prove truly successful.