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UNLOCKING CAPITAL FROM REAL ESTATE: SALE & LEASEBACK TRANSACTIONS

With continued demand from overseas investors for "trophy" real estate assets in the UK, sale and leaseback opportunities valued at £800m were put on the market in central London during August 2017[*] as businesses continue to look at alternative sources of finance. In this client briefing, we look at the advantages and disadvantages of a sale and leaseback transaction as a way for property-owning companies to release capital.

A sale and leaseback transaction allows a company to unlock cash that is tied up within its real estate and then use this cash to invest in its business, to discharge existing debt or to pursue alternative investments. Sale and leaseback deals may also offer tax advantages to the seller and strengthen its balance sheet.

WHAT IS A SALE AND LEASEBACK TRANSACTION?

In the context of commercial real estate, a sale and leaseback transaction involves the sale of a property to a third party investor for a lump sum payment, immediately after which the investor then leases the property back to the seller for an agreed period in return for the payment of rent by the seller. The seller therefore no longer owns the asset but can continue to use it for the purposes of its business.

WHAT ARE THE MAIN ADVANTAGES TO THE SELLER OF ENTERING INTO A SALE AND LEASEBACK?

An appropriately structured sale and leaseback transaction can bring a number of benefits to the seller:

- **Unlocks more equity than a conventional financing** – The economic effect of a sale and leaseback transaction is similar to borrowing money and securing it on the underlying property. However, whilst a mortgage-backed financing typically unlocks 60-70% of a property's value, a sale and leaseback transaction enables a company to receive 100% of the value of its property (subject to any tax costs: see below).
- **Cash without additional debt** – A sale and leaseback offers a way for a company to access capital without increasing its indebtedness. This may

What types of property are typically subject to sale and leaseback arrangements?

Many types of property are suitable for sale and leaseback transactions, which may be single asset deals (e.g. high value head offices of international companies) or multi-property portfolio deals across a range of sectors (e.g. pubs, supermarkets, retail stores, gyms or healthcare facilities). As long as an investor can re-let the property and generate income from it in the event that the seller ceases to occupy the property (e.g. if the seller goes into insolvency or does not renew its leaseback at the end of the initial fixed term) then a sale and leaseback transaction is a possibility.

[*] Source: Estates Gazette, 1 September 2017

be useful where a company is prohibited by the terms of existing financing arrangements (e.g. a loan or bond issue), by its constitution or by other contractual arrangements from incurring any additional debt.

- **Deductibility of rental payments** – A sale and leaseback transaction may offer various tax advantages to the seller, the main one being that rental payments under the leaseback are usually deductible in full as an operating cost of the business. This should be compared to a conventional financing, where the borrower is only entitled to deduct the interest element of the repayments.
- **Off balance sheet accounting treatment** – If the leaseback is structured so that it qualifies for accounting purposes as an "operating lease", rather than a "finance lease", then it will not be considered to be a financing transaction and as a result can be kept off the seller's balance sheet. Coupled with the fact that the conversion of fixed assets into cash by the sale of the property will increase the seller's ratio of current assets to current liabilities, this is likely to make short-term borrowing easier and more cost-effective for the seller. If, however, the leaseback is classed as a finance lease then the obligation to make future rental payments will generally need to be shown in the seller's accounts as a liability and the lease will need to be shown as an asset. Whether the leaseback is characterised for accounting purposes as an operating lease or a finance lease will depend on whether the lease transfers to the investor substantially all of the risks and rewards associated with ownership of the land, as well as other factors such as the duration of the leaseback, the total rent payable and whether the leaseback contains an option for the seller to re-acquire the land. The perceived benefit of the accounting treatment for operating leases relative to that for finance leases looks set to be eroded in the coming years as the new lease accounting standard, IFRS 16, requires almost all leases to be recognised on a company's balance sheet for annual periods commencing on or after 1 January 2019.
- **Reduces exposure to some of the risks of owning the asset** – Although the terms of the leaseback are likely to require the seller to bear some of the risks associated with property ownership (e.g. repair and maintenance), other risks that would otherwise fall to the seller could be passed to the investor (e.g. uninsured damage and possibly also defects if the building is newly constructed).

ARE THERE ANY DISADVANTAGES TO THE SELLER OF ENTERING INTO A SALE AND LEASEBACK TRANSACTION?

There are a number of potential downsides to be considered by a seller before entering into a sale and leaseback transaction, most of which are related to the fact that the seller no longer owns the valuable interest in the property once it has been sold to the investor:

- **No capital growth** – The seller foregoes any future increases in the value of the property, which accrues to the investor as the owner of the property.
- **Uncertainty at end of leaseback term** – If the seller cannot negotiate a renewal of the leaseback on open market terms when it expires then the seller may need to relocate its business, which may be particularly undesirable where the sale and leaseback is of the seller's long-term headquarters. As well as looking to the Landlord and Tenant Act 1954 for a degree of protection on the terms of any renewal, some of the risks

associated with this can be mitigated by including lease renewal options or an option to buy-back the property in the original sale and leaseback transaction (although buy-back options are likely to lead to the leaseback being classed as a finance lease for accounting purposes).

- **Loss of operational flexibility** – Although it may be possible to negotiate some flexibility into the terms of the leaseback, the seller will have less discretion in the use and operation of the property than it would have had as the outright owner (e.g. in relation to alterations, permitted use and sharing occupation). Also if the seller decides that it no longer needs to use the property for the purposes of its business then its ability to assign the lease will be constrained or, depending on the terms of the leaseback, may be prohibited entirely.
- **Reputational** – Depending on the nature of the seller's business, the management team could be accused of "selling the family jewels" by prioritising the desire for short-term profit and cashflow advantages over the long term benefit and security of the business.

"Although sale and leaseback transactions have historically been considered to be countercyclical, recent economic data suggests that this is no longer the case – they often now form an everyday part of a corporate's property strategy."

WHAT ARE THE MAIN TAX CONSIDERATIONS FOR THE SELLER?

A potential sale and leaseback transaction should always be carefully structured to mitigate any adverse tax implications. Some of the main points to consider are:

- **Capital gain or loss** – The seller may realise a gain or a loss when it sells the property. The treatment of this gain or loss for tax purposes will depend on whether the leaseback is characterised as an operating lease or a finance lease, but if it is an operating lease then the seller would usually be required to recognise the gain or loss immediately. Tax on any gain would reduce the proceeds from the sale of the property, unless the sale and leaseback transaction is timed to take advantage of any tax credits or losses that are available to the seller to offset some or all of the gain.
- **Stamp duty land tax (SDLT)** – The investor will typically pay SDLT on the purchase price paid for the property (including on any VAT paid: see below) although if the transaction is properly structured the seller should qualify for sale and leaseback relief from SDLT on the leaseback element of the transaction.
- **Capital allowances** – It may be possible for the seller to agree with the investor that the seller, in its capacity as tenant, can retain the benefit of any capital allowances available on qualifying plant and machinery at the property.
- **VAT** – Where the leaseback is granted to the seller after the seller has sold the property to the investor, the sale would not be a VAT-free transfer of a going concern. If the property has been elected for VAT purposes then this means that the investor will need to pay VAT on the purchase price (and the SDLT cost to the investor will rise accordingly).

WHAT'S IN IT FOR THE INVESTOR?

The appeal of a sale and leaseback transaction to an investor lies in the fact that they are buying a property that is already let and income-generating. For the duration of the leaseback the investor will receive regular income which will typically be subject to upwards-only rent reviews. And since the investor

owns the reversion to the property, it will also benefit from any appreciation in the value of the property (which also means that the investor bears the risk of any decline in property values during the leaseback period). The price paid by the investor will reflect the quality of the underlying asset and the covenant strength of the seller as tenant. If the seller is restricted from assigning the leaseback (see below) then economically speaking the transaction is similar to buying a bond issued by the seller.

The main risk to the investor is that the seller defaults on the leaseback. The investor will be able to forfeit the leaseback and take back control of the property (subject to the Court's equitable discretion to grant relief from forfeiture, although this would be unlikely in the case of a material default of an operating lease), but is then left with the burden of finding a replacement tenant, the ease of which will depend on market conditions at the time. The investor will also be left as an unsecured creditor of the seller in any insolvency proceedings.

HOW DOES A LEASEBACK DIFFER FROM A TYPICAL OCCUPATIONAL LEASE?

The precise terms of the leaseback will depend upon the nature of the underlying asset, the identity and commercial objectives of the parties and the agreed purchase price, but sellers in a sale and leaseback transaction are usually in a stronger position to negotiate favourable terms for their leaseback of the property than an average tenant. Possible differences between a leaseback and a typical lease negotiated at arm's length include:

- **Rent** – The rent payable may be an open market rack rent subject to upwards only rent reviews at regular intervals, but it is common for leasebacks to provide for an index-linked rent (often with an annual cap and a collar) or a stepped rent with defined increases at prescribed intervals. When setting the rent the investor will be looking for the purchase price, together with an agreed return, to be amortized over the term of the lease.
- **Alienation** – Since the identity and covenant-strength of the seller in its capacity as tenant are usually critical to the buyer's investment, it is not uncommon for leasebacks to prohibit the seller from assigning the leaseback entirely or to provide for the lease to be assigned on one occasion only but subject to the seller providing an authorised guarantee agreement to the investor. This ensures that the seller will always be "on the hook" for compliance with the tenant covenants in the leaseback, including payment of the rent. In return for accepting tight constraints on its ability to assign, the seller will typically benefit from greater flexibility to underlet the property. If the leaseback contains open-market rent reviews, the investor should take care to ensure that any provisions curtailing the seller's right to assign the property are disregarded on rent review or otherwise dealt with to ensure that the seller is not able to cite the onerous nature of the restrictions to secure a below market rent.
- **Repair, yielding up and alterations** – The seller may be able to use its strong bargaining position to negotiate more favourable repairing and yielding-up obligations (e.g. fair wear and tear in the last few years of the term may be excepted and the seller may be able to hand back the premises in a broomswept condition without having reinstated works carried out by the seller during the term). There may also be scope for the seller to negotiate more flexibility in relation to alterations (e.g. structural

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alterations may be permitted to the extent that they do not damage the value of the landlord's reversion or the investor may be required to give consent at the outset for wide-ranging works to the property that the seller may wish to carry out at some point in the future).

- **Insurance** – Although in a typical leasing arrangement the landlord would normally insure the building and insure against loss of rent, the seller in its capacity as tenant may prefer to retain the insurance obligations in order to maximise control over the terms of the policy and to minimise the cost of the insurance.
- **Renewal and buy-back rights** – As mentioned above, the seller may mitigate some of the perceived operational risks relating to uncertainty at the end of the leaseback term by demanding that the leaseback contains renewal rights and possibly an option to buy-back the property. The seller may also require a right of first refusal in the event that the investor is looking to dispose of the property and there may be a limited category of persons to whom the investor is not permitted to sell the property (e.g. competitors of the seller).

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