EASING LIQUIDITY CONCERNS BY UNLOCKING CAPITAL FROM REAL ESTATE: SALE & LEASEBACK TRANSACTIONS

Heading into the COVID-19 crisis, demand from overseas investors for "trophy" real estate assets in the UK translated into significant sale and leaseback opportunities as businesses looked to alternative sources of finance. With liquidity becoming paramount in the face of the economic fall-out from COVID-19, we are seeing a steady increase in companies looking at sale and leaseback transactions as a possible way to unlock cash that is tied up within their real estate which can then be used to invest in their businesses, 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.

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 from their real estate.

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.

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 be useful where banks are reluctant to lend or 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. Further interest barrier restrictions, which can apply in certain circumstances on conventional financings to deny tax deductions for interest repayments, do not normally apply to rental payments under the leaseback.
- **Off balance sheet accounting treatment** – In the past there used to be an accounting benefit to the seller of off balance sheet accounting treatment for sale and leasebacks structured as 'operating leases' (as opposed to 'finance leases') but this has been eroded by IFRS 16 which now generally requires a proportion of the value of the property to remain on balance sheet. Broadly, IFRS 16 introduced a single lessee accounting model and, in every case, requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.
- **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, albeit none are likely to override a compelling commercial need to raise cash in this way. Indeed, most 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. However, 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. However, if cash is needed to help the business survive at a time of crisis, then this concern is likely to be overridden by the seller's commercial funding needs.

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. Tax on any gain would reduce the proceeds from the sale of the property, although that cost may be mitigated by the use of tax losses or other reliefs to offset some or all of the gain, depending on the particular circumstances of the seller.
- **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

"With liquidity becoming paramount in the face of the economic fall-out from COVID-19, property-owning companies are looking at sale and leaseback transactions as a possible way to unlock cash that is tied up within their real estate which can then be used to invest in their businesses, to discharge existing debt or to pursue alternative investments."

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 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).

CLIFFORD CHANCE

- **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).

CONTACTS

Ian Painter
Partner
Real Estate

T +44 20 7006 4972
E ian.painter@cliffordchance.com

Mark Payne
Partner
Real Estate

T +44 20 7006 2726
E mark.payne@cliffordchance.com

David Saleh
Partner
Real Estate Tax

T +44 20 7006 8632
E david.saleh@cliffordchance.com