FINANCE

The Attractions of a Sale-Leaseback

BY AVRY DAVIDOVICH

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For those whom I have had the pleasure of knowing professionally and even personally these past many years, your eyes do not deceive you — yes, it's me, Avry Davidovich. Fortunately, my accent is barely detectable on the printed page, and I am pleased to have the opportunity over the coming year to address important issues that affect the convenience store and petroleum industries. With almost 30 years of operator experience, I am confident that my insights will prove valuable and timely for your own operation. So, thank you, NACS, for giving me this opportunity. Today on the agenda: the sale-leaseback transaction.

Capital Needs

Thin margins, rapidly changing technologies that require ongoing financial commitments, escalating oil costs and a shrinking pool of financing sources mandate that an operator take full advantage of all assets in order to realize maximum growth potential. Along these lines, I have seen no better time than the present for convenience store operators to consider sale-leaseback financing.

While the intricacies of this complex financing vehicle extend far beyond the scope of this article, the basic financing concepts are important to understand

and consider. Essentially, in a sale-leaseback transaction, an owner sells the real estate component of an operating business to a third-party investor and obtains funds that can be used almost immediately to pay down debt or expand operations. Now, for some details.

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How It Works

In its simplest form, a sale-leaseback transaction provides for ownership transfer of a company's fixed assets — real estate, buildings and, in some cases, equipment to an investor, which in turn leases the property back to the owner under a long-term triple net lease. When structured properly, a sale-leaseback allows the seller to retain full operational control of the property. As to the reasons to consider such an arrangement, there are substantial tax benefits and business financing advantages. But there are other considerations too, including lowering debt-earnings ratio — which in turn improves corporate credit and reduces balance sheet debt.

For companies wishing to expand and purchase additional assets — that is, store locations — sale-leaseback financing can provide more capital than traditional mortgage financing. Whereas most mortgage lenders impose loan-to-value limits, a properly structured sale-leaseback can provide nearly 100 percent of current market value. From a tax standpoint, the seller realizes a capital gain (or loss) on the transferred asset and subsequently begins claiming deductions on full rent payments. Previously, the seller could claim deductions only on the mortgage interest component of his monthly debt service payment.

thegist

- It's a good time to consider sale-leaseback financing.
- You retain full operational control.
- Investigate the tax benefits and business financing advantages.

Sale-leaseback arrangements generally provide triple net leases of 15 to 20 years in the primary term, with renewal options of an additional 10 to 20 years. Rent is usually a fixed percentage of the purchase price, and periodic rent escalations are worked into the lease. An owner considering a sale-leaseback transaction should factor in rental expense in a sale-leaseback financing versus debt service payments in a traditional mortgage financing, keeping in mind the tax consequences of the respective payments. Such an analysis may very well provide additional motivation to consider sale-leaseback financing.

Caveat Vendor

Whereas in traditionally financed property purchases, the seller realizes the residual value on the back end (when the property is sold), in the sale-leaseback context, the residual value is essentially earned up front. In my experience, this scenario works to the seller's advantage in the vast majority of circumstances. It is only when property values escalate very quickly — for instance, in California — that traditional financing proves the better course.

Because of the sale-leaseback's long-term nature, it is imperative that the seller obtain competent legal counsel to negotiate the most favorable terms possible, which also meet the seller's business needs. There are also significant accounting concerns, and the sale-leaseback transaction must meet strict Financial Accounting Standards Board (FASB) requirements. If the arrangement is constructed incorrectly and therefore deemed a disguised financing transaction, both buyer and seller must restate their tax and financial treatment of the transaction. This restatement will result in additional tax and perhaps penalties.

Final Considerations

These are, of course, just the basics. But for convenience store and petroleum retailers wishing to guide their companies to continued growth, a sale-leaseback clearly provides an additional financing alternative for your consideration, especially if the owner has encountered difficulties with traditional lending sources.

To fully assess the viability of sale-leaseback financing for your operation, consult experienced professionals who can critically assess your current financial situation and holdings by way of their thorough understanding of accounting principles, tax laws and sale-leaseback arrangements. ○

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