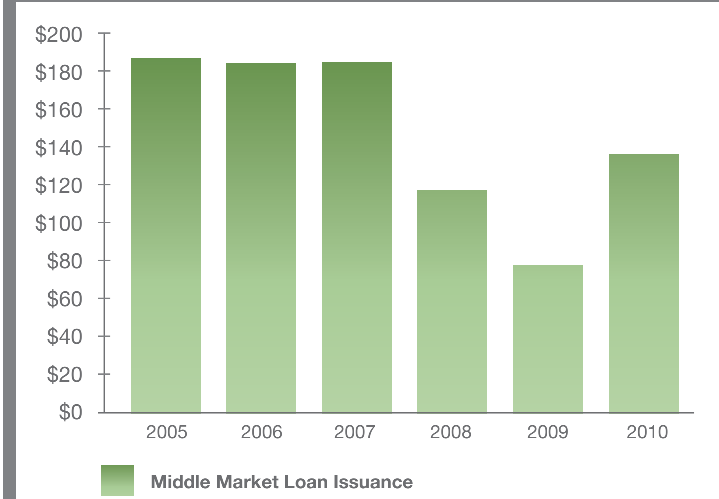
Sale-Leaseback Transactions:
A Financing Alternative for Middle Market Companies

Terrel G. Bressler – tbressler@srr.com
Tyler C. Willibrand – twillibrand@netleaseholdings.com – Net Lease Holdings, LLC

The last few years have been a very difficult time for middle market businesses. The general U.S. economic situation has affected many companies' ability to generate revenues and run their business operations. During the height of the recession, most capital markets were "locked up" making it difficult and in some cases impossible for middle market companies to attract bank financing to run and grow their businesses. Once the economy began to improve and the recession subsided, bank credit and other sources of capital became more available. As the economic recovery continues to build momentum, access to capital is generally improving.



Source: Reuters Loan Pricing Corporation/DealScan.

While banks are beginning to become more aggressive in pursuing new lending opportunities, bank credit is relatively expensive and more conservatively structured than prior to the recession. Furthermore, lower middle market companies, typically companies with less than $25 million in revenues, still struggle to find any bank financing at reasonable interest rates and terms.

The mezzanine funds have tried to bridge part of the gap in financing demand but at a significant cost. Mezzanine funds typically require an 18% to 22% all-in return which is comprised of a relatively high interest rate of 11% to 13% and warrants for equity to make up the additional return. While this type of capital can be useful if it really a very expensive part of any company's capital structure.

A company's investment in real estate and buildings are often overlooked as possible value in financing transactions. Many times the corporate real estate is underutilized as a financing source and is financed with a simple mortgage. An alternative to a mortgage financing that better utilizes a company's real estate is the sale-leaseback.

What is a Sale-Leaseback?

Most companies are not in the business of owning real estate but need the utility of land and buildings to produce their products or services. A sale-leaseback enables a company to reduce its investment in these non-core business assets (the land & building) and liberate the cash in exchange for executing a lease and paying rent. In a sense, a sale-leaseback separates the "asset value" from the "asset's utility value" in a company's real estate investment.

A real estate sale-leaseback is a transaction in which the owner-occupant sells the land and building used in its business operations to a special purpose investor and then simultaneously leases the property back from the investor on lease terms agreed to concurrent with the real estate sale transaction. Typically, this will be a long-term investment for the special purpose investor so the seller is able to negotiate directly with the investor a mutually agreeable and clear set of lease terms. Sale-leasebacks have become more popular in recent years as an alternative to mezzanine financing so companies can avoid the high mezzanine interest rates and dilution (ownership) requirements typically found in these types of debt structures.

Benefits:

In the right set of circumstances, a sale-leaseback transaction can have a number of benefits to the middle market company that is the real estate seller.

Set Your Own Lease Terms

Because the seller is also the lessee, the seller has significant bargaining power in structuring the property lease. In addition to realizing their investment in the real estate, the lessee has the opportunity to negotiate an acceptable lease agreement with the investor acquiring the property. Typical leases run 10 to 15 years. The seller, now the tenant, can also negotiate extension options after the lease expiration, and can also include terms for early lease termination if the tenant sees a need for more flexibility.

Retain Control of Real Estate

Most sale-leasebacks are structured as triple-net leases, so the tenant will be responsible for the taxes, insurance, and common area maintenance. A long-term, 'hands-off' lease from the investor provides the tenant similar control over the property as was the case when the tenant owned the property. The tenant can work with the special purpose investor and include options that will provide for future expansion and sublease of the property.

Tax Savings

Generally, lessees that are engaged in a lease are able to write off their total lease payment as an expense for tax purposes. As property owners, the interest expense and depreciation were the only tax deductions available. As a result, a sale-leaseback may have a greater tax advantage.

Greater Value to the Real Estate

Unlike a mortgage, a sale-leaseback can often be structured to finance up to 100% of the appraised value of the company's land and building. As a result, a sale-leaseback more efficiently uses the company's investment in the real estate asset as a financing tool.

No Financial Covenants

Because a sale-leaseback is not technically a financing instrument it does not have any covenants on the company.

Typical Covenants

Loans (Senior Debt)	Leases (Real Estate)
(1) Debt Service Coverage Ratio > 1.25x	Not Applicable ("NA")
(2) Monthly financial reporting requirements	NA
(3) Liquidity or asset turnover ratios	NA
(4) Minimum net worth requirements	NA
(5) Borrowing base limits including:	NA
80% on A/R less than 90 days	NA
50% on marketable inventory	NA

Fewer covenants provide a company with greater control over its own business and operations.

Attractive Implied Financing Rates

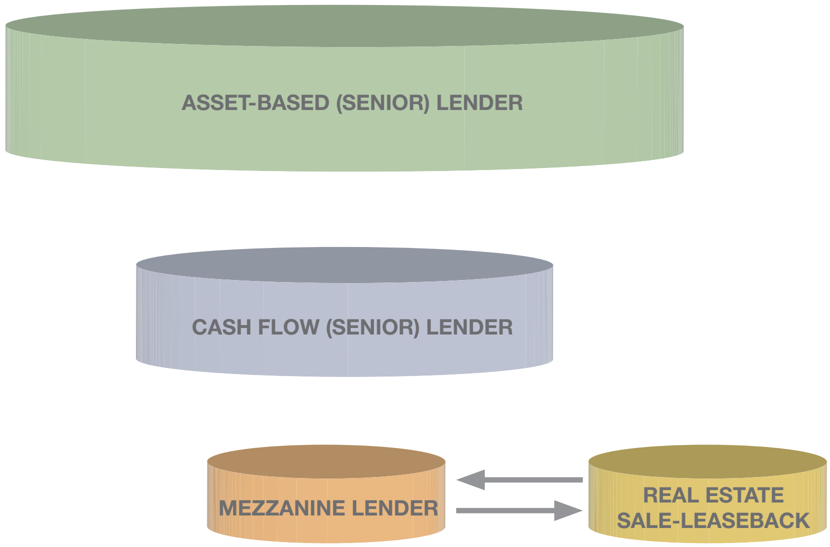
A sale-leaseback has an implicit financing rate, ("cap rate") imbedded in the future rent payments. Although the sale-leaseback cap rates are frequently slightly more than similar mortgage rates, a sale-leaseback provides cash proceeds for up to 100% of the appraised value of the property versus the 70% to 80% of appraised value under a typical mortgage. A sale-leaseback investor has only the real estate as collateral and a relationship with the seller through the lease agreement. As a result, the sale-leaseback is slightly more expensive than senior financing and less expensive than mezzanine financing.

Typical Sale-Leaseback Applications

Senior or Mezzanine Debt Alternative

As described earlier, typical mezzanine financing has an all-in cost of between 18% and 22%. These mezzanine lenders will often include PIK [Payable in Kind] interest and equity ownership as part of their total return structure. The implied financing rate, Cap Rate, of a sale-leaseback is generally hundreds of basis points lower than mezzanine capital and does not require equity ownership from the selling entity. The proceeds from a sale-leaseback transaction can be used to refinance the mezzanine portion of the capital structure or as an alternative, if there is no mezzanine to replace the company's senior debt. In both instances the company's balance sheets ratios will improve substantially.

“Alternative Financing” to Mezzanine Debt



Asset-Based (Senior) Lender
- Fully Secured by Tangible Assets
- Examples: Revolver, Real Estate Mortgages, or Equipment Loans

Cash Flow (Senior) Lender
- Mostly Secured by Tangible Assets
- Based on a Multiple of EBITDA

Mezzanine Lender
- Unsecured
- Rates 3-5 Years ago: 12% + PIK
- Current Rates: 16-18% + Warrants
- 5 year loan terms are expiring and refinancing alternatives are needed

Capital for Growth

A sale-leaseback can be used to free up cash to grow a business through acquisition or acquire additional facilities, technology, and equipment. With the tightening of the credit markets, many businesses do not have access to as much credit as they need to achieve their growth objectives; many are too close to their borrowing limit to consider expansion or make an acquisition of a competitor. Sale-leasebacks can be used as an off balance sheet financing structure that gives the seller the opportunity to turn a non-earning asset into growth capital. The company can then save the available bank financing for acquisitions and growth opportunities in the future. The sale-leaseback proceeds could also be used for other corporate purchases like the buyout of a shareholder or a special cash distribution to all the shareholders. The absence of covenants in sale-leasebacks provides business owners with significant discretion on what is the best use of their company’s cash.

Corporate Restructuring/Exit Financing

Businesses that are struggling for liquidity to pay creditors or are considering a bankruptcy might look to a sale-leaseback for capital. Depending on the value of the company’s real estate, a sale-leaseback can supply a considerable amount of liquidity and be a quick initial step to begin a reorganization process.

Sale-leaseback investors can work to meet tight time frames. If a potential seller is able to provide good historical financial statements, a business plan, and projections and a description of the planned uses of proceeds from the sale-leaseback as its role in the reorganization, then in these circumstances these special investors can make rapid investment decisions often within 45 days, if the due diligence materials are readily available.

Packaging Business for Sale

It is well known that most private equity groups are not in the business of owning and managing real estate. Often a savvy business owner who is contemplating selling his company can benefit by taking the real estate out of the company sales transaction and, by doing so, maximize the value of the real estate and increase the overall gross sale proceeds.

If the real estate is left in the transaction the full value is seldom realized, as the EBITDA multiple often does not value the company’s real estate at its true fair market value. Sale-leaseback investors will typically make their offer price based on an appraisal, extensive real estate market study, and a review of comparable market lease rates. The seller can complete a sale-leaseback and negotiate a long-term lease and pull out the real estate sale proceeds or repay corporate debt before the sale of the business.

The example on the following page shows how a sale-leaseback helps to increase the proceeds to the seller in a corporate sales transaction.

As shown, the rent expense will slightly lessen the EBITDA, therefore lessening the price of the operating entity. However, when the proper value of the real estate is recognized in a separate sale and added to the proceeds of the company sale a higher overall price is achieved.

Straightforward M&A Sale	
EBITDA	$ 4,000,000
EBITDA Multiple	5.0x
Total Purchase Price	$ 20,000,000

Amount allocated to Operating Co.	70%	$ 14,000,000
Amount allocated to Real Estate	30%	$ 6,000,000

Amounts allocated to Operating Co. vs. Real Estate may vary widely

Operating Co. Value post SALE-LEASEBACK	
EBITDA	$ 4,000,000
Rent Payment	600,000
EBITDA (Net of Rent)	$ 3,400,000
EBITDA Multiple	5.0x
Operating Co. Purchase Price	$ 17,000,000

ADD REAL ESTATE PROPERTY VALUE	
Rent Payment	$ 600,000
CapRate paid on Rent	10%
Equivalent Multiple paid on Rent	10.0x
Real Estate Purchase Price	$ 6,000,000
+ Operating Co. Purchase Price	$ 17,000,000
Combined Purchase Price	$ 23,000,000

SELLER'S ADVANTAGE	
Enhancement in Total Purchase Price	$ 3,000,000
Effective EBITDA Multiple	5.8x

FINANCING COMPARISON: Sale-Leaseback vs. Mezzanine Lending

SALE-LEASEBACK with NLH II		Mezzanine / Subordinated Lenders		Footnotes as related to Mezzanine:
Cash Rental Payment	8 - 12%	Cash Interest Rate	14 - 18%	Range varies depending on credit quality, total debt & EBITDA size
Other Costs/Fees	0%	Non-Cash Interest Rate	2 - 4%	Often consisting of PIK or expensive Warrants (equity substitutes)
Typical Lease Term (years)	10 to 20yrs	Typical Loan Term (years)	4 to 6yrs	Exposed to short-term interest rate volatility
Financial Statement Covenants	NO	Financial Statement Covenants	YES	Often includes limitations on Distributions, CAPEX & Total Debt
Off-Balance Sheet to the Operating Co.	YES	Off-Balance Sheet to the Operating Co.	NO	Credit markets can "dry up" based on economic factors

The Investor Underwriting Process

All sale-leaseback investors will follow a disciplined approach to conduct their due diligence that is similar to the due diligence efforts used when acquiring any real estate. Building and land appraisals, local market research, comparable lease and sale data, location, and accessibility analysis are just a few areas which will be considered during due diligence. The investor will also evaluate the tenant's credit strength using analysis similar to lending institutions and corporate acquirers. Finally, when a sale-leaseback investor considers an investment opportunity they will consider the long run marketability of the real estate once it is vacant.

The size and shape of the building will also play in the functionality equation when underwriting the property. The investor is very interested in the alternate uses and users for the real estate when the tenant vacates the property. All of these alternative use factors will affect the lease payment in the sale-leaseback transaction.

Conclusion

A sale-leaseback transaction represents another alternative middle market companies can use to raise capital and finance future operations and growth.

Sale-Leaseback Benefits

- Greater financing value for real estate
- No equity dilution
- Relatively quick closing
- No covenants
- Friendly lease terms
- Improved balance sheet
- Favorable borrowing rates (cap rate in the lease)
- Potential tax savings

Properly structured a sale-leaseback can more efficiently use a company's assets as a financing tool. It is important to work with an experienced team of attorneys, tax professionals and investment bankers to structure a deal that meets the company's specific circumstances. It is also important to find the right special purpose investors that will provide a market price for the real estate and negotiate a market lease with the seller.

Terrel G. Bressler is a Managing Director in the Investment Banking Group at Stout Risius Ross (SRR). He has originated a wide variety of M&A and capital raising assignments and has assisted numerous middle market companies and their shareholders with acquisitions, mergers, arranging debt, mezzanine and equity capital, and other investment banking transactions. Mr. Bressler can be reached at +1.312.752.3359 or tbressler@srr.com.

Tyler Willibrand works in acquisitions at Net Lease Holdings, LLC a real estate sale-leaseback fund based in St. Louis. Net Lease Holdings targets single-tenant real estate investments of $2 - $10 million, all over the United States. Mr. Willibrand can be reached at +1.314.991.1119 or twillibrand@netleaseholdings.com.