Financial Officer

SALE/ LEASEBACKS OF CORPORATE REAL ESTATE HOLDINGS

Volkswagen of America, Inc., needed to raise cash to invest in its core business and saw a sale/leaseback of some of its key operating properties as a way to accomplish this goal. Volkswagen raised $26 million through a sale/leaseback with TriNet Corporate Realty Trust, Inc., a company that specializes in the acquisition and management of long-term net leases of corporate real estate.

Major companies are realizing that by selling real estate assets such as corporate office buildings, retail outlets, and distribution facilities while continuing to occupy the property and maintaining long-term operating control, they have greater flexibility and additional resources to invest in their core businesses.

For Volkswagen, the sale/leaseback involved facilities that it was prepared to commit for a minimum of 15 years. These properties consisted of three modern, high-quality, general purpose warehouse and distribution facilities with a combined total of 629,000 square feet located in Los Angeles, Chicago, and Jacksonville. The transaction included a 15-year triple-net renewable lease.

Under a net, net, net lease, the lessee is responsible for rent payments and all expenses associated with the operation of the property—fixed expenses such as taxes and insurance and all operating expenses including costs of maintenance and repair. The lessee can lease the property for as many years as needed, usually 15 to 20, and can negotiate an option to renew the lease or to repurchase the property at the prevailing market price when the original lease expires.

Additionally, by structuring the lease as an operating lease in accordance with SFAS 13, "Accounting for Leases," a sale/leaseback is treated as an off-balance-sheet financing transaction. Thus, by removing a depreciating asset from its books, the selling corporation not only strengthens its balance sheet but eliminates depreciation expense.

Other benefits may include reduction or elimination of higher cost debt, expanded borrowing capacity, improvement in the company's net worth, capital ratios, credit rating, and reduction in future borrowing costs. Typically, the cost of a sale/leaseback is lower by approximately 150 basis points than traditional long-term debt financing because there is no residual value to pay back.

A sale/leaseback also can send a signal that a company is focusing attention and resources on growing its core businesses, which can result in an improved perception in the minds of stock analysts and investors. When entering into a sale/leaseback transaction, a company must have a clear view of its strategic objectives.

Sale/leaseback investors typically have the following objectives: to secure cash flow through rent payments, maximize the return on their investment, and minimize the amount of risk associated with the corresponding rate of return. Investors maximize the return on their investment by taking advantage of tax benefits associated with property ownership, taking advantage of the residual value of the property at the end of the lease term, and by negotiating rent payments that include an attractive rate of return. The lessee can write off the full amount of the lease payments for tax purposes.

Investors generally look for properties with fair market values greater than $5 million. They often will group a company's real estate holdings into a package to achieve the critical minimum purchase. Potential investors include insurance companies, pension funds, private and institutional investors, venture capitalists, and real estate investment trusts like TriNet.

A typical sale/leaseback transaction takes two to nine months to complete. The actual amount of time it takes to close the transaction depends upon the complexity of the transaction, the credit history of the lessee, the overall transaction size, the legal counsels and their familiarity with similar type transactions, the business purpose of the facility, and the viability and stability of the seller's industry.

Everything in the purchase contract and lease agreement is negotiable, within limits. Due to the long-term nature of a sale/leaseback, it is essential that the company employ a strong real estate professional with accounting and legal support for negotiating both the purchase contract and lease agreement.

A significant concern is the presence of environmental contamination and associated liability. Federal and state laws provide that the property owners, as well as the contaminator, are financially liable for any contamination, clean-up costs, and injured third-party lawsuits. As a result, investors and lending institutions together with their insurance brokers will conduct exhaustive investigations of the facilities to determine the existing conditions at the time of the purchase. Extensive exclusion clauses will be incorporated into the documents often with supporting tables, graphs, and site drawings to eliminate any financial exposure or liability for the investor. This activity substantially increases legal fees that are paid by the seller.

A sale/leaseback is a creative and increasingly common corporate finance transaction. Astute management recognizes that a properly negotiated and structured arrangement can optimize a company's return on its investment in real estate.—*Renita Wolf, CMA*

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