THE BOTTOM LINE

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Sale Lease-Back An Option for Owners

BY PETER MERRICK

Your best clients have worked hard to build a better life for their families and themselves by succeeding in creating solid profitable companies, which might also own the real estate on which they operate. But while owning both may have had practical reasons in the past, many sellers get an unpleasant surprise when they discover their business real estate presents a very real obstacle in the way of a headache-free retirement.

I would like to share with you the conversations I have observed over the years when it is time for your best clients to negotiate the sale of their companies to potential buyers:

Potential buyer: "Our group of investors want your company, but not your real estate."

Seller/client: "If I don't have my business, what good is owning a building that doesn't have a tenant?"

Potential buyer: "Sorry. But our firm is in the business of acquiring profitable companies, not in the business of managing real estate holdings."

These conversations are beginning to occur more and more as 550,000 businesses - half of all active Canadian companies today - are getting ready to change ownership within the next decade. These businesses have a collective estimated value of $3.7 trillion.

One method to mitigate these situations before they become an issue would be the implementation of the real estate sale lease-back solution, which would ensure putting equity back in your current business clients' pockets. To further explore this solution I began a very informative dialogue with Allen **Grinberg,** Executive Vice-President & Partner of Real Facilities, a leading corporate real estate provider in Toronto and contributing author for the real estate sale lease-back solution section of my LexisNexis 2013 book, Advisors Seeking Knowledge - A Comprehensive Guide to Succession and Estate Planning.

"On the first glance, it looks great that a business owns the real estate it operates from," **Grinberg** began. "Better to pay yourself rather than someone else, right? But trouble lurks ahead. You see, if you decide, like most people, that you want to sell your company and sell your real estate ... your real estate ... will be worth much less than if you were to sell it now and lease it back for a minimum term of 10 years, and then sell the business during the term of your lease.

"Business owners should be made aware that real estate values are far higher ... when they are sold with a tenant in tow rather than selling the asset empty."

To illustrate, **Grinberg** suggested imagining that your client first sells their land and building, but not their business, in order to realize capital gains and sock away some money for the future, kids or grandchildren. If the client sells the building empty, it'll be for 30 to 40 per cent less than what they could get selling it to an investor/buyer with a tenant paying rent.

Take the example of a business owning and operating out of a 100,000 square-foot facility. If they can sell the empty building for $50 per square, or $5 million, they will probably be able to sell the asset tenanted by their company for upwards of $70 per square foot, depending on how strong the company's financials and covenants are.

A covenant is how healthy a company is financially to pay the expected monthly rent that is owed, and abide by all the terms of the lease agreement. "In other words, the higher the covenant strength, the lower the expected capitalization rate the investor/buyer will expect to yield. Investor/buyers are willing to take smaller returns if they have a better comfort level that the tenant will not default on rental obligations," said **Grinberg.**

"So, if your client's company has been in business for 20 to 30 years and has a clean balance sheet, the investor/buyer will likely want to make a seven to nine per cent range as their return on investment (ROI) for your client's building and tenancy. If your client is a large organization with billions in assets, which most companies are not, then an investor/buyer will be willing to pay in the range of a five to six per cent return."

To clarify, let's say your client agrees to keep operating their business for the next 10 to 15 years, but wants their real estate capital now, the following will need to take place:

Assume that your client has a 100,000 square-foot facility, investors are willing to take an eight per cent return, and your client sells them the building and land for $7 million. Your client's $70 per square foot will now attach an eight per cent return which will translate into a $5.60/square-foot net rent ($70 x 0.08) with bumps over a 10-year term. As in the case of ownership, your lease-holding client would continue to pay the taxes, maintenance and insurance.

Most companies looking to buy other companies would much rather have the flexibility in dealing with the real estate component rather than being held to an asset that may not work for the long-term plans of the investor group buying a business. Usually, business investor groups are seeking a minimum of 20 per cent ROI, which conservative real estate holdings rarely yield.

"The trick is for your clients to get their money out now while commercial real estate values are high and while they still have their health to operate their business. The difference is staggering" and if it is not done "your client will lose out on being able to make a premium on their money while still operating their business," **Grinberg** said.

The real estate sale lease-back solution can perhaps provide your business clients with one less headache to confront when they do decide to make the transition.

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