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## Deal or no deal?

### THE PROS AND CONS OF SALE-AND-LEASEBACK ARRANGEMENTS

*Sale-and-leaseback deals by companies have become increasingly common. Interest has been further stimulated in the UK by proposed changes that will make it easier for property companies to become Real Estate Investment Trusts, or REITs, which enjoy considerable tax advantages. However, the economic and financial fundamentals offer a better guide than taxation as to when and where such deals make sense. Based on work Frontier has done with a number of clients, this bulletin works through the basic issues.*

The sale and leaseback of assets has become something of a corporate fashion. The proceeds have been used to pay off debt, finance new investment, narrow pension fund deficits or even return cash to shareholders. This marks a big change in thinking since the days when companies thought of their bricks and mortar as the family silver, to be held on to through thick and thin.

A less emotional view of the company's physical assets is certainly a step forward – but is the fashion in danger of being taken too far? In the retail sector, where the management of the property portfolio was traditionally seen as hugely



important to success, views on the virtues of sale and leaseback arrangements differ quite widely. This bulletin tries to help companies to weigh up the arguments, whose outcome depends on the nature of the business.

### BACK TO FINANCIAL BASICS

Among the reasons put forward for sale-and-leaseback deals are that they may:

- help companies to secure tax efficiencies;
- allow companies to take timely advantage of good financing deals; and
- help them achieve a re-rating, by boosting financial performance measures, such as return on capital employed (ROCE).

Of course, particular deals may deliver better tax positions, and markets may offer moments of opportunity for good financing arrangements. But not all transactions will offer these advantages. Meanwhile, the third argument ignores the fact that financial analysts increasingly recognise long-term lease obligations as debt, whether or not they appear on the balance sheet. Sale-and-leaseback deals are only likely to be seen as having a fundamental effect on the company's value, therefore, if they are seen as freeing management to spend more time on the things they are better at than managing a property portfolio.

The right place to start is with the financial fundamentals: in particular, the principle that the value of any asset should be equal to the present value of the cash flows that it will generate throughout its useful life. For commercial property, this value will normally be based on one of two calculations:

- the profits that the property owner can reasonably expect to earn from the business conducted on that property; or
- the stream of rents that the property owner can reasonably expect to be paid by someone leasing the property.

The two are clearly related. The higher the operating profits earned on the site, the more the rent for it is likely to be bid up. The precise relationship will depend on the characteristics of the local property market (location, the demand for commercial property, planning restrictions and so forth); but in general, the connection is clear. So if we assume that the financial markets are efficient, companies should in principle be indifferent as to whether they own or lease their properties. In practice, this means they need to review their strategic requirements and capabilities, in order to decide on which side of the fence to sit.

### FORGET THE FREE LUNCH

The principle of indifference reminds us that it is a fallacy to suppose that selling and leasing back property is a cheap way of raising capital. It is sometimes argued that this must be so, if the cost of capital in property is lower than in the core business. However, this argument fails to make the distinction between:

- the cost of capital for the activity from which funds were raised; and

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- the cost of capital for the activity in which the funds are deployed.

Investors will expect a return that is typical of the business you are investing cash in, not of the business that the cash came from. Investors care about the risk profile they are now assuming on the capital you are investing on their behalf. Unless, by chance, that activity has the same risk profile as the property side of the business, it is clearly unlikely that the cost of capital will be the same.

The principle of indifference should lead businesses to think more rigorously about whether they really want to be invested in property. It may be that understanding the property market is such a key competence in the business that it would be hard, or foolish, to try to separate this off. At the other extreme, many businesses merely own their property by default, have no special expertise, and hire management with quite different skills. The views of investors will be important: do they see the business as essentially property-related, or not?

Another way of looking at the same question is to ask whether a business that is currently leasing its property would do better to purchase it outright. Investors may very well be sceptical of large capital expenditures on property by companies with no particular expertise in the field.

### REMOTE CONTROL?

On the other side of the argument, however, is the loss of control that may arise from selling and leasing back assets. Most businesses can put up with the minor irritations that flow from living on a leased property, provided the contract is well-written. But assets are likely to be more valuable the scarcer they are, and the more profits they generate. A business will raise more cash from selling and leasing back core, scarce and strategic assets, and so these may be the ones for which the most tempting deals are offered. But these are also the assets a business least wants to lose control over. So there may be a serious tension between the desire to raise cash and the need to retain operational control.

It is possible to mitigate this loss of operational control by taking an equity interest in the landlord company. However, this obviously limits the amount of cash that can be raised. And a controlling stake risks the reappearance of the property on your balance sheet. If companies choose to go down the REIT path, they will similarly find it restricted, as REITs must be operated at arm's length from their tenants.

However, the change in legislation does offer the prospect of some significant additional tax advantages. This is because, in order to make it easier for individuals to invest in property, the Chancellor has decided to make it easier for property companies to become investment trusts, which in turn exempts them from corporation tax. It is too soon to say how significant this will be in terms of expanding the market for sale and leaseback deals. REITs may afford further tax breaks to companies for which sale and leasebacks already seemed to make sense. But just as with regular sale-and-leasebacks arrangements, the use of REITs does not give a business money for nothing.

Both methods help to raise cash. But with both, there is a requirement to pay rents that did not exist before. Whether either makes sense from a tax

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perspective essentially depends on whether there is a significant advantage in replacing the depreciation allowances the taxman is prepared to offset against profits with the rents payable to the new property owner or REIT. Clearly tax can distort investment decisions, but companies seeking to take advantage of the new arrangements should still have a weather eye to the fundamentals, not least because tax advantages often disappear almost as soon as they have arrived.

#### TOP TIPS FOR SALE AND LEASEBACKS

The fundamental arguments, as well as the tax ones, need to be weighed up on a case-by-case basis. So do the details of the risk exposures involved in the different types of deal. The following checklist may help.

- **Do think about the risk of an increase in the buyback price.** Accounting conventions prohibit you from fixing the buyback price at the outset, if the asset is to remain off-balance sheet. Property buyback prices are typically based on the open market value of rents on the assets at the time of buyback, so exposing you to risk.
- **Do avoid losing control of core, scarce and strategic assets.** Weigh up the pros of raising cash and taking assets off-balance sheet against retaining operational control (and think about alternatives).
- **Do separate your thinking about sale-and-leaseback from financial strategy.** There are other ways of raising money, after all.
- **Do not undertake sale and leasebacks to manipulate financial ratios.** Agree to sale and leasebacks only if they are likely to improve the underlying value of the business.
- **Do not assume the deal will automatically increase value.** Assess whether temporary market distortions offer a genuine opportunity

#### CONCLUSION

The British Chancellor's announcement that he intended to make it easier for real estate companies to become REITs has further stimulated the corporate appetite for sale-and-leaseback deals. Such deals have already proved attractive to many international companies. A proper assessment of pros and cons, however, requires more than a tax calculation. What is needed is a full analysis of the extent to which loss of ownership of the assets will constrain the strategic development of the business, or free management to focus on the issues key to its success.

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