

## assetmonetization

# monetization of owned real estate via sale/leasebacks

The Federal Reserve raised rates four times during 2018, most recently in December. Major stock indexes have rallied this year despite mounting evidence of a slowdown in global growth, in part because central banks signaled they will back off plans to normalize monetary policy. Bullish views changed when reported factory output in the eurozone fell in March at the fastest pace in nearly 6 years, and a gauge of US manufacturing activity slipped to its lowest level in two years. The Japanese government downgraded its assessment of the economy for the first time in three years, blaming the U.S.-China trade war for slumping exports and industrial output. Stocks responded to this news by posting their second biggest one-day loss of 2019 and, perhaps more importantly, the U.S. Treasury yield curve inverted for the first time since 2007.

Bond markets globally have been raising red flags about a slowdown, and these signals have recently become more pronounced. In the U.S., the spread between the 3-month bill and 10-year note inverted late March, which is widely viewed as an important economic recession indicator. According to the Federal Reserve of San Francisco, an inversion of the yield curve has heralded every U.S. recession since 1955 with only one exception. Timing is less clear: During the last cycle, the spread fell below zero in January 2006, almost two full years before the start of the recession. In Germany, where the export-driven economy

is highly sensitive to slowing global growth, yields went negative for the first time since October 2016, leaving its Central Bank little room to maneuver if recession strikes. Other countries in Europe and Japan are in a similar position with no room to ease if easing is needed to boost economic conditions.

The long federal government shut-down, global trade tensions, slowing growth in Europe, China, and Japan, and an unresolved Brexit plan have caused a slowdown in growth that has changed the U.S. economic outlook. The U.S. economy expanded by 3.1% in 2018, and the Fed's most recent

outlook for 2019 is 2.1%. In March, the Fed signaled a dovish outlook, saying it is unlikely to raise rates at all during 2019 and will end the draw-down of its balance sheet in September. More bearish views anticipate a cut in rates by the Fed in 2019.

Is this the long-awaited slowdown of the economy or signs of a pending recession? Only time will tell.

Now is an opportune time for businesses to consider a sale/leaseback of owned real estate. Cap rates are at historic lows and are likely to remain low even if interest rates begin

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to climb. The spread between cap rates and interest rates remains above peak lows for many properties, offering room for spread compression to off-set rising interest rates. The flood of private investment capital for real estate resulting from changes to the tax code will keep cap rates low and broaden the risk profile that investors are willing to accept. Ample and cheap debt, improving real estate fundamentals, and strong risk-adjusted returns for real estate will keep investor demand high. Importantly, the new tax code will shift tax efficiencies from owning to leasing for many businesses, adding supply to a product-starved demand.

### Monetizing Owned Assets Offers Advantages to Corporate Owners/Occupiers

#### Optimizes the new tax code

Owning real estate will no longer offer the same tax benefits for many corporate occupiers. This is especially true for businesses that exceed the 30% threshold for interest deductibility as the cap doesn't apply to nominally non-interest expenses, like rent. Rent expense resulting from a lease will continue to be a deductible item under the new code, making leasing a better choice for many companies.

#### Accesses low-cost, long-term financing

The pricing of capital in a sale/leaseback is at peak aggressiveness for quality properties. Cap rates are at historic lows, so locking in inexpensive capital via a sale/leaseback is a smart move. Corporate borrowing requires full principal repayment; sale/leasebacks provide positive leverage to a company,

as only a portion of the capital is typically recovered during the term of leaseback. This arithmetic results in a cost of capital in a sale/leaseback that is often below corporate costs of debt once principal repayment is included.

#### Improves financial performance

Sale proceeds raise cash, and the capitalization of leases often results in a smaller balance sheet impact than most ownership financing scenarios. Using monetization proceeds to pay down debt cuts interest expense and enhances borrowing capacity by deleveraging the company, and removal of depreciation expense resulting from the sale can increase earnings-per-share. For financial institutions, monetizing owned properties can relieve stress as they face a tighter regulatory environment requiring higher capital reserves against owned real estate.

#### Unlocks capital for growth and operations

Capital locked in bricks and mortar provides no real return for a business and monetizing these illiquid assets liberates capital for more productive uses. Companies achieve a significantly higher return on capital invested in their core business than the cap rate defining the leaseback expense.

#### Raises capital via non-traditional sources

Maintaining cash and preserving traditional lines of corporate borrowing are important as the global economic recovery continues. Real estate investors and their lenders are new sources of financing that do not require restrictive covenants found in most corporate debt instruments.

#### Transfers obsolescence and residual risks of ownership

Monetization can be achieved with relatively short terms of leaseback for

quality real estate assets in healthy markets, making a sale/leaseback a strategic option for maximizing proceeds while planning for changing occupancy requirements. Selling assets subject to leases of even a few years can create higher net proceeds than selling properties once they are vacant. Additionally, a sale and partial leaseback can be a great option for companies with smaller space requirements today. The new tax code rewards spending on most major improvements, which should increase investor appetite for value-add opportunities like partial sale/leasebacks.

#### Maintains control of property for as long as needed

Lessees can maintain flexibility and asset control for extended periods through renewal options, expansion rights, and other lease clauses. Repurchase options or participation in residual upside can be achieved, depending on the accounting treatment desired for the leaseback.

The timing for monetization of corporate owned and occupied real estate is very favorable today, and the newly signed tax law will increase motivations by both corporate owners and investors. Corporations can optimize tax positions, access new and cheap sources of capital to liquefy non-productive assets, improve balance sheet performance, facilitate right-sizing, and maintain asset control while transferring risks of ownership.

### For more information:

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