monetization of owned real estate via sale/leasebacks

December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act, a $1.5 trillion tax cut that is the most comprehensive tax legislation in more than a generation. The largest element of the revised tax code is that businesses will be able to reduce tax rates from 35% to 21%, an essential element to the administration's goal of making American businesses more competitive. Capital investment also gets a boost: Over the next five years companies will be able to immediately deduct 100% of the cost of investment in equipment and other qualified property, offering a powerful incentive for businesses to invest.

Not everything in the Act will be positive for all businesses. The new tax code limits the net interest payments a company can deduct to 30% of its adjusted taxable income, which approximates its EBITDA. Any amount above 30% will not be deductable. This tax change could hurt weaker companies and make them more susceptible to deeper financial problems if earnings decline and interest expense grows as a percentage of EBITDA. Further, EBITDA changes to EBIT beginning 2022, when companies will no longer be allowed to exclude depreciation and amortization for the 30% test, making the cap easier to reach.

The clear winner appears to be commercial real estate investors. Pass-through entities will be eligible for a 20% income deduction, full deductibility of mortgage interest expense, full deductibility under a broadened range of capital improvements for the next five years – all on top of the lower tax rate. Most real estate investment vehicles are structured as pass-through entities, which will undoubtedly increase investment capital seeking real estate.

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 as interest rates climb. The spread between cap rates and interest rates is still above peak lows, offering room for spread compression to offset rising interest rates. The expected flood of investment capital for real estate triggered by changes to the tax code will keep cap rates low and broaden the investment 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.

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assetmonetization

Monetizing Owned Assets Offers Advantages to Corporate Owner/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 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 under current lease accounting, rent expense for operating leases is reflected in the footnotes. This will soon change under the new lease accounting standard. Still, the capitalization of leases will result 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 rate of 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 typically 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.

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