Lease-back sales gaining traction in SA

According to commercial property consultancy Knight Frank, lease-back sales are fast gaining traction in the South African marketplace, and are now an increasingly popular component of company financial management and a preferred option for many commercial and industrial property owners.

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Says John Jack, head of Knight Frank Corporate Real Estate states, "Retaining control of production or operations while freeing up capital has become a necessity to many businesses, with lease-back deals offering exactly that. As a company, we've noticed a marked uptick in the number of such deals in recent months, a trend we expect to continue well into 2017."

Access to illiquid capital

In a typical sale-leaseback transaction a property owner sells its owner-occupied building to an investor in exchange for a lease commitment (typically long-term) by the owner. This transaction allows the owner company to access otherwise illiquid capital tied up in its real estate and redeploy this capital in order to achieve higher returns, typically into its core business. Buyer demand is strong with many investors seeking long-term stable and predictable bond-style returns through corporate leased real estate assets.

Knight Frank recently concluded a sale and lease-back deal whereby a portfolio of 16 properties in Nampak's property portfolio was sold to Collins Property Group for a total of over R1.7bn. One of the properties was an outright sale. "Nampak will lease the properties for 15 years, with an option to renew the leases for a further 10 years," says Jack.

The deal was in line with Nampak's strategy to deleverage its balance sheet, strengthen its debt covenant positions and create the capacity for future growth. Said Nampak chief financial officer Glenn Fullerton at the time, "The transaction has significantly improved the group's gearing ratio through a boost to equity and a substantial reduction in interest-bearing debt, with a clear focus to now deploy capital for the highest return."

"Seller benefits from sale and lease-back transactions are numerous," says Jack. "The sale of core and non-core properties generates immediate cash flow and allows companies to place proceeds in their higher yielding core businesses or embark on new acquisitions which can significantly enhance shareholder value. Other benefits include an improved balance sheet, reduced debt, improved profitability and also reduced risk due to fixed future occupational costs."

Analyse the current market cap rate

Leasing versus owning real estate is a capital allocation decision affecting both balance sheet and income statement. When considering a sale-leaseback, a company must analyse the current market capitalisation rate (cap rate), the book value and residual value of the property, the corporate tax rate and proposed triple-net lease rate (a lease agreement on a property where the tenant or lessee agrees to pay all property taxes, building insurance, and maintenance - the three 'nets'- on the property in addition to normal rent or utilities fees as expected under the agreement). Unlike other types of transactions, sale lease-backs can place as great an emphasis on the seller/tenant financials as they do on the characteristics of the asset itself. As with all real estate transactions, asset quality, asset location and lease structure are, of course, considerations in the pricing.

While sellers are looking to free up capital to reinvest in their core business, investors are seeking a predictable investment return for a period of time. Adds Jack, "Advantages to the investor in a sale and lease-back deal include a predictable long-term stream of cash flow, relatively low management required for the investment, as well as the appreciating value of the property and annual rent increase which can provide a hedge against inflation."

Evident abroad

The sale lease-back trend has been evident abroad for some time, particularly in the US and Europe. Even in the UK, where the Brexit announcement hangover has investors wary of making any big moves, lease-back sales appear to be on the increase. In a recent example, a South East Borough Council of Surrey sealed a £360m sale and lease-back transaction with BP over a 20-year lease agreement in a deal described as the biggest commercial property transaction ever undertaken by a UK local authority. In North America the same trend is evident. In August this year US luxury retailer Coach Inc concluded a record deal worth $707m on their New York headquarters under a sale and lease-back agreement over a 20-year lease agreement.

"In South Africa, the seller needs to consider the implications of IAS17 which sets out the required accounting treatments and disclosures in terms of categorisation of the lease," states Jack.

Knight Frank has a proprietary system called Tracker where all industrial and office properties are geo mapped and the relevant vacancy and lease information is captured. Their research team absorbs over 180 vacancy schedules monthly. "In order to determine market rental levels we compare buildings that are currently held for let in the area. These figures are then proposed to the bidder who may want to negotiate further," he explains. "Ultimately we agree on a number suitable to both parties that is market related. The yield is determined by the strength of the lease covenant (in the case of a listed company, such as Nampak, this is very strong), term of lease (as this effects gearing for the investor) and, whether or not the rentals are above or below market," Jack says. "Above market rentals mean the investor will have to take into account the inevitable rental reversion to market at a point in time, so this always avoided as it leads to overpayment on the asset."

"Going forward, and given the current economic climate, we suspect the number of companies interested in pursuing this as a real estate strategy will undoubtedly increase," says Jack.