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Insights

IMPROVING LIQUIDITY FOR ASIAN REAL ESTATE INVESTORS - PART 3

SALE AND LEASEBACK ARRANGEMENTS

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SUMMARY

A common route for property owners to effect divestiture of their real estate assets to de-risk their investments and to improve liquidity is to sell down part of the asset and form a joint venture with the buyer. Alternatively (or as a hybrid), an owner may sell the whole or part of its properties – but on the basis that it receives a lease back immediately on completion so that it can continue to use the property (or properties). In this third article in our "Improving Liquidity for Asian Real Estate Investors" series, we explore sale and leaseback arrangements and how these arrangements can help de-risk investments and provide liquidity for real estate investors in Asia.

In case you missed them, you may be interested in Part 1 and Part 2 in the series which examined the key issues that Asian real estate investors should consider if they are contemplating a partial sale and entering into a joint venture with a new capital or operating partner.

HOW IT WORKS

As the name suggests, a sale and leaseback transaction is where an existing owner or investor of real estate sells a property to a buyer and immediately upon completion, the buyer leases the property back to the seller. The seller who has then become the tenant is therefore able to continue to occupy the property after the sale and, in the case of a corporate seller, to continue its trade or business from the same property. In some sale and leaseback arrangements, the seller/tenant has the option to repurchase the property from the purchaser/landlord at the end of the term of the lease. Alternatively, there may be an option for the seller/tenant to renew the term of the lease.

INCENTIVE/ COMMERCIAL DRIVERS

The most obvious incentive for an existing property owner to enter into such transaction is that it will be able to release capital from the property while also continuing to use it and generate an

income stream from the property. It can be a very helpful solution for businesses who have run into cash flow problems during times of economic distress. The proceeds from the sale of the property can help alleviate liquidity issues and help keep the business operating as a going concern. In addition, it is a particularly relevant option for a business which has already charged or mortgaged the property for prior financing or otherwise has a high debt to equity ratio and is unable to resort to further financing.

Sale and leaseback transactions are seen in respect of a range of real estate assets. Where the subject property is a "trophy asset" (which refers to a property that is in exceptionally high demand by investors due to its underlying "real" and intrinsic property value and fundamentals, such as an iconic office building in a prime location), the sale of the trophy asset would allow the owner to benefit from the high demand and realise the "trophy" value of the property which the owner would otherwise be unable to monetise. Sale and leaseback arrangements are also common in respect of large retail premises and industrial buildings (such as manufacturing factories or logistics centres), as the business activities in these types of properties generate income without requiring ownership of the properties per se. In the hotel context, it could be a sale by the brand and "manage back" of the premises.

From the perspective of the purchaser who will become the new landlord, its incentive of entering into such arrangement is in securing a specified return on investment, being the rental receivables from the lease. The rent payable by the seller/tenant would be negotiated and calculated at the outset with reference to the purchase price and an agreed return. The lease typically has a longer lease term compared to the term of an average lease of the same type of properties, so as to allow the purchaser ample time to realise their return on the investment. This saves the purchaser/landlord's cost and time in looking for a tenant replacement every few years. While it is an inherent risk in every leasing transaction that the tenant may default, the risk of the seller/tenant defaulting in a lease under a sale and leaseback arrangement is arguably lower. Given that the scale of a sale and leaseback transaction as compared to a typical leasing is often larger, the purchaser/landlord would have more opportunity and information to gauge the strength of the creditworthiness and covenant strength of the seller/tenant. To the benefit of both parties, time and costs may not need to be incurred in fitting out of the premises and the existing business can continue to trade uninterrupted (on a "business as usual" basis) notwithstanding the change in ownership of the underlying property. If the lease has a long term, however, a key issue for negotiation will be the "hand back" condition. We will discuss this in more detail below.

DRAWBACKS

From the perspective of the purchaser/landlord, its main risk is the default of the seller/tenant, as discussed above. Further, compared to a more traditional lease, it may have less control over the property than a typical landlord since the seller/tenant is likely to have been already using the property for a certain period of time and will typically look to maintain as much as control as

possible over the premises (despite the sale). Some common issues which arise in lease negotiations are highlighted in the next section.

From the perspective of the seller/tenant, it loses the chance to benefit from any capital growth of the property after the sale in a rising market (unless the purchase price of the sale has factored in and reflected such consideration). On the other hand, if the property market (in particular, the commercial rental market) is experiencing a downturn, whether the seller/tenant will effectively suffer a loss from the arrangement depends on how the rent under the lease is structured or determined. If there is no rent review clause or if there is an upward-only rent review clause, the seller/tenant will likely be paying a higher rent than market rent during a downturn, since the lease term in a sale and leaseback arrangement is generally longer than average and it may not have the opportunity to renew the lease and negotiate for a lower rent. This is to be contrasted with the more advantageous position of the purchaser/landlord in this respect, who, in the event of a rising market, will get the increase in the value of the property, and in the event of a depreciating market, will receive a stable stream of predetermined rental income.

LEASE NEGOTIATION

The power dynamics and the focal points in the negotiation of a lease in a sale and leaseback arrangement can differ from that of a more conventional lease negotiation. This is because the seller/tenant will most likely already be in occupation and have control of the property prior to its sale. If the seller is the party initiating the process, it may well have greater expectations (compared to a tenant under a conventional lease) in respect of its bargaining power and the control it should have over the property during the lease term.

In this section, we discuss some of the common issues that we often see arise during the lease negotiation.

Structural Alteration

A tenant typically does not have any right to make any structural alterations (such as changes to the roof or the external walls) in respect of the property, but the seller/tenant may insist on having such rights so to have maximum flexibility to alter the layout of the property to suit its operational/business needs.

Yielding-up / Dilapidations / Make Good

The condition upon which the property is to be handed back to the purchaser/landlord at the end of the lease is often also a heated point of negotiation. The yielding-up or dilapidations or make good clause in a commercial lease typically would require the tenant to yield up the premises to the landlord in the original condition it was in at the commencement date (or alternatively, in a bare shell condition). In either case, the tenant would be required to reinstate any changes it made to the premises (unless otherwise agreed). In a sale and leaseback arrangement, as the property is not

actually handed over by the landlord to the tenant at the start of the lease, there may be no "original condition" to be referenced to as the yielding-up standards. Also, there may be existing unauthorised structures or defects of the property which the purchaser would want the tenant to make good before it hands back the property at the end of the lease (see further below on existing compliance issues). Further, the seller/tenant may already have in mind certain structural alterations that it plans to carry out during the term and it will not be keen to have to incur costs at the end of the lease term to undo these works. Both parties should carefully consider what condition the property should be in at the end of the lease and make it as clear as possible in the lease (e.g. by drawing up a schedule of dilapidations with diagrams and photo references for clarity).

Pre-existing compliance issues

The purchaser may discover during its due diligence that there are compliance issues with the property or its usage. Examples of such issues include building notices issued by the building authority regarding unauthorised building works not having been rectified or appropriate licence not having been properly obtained for its specific industrial use. Unlike a typical sale and purchase, a seller/tenant still has a stake in the subject premises after completion and therefore, if the non-compliant issues are not resolved prior to completion, the parties need to consider and make clear in the lease document how such issues should be handled and how relevant risks should be allocated between them. For example, which party will bear the costs of rectifying the issues during the lease term? Will the seller/tenant be allowed to continue to operate in and use the property pending the rectification of the issues?

Insurance

In a typical leasing arrangement, it is usually the landlord who has the obligation of obtaining insurance in respect of the premises. In a sale and leaseback setting, the seller/tenant may be the party to bear the insurance obligations instead. Since the seller/tenant would already have been obtaining insurance in respect of the property prior to the sale, it may be more cost-effective for the seller/tenant to continue the existing insurance coverage or that the seller/tenant may wish to ensure that the insurance coverage is within its control. There have been cases where it is commercially impossible for the purchaser/landlord to obtain an insurance coverage as good as the existing insurance and it may make commercial sense for the parties to shift this obligation to the tenant.

Alienation / assignment

As discussed, the identity and covenant strength of the seller/tenant is one of the key (if not the key) commercial drivers for the purchaser entering into a sale and leaseback transaction. The purchaser/landlord would therefore be reluctant to allow the seller/tenant to assign the lease to an unrelated third party or to otherwise part possession with the property. It is nonetheless noted that in

the commercial leasing market of Hong Kong, the tenant's right of alienation/assignment is usually very limited in any event even in a typical leasing arrangement.

CLOSING REMARKS

Like partners in a joint venture, the seller/tenant and the purchaser/landlord in a sale and leaseback arrangement will hopefully have a collaborative and mutually beneficial relationship. However, their interests will not always be aligned. While on some issues (such as the need to maintain the property and to ensure compliance with legal and regulatory requirements) their interests will be aligned, on others (such as the allocation of risks and costs and the rent review mechanism), they will not. Before contemplating a sale and leaseback transaction, investors should carefully consider these issues ahead of time and set out the agreed positions clearly in the sale and purchase agreement and the lease document.

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