As published in the Restaurant Finance Monitor, Volume 26, Number 7, July 16, 2015

Sale-Leasebacks: Caveat Venditor

By Chris Kelleher, Managing Director, Auspex Capital

Most people are aware of the Latin phrase, "Caveat emptor," or "Let the buyer beware." In today's turbo-charged sale-leaseback market, restaurant owners also should know the Latin term "Caveat venditor!" or "Seller beware!" Any operator with more than a dozen units is getting a call a week from someone promising to turn their real estate into gold.

Before selling your real estate and leasing it back, it's important restaurant owners have a thorough understanding of what they are getting into. Investors buying restaurant properties at these cap rates aren't looking at the underlying intrinsic value of the real estate and improvements. What they're buying is a long-term income stream which, when compared to the yields currently available from the bond market or bank CDs, offers a comparatively attractive return. (Whether they are actually getting that is a topic for a separate discussion.)

As expected, investors want to ensure the long-term revenue stream they buy is never interrupted. To accomplish that, they enlist their lawyers to work on the leaseback portion of the deal, which is where things can get dicey for the unwary franchisee. A restaurant owner entering into a sale-leaseback transaction must approach lease negotiations with the same level of diligence as with any landlord. Unfortunately, the pot of money sitting there ready for the taking has a way of distracting attention away from the last 20 to 25 pages of the lease agreement.

The most prominent areas of concern I see are as follows:

Overly broad environmental indemnities

Sale-leaseback buyers expect the seller to fully indemnify them for any environmental problems and these indemnities find their way into the lease. The problem arises when the franchisee goes to sell his business and asks a buyer to assume the lease, and therefore the environmental indemnity. The buyer will have second thoughts about assuming real estate liabilities the seller took on as part of selling the properties. Those second thoughts may translate into a material reduction in the sale price of the business.

Broad UCC filings can impair the owner's ability to leverage his business

Sale-leaseback buyers expect a seller to provide clear and unfettered title to the properties. Many sale-leaseback providers secure title, in part, through a security agreement and UCC filing on "fixtures," which are typically defined as equipment permanently affixed to the real property. If the sale-leaseback buyer's definition of fixtures is overly broad, future lenders to the restaurant business may not be able to use the fixtures as collateral to secure their loan.

Difficult assignment provisions can impair of complicate the sale of the business

Sale-leaseback buyers have a strong say in who will occupy their property. While it is not unusual for landlords to have consent rights for lease assignments, landlords are notorious for imposing comprehensive and restrictive consent rights, which can complicate a sale of the restaurant business and/or impair its value.

Master leases impair flexibility and raise franchisor ire

Sale-leaseback buyers acquiring multiple properties often require a single "master lease" covering all of them. A master lease affords the landlord numerous economic and legal benefits, all of which may be to the determent of the restaurant tenant. When it's time for the tenant to exercise an extension option, the tenant also will have to extend the lease on money-losing restaurants, too, or risk losing his good stores. Many franchisors have become aware of how damaging this loss of flexibility to their franchise system is, and some are now prohibiting their franchisees from entering into master leases.

Complicated process to get lease modifications
Many properties subject to a sale-leaseback end up in the hands of large institutional investors. The leases, with extensions, may last 40 years or more. Invariably, over such an extended period of time, situations arise that necessitate adjustments or modifications to the lease. Even if the tenant is lucky enough to get a return phone call or email, the chances of a landlord representative having an understanding of restaurant industry issues, or local real estate market dynamics impacting the occupancy, are remote.

Ongoing corporate or personal guarantees
It's not unusual for the sale-leaseback buyer to require corporate and/or personal guarantees. While it's perfectly reasonable to ask a tenant to stand behind the lease, the tenant needs to understand the guarantees will, in all likelihood, remain in place forever. It is highly unlikely a landlord will release a guaranty, even if the tenant sells his restaurant business.

Other onerous lease provisions
A restaurant owner who enters into a sale-leaseback must pay close attention to all of the details of the lease. Left unchallenged, a sale-leaseback buyer will impose as many landlord-friendly provisions as the restaurant owner and his lawyer will allow.

Other lease provisions tenants should be concerned about include out-of-market insurance requirements, restrictions on upgrades and remodeling, one-sided casualty and condemnation provisions, leasehold or equipment lien restrictions, limited alternative-use restrictions, continuous use clauses and onerous sublease requirements.

High transaction costs
Real estate brokers typically charge 4% to 6% to place sale-leasebacks. The buyer typically requires the seller to provide Phase 1 environmental reports, ALTA surveys and physical inspection reports. Those three reports can easily total $10,000 per property. Other transaction costs typically absorbed by a seller/tenant include title, escrow and legal fees. Many states impose real estate transfer taxes, which can be substantial. When all is said and done, the total cost of the sale-leaseback could exceed 10% or more of the gross sale price.

A sale-leaseback may trigger capital gains and depreciation recapture taxes
Sale of appreciated real estate will trigger capital gains and depreciation recapture at the federal, state and even local level. The long-term capital gains rate, now 20%, and depreciation recapture, which is taxed at the ordinary income rate, can when the 3.8% Obamacare surcharge is included, be as high as 43%. State income taxes may make it even higher.

In some states the sale-leaseback will trigger property tax reassessment
Some states, including California, reassess real estate whenever a property is sold. Restaurant tenants are obligated to pay the property tax. Restaurant owners, particularly those who have held their restaurant property for a long time, could be in for a shock when they get the first property tax bill after a sale-leaseback. To make matters worse, if the sale-leaseback buyer later flips the property for a profit, the restaurant owner will get hit again.

One of the most common refrains you hear from someone pitching a sale-leaseback is this: "Are you in the restaurant business or in the real estate business?" The reality is this: Regardless of whether you own or lease your properties, you are in both businesses. To be a successful restaurant operator you must understand real estate, or have trusted advisors that do. A thoughtfully crafted, carefully structured sale-leaseback, placed with a reliable investor is a powerful financial tool to cost effectively free up equity—equity that can be redeployed to acquire or develop additional units.

It is important for restaurant owners to know it's a seller's market right now. That means high prices for restaurant properties, but perhaps more importantly, owners can negotiate more favorable lease terms.
Restaurant owners contemplating a sale-leaseback, however, must keep in mind that 20 years is a long time. Factoring in 10% rent bumps every five years can really add up. My advice: When negotiating the lease, the devil is in the details. Caveat Venditor!

Chris Kelleher is Managing Director of Auspex Capital, an investment banking firm specializing in the restaurant industry. You can reach him at (562) 424-2455 or ckelleher@ auspexcapital.com.