

SALE AND LEASEBACK TRANSACTIONS

LEVERAGING CAPITAL FROM REAL ESTATE PORTFOLIOS

The COVID-19 pandemic has put a considerable strain on the cashflow of many businesses. With traditional debt markets hardening, sale and leaseback transactions may be an attractive alternative, enabling access to capital from valuable real estate while remaining in occupation. We consider three key areas for potential corporate occupiers to consider.

1. Transaction structure

Sale and leaseback transactions come in a variety of forms. The structure may affect the level of rent and consequently the purchase price that the selling occupier receives. It will also be critical to the tax treatment and therefore tax cost of the transaction.

The investor will commonly acquire a freehold or long leasehold interest and immediately grant a lease back to the seller. The lease may include a combination of:

- A market rent, likely to result in the highest purchase price received by the tenant, often with five-yearly upward-only open-market rent review
- A (lower) ground rent. This can work well with traditional funding (subject to lender consents) as capital value remains in the lease, which can therefore be used as security, as well as providing comfort to the investor who could realise that value in an enforcement scenario
- Index-linked rent review, usually subject to a cap and collar
- A term of anything from c. 20 years for market rent arrangements to over 100 years for ground rent arrangements
- An option for the tenant to re-acquire the interest at the end of the term. If for a nominal amount, the arrangement is known as an “income strip” and pricing will reflect the rental stream only, not any additional reversionary value to the investor
- Options to renew, often with a day-one rent review.

2. Covenant strength

The price the investor is willing to pay will be affected by the covenant strength of the leaseback tenant as well as the intrinsic value of the property itself. Certain investors will only accept tenants with investment-grade ratings.

An appropriate guarantor may be required to support the tenant’s covenant, but other forms of security which are traditional in leasing more generally are unlikely to be appropriate for a transaction motivated by a desire to access liquidity.

The investor’s concern for an appropriate covenant may result in specific controls on assignment of the lease, such as the need for any assignee to meet a particular profits test or rating requirement. This may affect the future marketability of sites within a tenant’s portfolio.

3. Occupier not owner

Implementing a leaseback will result in a loss of control as the tenant gives up its rights as owner to the more restricted position as occupier. The impact on operational flexibility, as well as indirect costs associated with such controls, need to be considered as part of the overall package.

Thought should be given to the degree of flexibility realistically required for changes of use, alterations, and even disposals of the lease should the tenant’s business needs change. This will need to be balanced against the investor’s interest in protecting investment value, which will often be protected by consent rights. The tenant should consider the administrative, timing and cost implications of obtaining such consents.

For corporates with larger portfolios, one mitigation may be a substitution right. This allows a tenant to remove a property from the leaseback structure and replace it with another of equivalent value. Common conditions include an acceptable title, survey and environmental report. This right is particularly useful if a property within the structure is identified for redevelopment and change of use, for example.

According to [Savills](#), around €2.4bn of retail properties were sold and leased back in 2019. Given that these transactions may offer a welcome injection of capital from existing assets, we expect them to remain of interest to corporates. With the right structure and focus on the terms that are most important to long-term operations, the overall cost may prove competitive.

OUR EXPERIENCE

We have acted extensively for both investors and occupiers in relation to sale and leaseback transactions, so we understand the key motivations and pressure points in managing these complex multi-property deals. Recent experience includes advising:

- **Legal & General** in relation to the sale and leaseback of portfolios of pubs and care homes, including income strip arrangements and other property-backed financing structures. We also advised on the £550 million acquisition of, and subsequent disposal of properties from, the Hyperion portfolio, comprising 55 properties largely let to the NatWest Group under a sale and leaseback structure
- **Midlothian Capital Partners** on a number of sale and leaseback and ground rent financings involving a range of property assets, including garden centres, holiday parks and activity centres
- **Ocado** on the sale and leaseback of a customer fulfilment centre and a distribution centre
- Clients include **John Lewis, Marks and Spencer, Taylor Wimpey, ITV and Whitbread** in relation to property-backed sale and leaseback pension funding structures
- **Bupa** in connection with the restructuring of its existing sale and leaseback arrangements and the subsequent disposal of two care home portfolios
- **Spire** in connection with the restructuring of the sale and leaseback structure of its care home portfolio
- A number of clients on income-sharing headlease structures including **Derwent London, Aviva, The Clothworkers' Company and The Fishmongers' Company**

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