LCN Capital Partners

Are LCN Sale-Leasebacks a Credit or a Real Estate Investment?

Where do Sale-Leasebacks Belong?

When we discuss LCN's sale-leaseback strategy with investors, a question that sometimes comes up is "should I put this investment in my credit allocation, or my real estate allocation?"

One can easily categorize sale-leasebacks as credit investments. We provide capital to a company and in return receive a series of fixed payments per the lease contract. The certainty of those payments relies on the company's financial strength. Accordingly, prior to entering into a sale-leaseback transaction, we underwrite the company from a credit perspective and negotiate financial covenants, just as a lender would.

Yet, sale-leasebacks are also real estate investments, since we purchase and own property. We underwrite the property as a real estate investor, evaluating the market, comparable rents, industry trends, and alternative uses. And like real estate, the return on the investment comes from the property's cash flow and sale price.

The simple answer is that LCN sale-leasebacks contain core elements of both credit and real estate, and therefore can be placed in either bucket. They are additive to either type of portfolio because they combine the strengths of each asset class in a way that mitigates weaknesses.

Sale-Leasebacks vs. Credit

Credit is a central allocation for investors due to the predictable cash flows they generate. However, the asset class brings several risks, including impairment, prepayment, and inflation.

Though most credit investments perform as expected, when a credit becomes impaired and the company enters bankruptcy, credit investors typically suffer significant losses. Interest payments are immediately suspended, and creditors must wait for the company to restructure or liquidate in order to recoup any of their investment, normally at a discount to their outstanding loan balance.

Paradoxically, creditors also face risks when a company gets financially stronger. The company is then more likely to prepay its debt by using available cash or refinancing it at lower rates. In this scenario, the investor doesn't benefit from the improvement in the company's health. Instead, their outperforming investment is converted to cash.

Credit investments are also exposed to volatility in inflation and rates. If inflation and rates decline, prepayment risk increases since companies will want to refinance existing debt. If inflation and rates increase, the credit's fixed cash flow becomes less valuable.

LCN sale-leasebacks address each of these risks. Since the lease cannot be cancelled by the company, there is no prepayment risk. Therefore, if a company's credit strength improves, the sale-leaseback investor benefits. The lease would now be backed by a financially stronger company, increasing the certainty of cash flows and the price at which the leased property could be sold.

Similarly, if rates decline, sale-leaseback investors retain their more valuable investment. In fact, in a declining rate environment, sale-leaseback investors can capture the value created by a lower

rate environment through refinancing any mortgage debt on the property, while the tenant remains committed to the property under the original terms of the lease.

In an inflationary environment, LCN sale-leaseback investors are better protected, because our leases have contractual annual increases. Unlike credit investments, where the cash flow is fixed, cash payments from our sale-leasebacks increase over the life of the lease. Returns are further enhanced because lease payments are made in advance, unlike interest on debt, which is paid in arrears.

Sale Leasebacks vs. Real Estate

Real estate is another major allocation in institutional portfolios, due to the combination of ongoing cash flow and potential property appreciation. The asset class has multiple embedded risks, however.

Real estate investments are heavily exposed to market and industry trends. Consumer preferences, industry dynamics, and company processes are constantly shifting. Formerly solid real estate sectors can find themselves on the wrong end of a trend, resulting in diminished cash flow and collapsing values. The most dramatic example at the moment is how structural changes in demand for office space is causing major disruptions in the multi-tenant office sector both in central business districts and suburban markets.

Real estate owners can adjust by trying to improve or adapt their buildings and signing new tenants to replace old ones. But this comes with substantial expenses related to new tenant build-outs, broker fees, and carrying costs during the vacant period.

While real estate can benefit from inflation (if rents and property values increase), they also can suffer when costs spike. Because the property owner typically pays maintenance, taxes, and insurance, escalating costs materially impact net cash flow. This has become an acute issue recently, with real estate ownership costs rising, and some expenses (like insurance) increasing more than 30% in just the past year.

Over much of the last decade, declining interest rates and low inflation created a comparatively easier environment for real estate investors, as cap rate compression lifted values across the board. But with this trend now reversed, real estate has entered more volatile territory.

LCN sale-leaseback investments mitigate these risks and volatility. They are less exposed to shifting industry trends because the property is 100% leased on a long-term basis to a single tenant. This makes the cash flow much more stable and easier to predict, since it relies on a specific company's health, versus more complex and less predictable market dynamics.

LCN sale-leasebacks also protect against inflation. The contractual annual rent escalations ensure the cash flows grow each year. The increase in returns is further magnified because the cost base associated with the investment is fixed. All of LCN's leases are triple-net, which means our tenants pay all expenses directly, shielding LCN from variability in these costs.

Finally, the exclusive use of fixed rate debt to partially finance the purchase of a property makes the cash flow stream highly predictable and only variable in the event of a tenant default.

The Importance of Importance

We've discussed underwriting sale-leaseback transactions from both a credit and a real estate perspective. However, there is a third type of analysis that is equally crucial, since it serves as the link between the tenant's credit and the value of the real estate asset: the importance of the property to the company and the industry at large.

Our goal is to only execute sale-leaseback transactions on properties that are central to a

company's ability to operate and generate revenue. Examples are central distribution facilities, headquarters campuses, and key manufacturing plants.

This is crucial because in a downside bankruptcy scenario, companies typically seek to restructure. During that restructuring process, companies must continue to operate, generating cash flow that helps support the restructuring process. For example, if a company makes 100% of its products at a factory owned by LCN, the company must continue to operate that factory during the restructuring process if that process is to be successful.

This brings us to an important distinction between landlords and other potential creditors in a bankruptcy. In bankruptcy, any creditors with secured or unsecured claims will see interest and amortization payments frozen, and recovery is only determined at the end of the bankruptcy process.

However, as a landlord, LCN has an administrative claim with the court. If the tenant wants to continue operating at the property owned by LCN, it must continue to pay rent under the original terms of the lease – there is no court mandated renegotiation.

This is why the importance of the property to the tenant's business operations is so critical to our underwriting process. If the tenant needs to operate in our property in order to generate cash flow during restructuring, then it will need to affirm the lease and continue paying rent in full. By selecting properties important to our tenants' businesses, LCN is able to vault the entire capital stack during bankruptcy, and continue to receive rent in full (with no modification to the lease).

For the sale-leaseback investor in this scenario, there is no disruption to rent payments during the bankruptcy process. And when the company emerges, the investor is left with a more valuable property, leased to a financially stronger company.

In a liquidation scenario, unlike a secured creditor, the sale-leaseback investor does not have to wait before taking control of the property (our collateral). Because we already own the property, LCN can immediately move to sign another tenant or sell the building. This is where our real estate underwriting demonstrates its value in a downside scenario, as we seek properties that are attractive to companies beyond the current tenant.

Choosing Where to Place Sale-Leasebacks

Since sale-leasebacks can be allocated to either an investor's credit or real estate portfolio, what might determine where they are placed? If an investor is actively allocating in one asset class but not the other, that often drives the decision. But all things being equal, we've seen other factors at play.

LCN sale-leasebacks are attractive additions to credit portfolios because they usually have higher yields than the equivalent debt of a company. This outperformance was especially helpful to investors seeking meaningful credit returns in the low-rate environment we experienced until recently.

But even in the current higher rate environment, sale-leasebacks continue to be valuable in credit portfolios. The investor may be seeking higher relative yields or wants to be better insulated against defaults at a time when companies are finding it harder and more expensive to refinance existing debt.

Regarding an investor's real estate portfolio, sale-leasebacks bring a more stable form of exposure to the asset class. Real estate is experiencing a tremendous amount of volatility as the market adjusts to the post-Covid world of changing work and consumer trends, higher inflation, and higher rates.

LCN sale-leaseback investments, with their contractual rents, fixed-rate debt, high-quality

tenant credits, and importance to company operations, provide predictable cash flows while still retaining upside potential from property appreciation.

Execution is Critical

Sale-leaseback transactions have a number of structural advantages, yet these advantages can only be realized when the investment is properly executed.

Sale-leasebacks are not investments that can be made en masse. They are specialized investments that require extensive sourcing efforts. We look for fundamentally strong companies that will benefit from unlocking capital from operationally critical properties (for a discussion on the advantages of sale-leasebacks for companies, see our paper "Financing the Resurgence of American Manufacturing and Addressing the Debt Maturity Wall").

Once opportunities are identified, they must be underwritten by a team that has deep credit and real estate investing expertise. Then a long-term lease must be negotiated that contains strong financial covenants, including requirements that the sale-leaseback proceeds be used to improve the company's financial strength (and not simply paid out as a dividend to owners of the business).

From there, the company must be actively monitored to ensure it is meeting ongoing financial covenants negotiated into the lease. The property also must be monitored to ensure that the tenant is complying with building maintenance and upkeep obligations. This requires a close ongoing relationship with the company and regular site visits.

When we successfully execute each stage of this process, we create a "double layer" of protection that improves the attractiveness of the sale-leaseback versus comparable pure play credit or real estate investments. We're fundamentally making a credit investment, and if the credit performs, our investment performs. But when the credit aspect doesn't perform, we have the real estate ownership to fall back on.

As a result of the strength of the sale-leaseback structure and our success with execution, over LCN's 12-year history and more than 100 transactions, we have not yet experienced a single loss on any LCN investment.[1]

Authors:

Edward LaPuma
Co-Founder and
Managing Partner

Maxwell Eliot
Partner

Contact:

Information@LCNPartners.com

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[1] This is not a prediction that we will never lose money on a transaction. But it is an important data point, since it illustrates the level of downside protection embedded within the sale-leaseback structure. Past performance is not indicative of future performance.