

# Why a promising deal can collapse



Jitters abound in commercial real estate deals as sellers look for lease-backs and new owners ponder long-term rents.

The commercial real estate market has an entirely new feel these days. Gone are the buyer-fueled bidding wars brought about by too few buildings chased by too many occupants — the classic supply-demand imbalance.

We were clipping along at warp speed for the first five months of 2022 when bam! We hit a massive speed bump named the Federal Reserve.

You see, to tamp down rampant inflation, the Fed raised interest rates — some would opine too aggressively. Buyers felt emboldened to behave, well, like buyers. Personally, our team has felt the impact as we've had three deals canceled at the altar. Jilted indeed.

Our latest divorce, a terminated transaction, involved a private investor in his search for a suitable up-leg purchase. He sold a property in June and now must redeploy the proceeds to defer capital gains taxes.

As we scoured the universe of available leased buildings, we settled on single tenant net leased industrial buildings ideally in Southern California. What we found in our search area were many sale-plus-lease-backs. After all, net leased real estate is created by one, an investor believing now is the time to sell, or two, an occupant who needs the equity from her owner-occupied facility. The latter was the genesis of our deal implosion.

Therefore, I thought it would be column-worthy to review the sale-leaseback and some things to consider when pursuing them. So here it goes.

I've advised a number of my clients recently to consider selling their commercial real estate and striking a three- to 10-year lease with the investor that buys it. A few have listened.

This structure, in our parlance, is known as a sale-lease-back. Different than a straight lease and not a short-term lease that accommodates a purchase, a sale-lease-back allows an owner-occupant the chance to sell at today's high prices and remain in the building — albeit as a tenant — and avoid a move.

It's a slick arrangement when the correct motivations are involved.

But let's also discuss the downside of a sale-leaseback.

The message it sends: When a sale-lease-back is listed and marketed for sale, buyer questions range from “why is she selling?” to “is her company leaking at the gills and needs cash to survive?”

Generally, there is a story and it's critical to understand the story: Why is the seller selling and how will the financials present? Our challenge recently was the creditworthiness of the occupant and the seas of red ink we were asked to navigate. In the end, we said “next” and moved on.

Rent: Value is determined by taking the rent a company is willing to pay and packaging that payment as a return on investment. Simply put, if the business pays \$10,000 per month or \$120,000 per year, and the return is 5%, the resulting value is \$2.4 million. Easy, yes?

Now the fun begins. Where is \$10,000 per month in relation to what other comparable buildings achieve in rent? It's either above or below or at par. If it's par or below, you're golden. Above and you're scrambling. You see, an investor looks at the worst-case scenario: If the occupant spits the hook after a year and can't pay the rent — or worse files bankruptcy — then you're stuck with a building you can't rent for the same amount she was paying. Thus was our conclusion in the failed deal.

The operating company is strapped: One of the benefits of owner-occupied real estate is the flexibility when times get tough.

As an example, we own the office building we occupy. We're the owner and the tenant. When our revenues dipped in 2009 and 2010, we simply reduced our monthly payments to ourselves. Once an arms-length investor enters the fray, you're simply a tenant and the flexibility evaporates.

In our canceled scenario above, the rent was inflated to get the most dollars out of the sale. The problem was the rent was unsustainable.

The tax consequences: As we've discussed, selling appreciated commercial real estate comes with a heavy tax consequence, unless a tax-deferred exchange is employed. Yes, equity is fed but at a significant cost, in some cases up to 35%. You may be wondering why this matters. Unless the seller has carefully thought through these consequences, the deal can screech to a halt.

Fortunately, we still have the engagement and are proceeding to the second possibility. This time the seller is arms-length from the company. So we'll see.

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