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Lease-Accounting Rule Change Adds New Growth Financing Wrinkle. By Mark Radosevich

Fifteen years ago I worked as a deal originator for a Lehman Brothers entity focused on sale-leaseback (SLB) as an alternative to traditional debt financing for retail petroleum acquisitions. Some of the advantages of SLB that we featured included reduced buyer equity (many times we could finance 100% of the cost of a deal), tax deductibility of rent payments and the off-balance sheet features of a lease, whereby the overall lease obligation is not reflected on the company's balance sheet, making the company seem financially healthier than it may otherwise be.

Over the past few months, the Financial Accounting Standards Board (FASB), the entity that sets accounting rules for U.S. companies, has decided to require companies to add to their balance sheets their various lease obligations. Mandatory compliance of this rule will begin in 2019. The rationale for this rule change is aimed at better reflecting a company's financial condition by including both lease and long term debt obligations, thereby making some companies appear deeper in debt. This may not pose a big problem for larger companies, as sophisticated investors already calculate lease obligations into their evaluations as to the true financial strength of a company. The rule will ultimately increase transparency and allow smaller investors to obtain a clearer picture of a company's financial health. This change, combined with renewed focus on SLB as a growth financing tool for many large sophisticated c-store operators has prompted me to revisit the topic including a brief SLB strength and weakness overview.

Limited Flexibility

SLB seems to be best suited for well located, new to market stores that are developed to stand the test of time in terms of trade area growth and potential competitive intrusion. Long term leases of this nature typically include assign-ability clauses that limit a company's flexibility to exit out of a property in the event of an unforeseen situation that negatively impacts a stores financial performance. To exit, the company can only assign the lease to an "equal or better credit rated" tenant. Thus, when entering into one of these leases, the tenant must be sure that the subject store has viability all the way through the lease. In some instances, the lease will allow the tenant to substitute the lease to another property, thus allowing an exit from the impacted store. This clause is generally seen in Master Lease situations where more than one property is encumbered by the lease.

Standing the Test of Time

Great care must be taken when using SLB to finance an acquisition of multi-unit store packages whereby the stores may be currently cash flowing at an acceptable level but because of their age, size, configuration and location, are vulnerable should a sophisticated store operator enter the market. For all of the flexibility reasons outlined above, the key criteria when considering SLB as the financing tool for an acquisition is insuring that the subject stores can stand the test of time. Sites in the package that fall below this threshold should be acquired using traditional debt financing.

Investing and Gaining Equity

In today's market, traditional marketers seem best suited to growing through debt. For small to mid-sized acquisitions, financially healthy companies can access financing at very good rates and terms. They generally do not stretch for an acquisition and as such, have on hand the required amount of equity to secure the loan. Most importantly, they maintain the flexibility to dispose of a property with no long term lease interference and gain increased equity as the loan is paid down.

Summary

Despite the new lease rule changes, sophisticated store operators will continue to utilize SLB as an important financing tool for their new to market stores built to a modern standard of size, offerings and operational quality. Using SLB to fund acquisitions will hold hidden challenges unless leases are adapted to provide greater flexibility to enable operators to exit out of stores through the life of the lease. Although the lease obligations will now be reflected on company balance sheets, the risks associated with lease encumbered stores that do not stand the test of time will not be. For this reason, investors must continue to do their due diligence before investing in these companies.

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