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Why it pays to negotiate items such as a buyout provision upfront.

Smart use of sale/leaseback

Ways to add value, flexibility

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Over the years this column has addressed the use of sale/leaseback as a franchise finance vehicle. While interest rates have been moving up fairly quickly and the prime rate of interest is now above 8 percent, the cap rates or effective financing cost of using sale/leaseback have stayed pretty flat.

Since sale/leaseback is still a viable and effective means for providing real estate financing for the franchise business, the user should take a critical look at the appropriate structure and terms of the lease transaction.

Obviously the negotiated amount of rent and step increases in the rent go right to the heart of the acceptable economics for the unit being sold and leased back. There are other items that create flexibility in the ownership of the leasehold interest, and these items may bring great value to the business and business enterprise post sale/leaseback.

Consider the following value adders:

1. Assignment. Strong lease assignment rights are key. These rights need to recognize changes may occur in (i) the sites, (ii) the demographics around the sites, and (iii) the ability to operate the given franchise. There are three different issue levels to address as to assignment, subletting and release:

A. Level one—Lease assignments that do not require the consent of the landlord. These are normally assignments to another franchisee or the franchisor of the tenant's concept. In most cases, this type of assignment provides for a release of the original tenant.

B. Level two—Lease assignments that are permitted but do not provide for the release of the tenant. This assignment should be a broad right of assignment for the leased site and allow a broad retail spectrum of uses. Again, this assignment should not require the landlord's consent and would not normally provide for the release of the tenant.

C. Level three—Lease assignments that totally change the concept or business (and type of activity) from the original use and would require significant alteration to the leasehold premises. This assignment requires the landlord's consent and may or may not provide for a release of the tenant. Also, this assignment requires a financial review by the landlord of the proposed tenant's financial position.

2. Franchisee financing. When you are entering into a sale/leaseback arrangement, it is important to recognize that you, as the tenant, are going to operate a franchise business on the site. Franchised businesses need to be able to borrow money (which, in most cases, requires the granting of a leasehold mortgage on the leasehold interest). This key ability to finance and grant a leasehold mortgage should be stipulated in your lease and be an ongoing right. In addition, the tenant should be able to secure financing for future improvements on the property (e.g., remodels required by the franchisor). In order to accommodate this financing, the lease should allow for a junior lien or a carve out, where a lien is allocated on specific assets created as a result of the remodel.

3. Landlord financing. If the landlord has financing on the property, the tenant should be able to obtain a non-disturbance agreement from the lender. The agreement should stipulate that if the tenant pays the rent and complies with the lease, the landlord's lender has no right to displace the tenant from the property through a foreclosure or eviction.

4. Franchise agreement rights. The lease agreement needs to provide for the right of the franchisor to enter and inspect the property, pursuant to the terms of the franchise agreement.

5. "Go dark" provision. When negotiating the lease, it is important to include the ability to "go dark" for a period of time so the property can be remodeled, rebuilt or reconfigured. The franchise concept may need to be substantially altered during the course of a 20-year lease, thus necessitating major changes to the premises. Also, the tenant may need to bring a new franchise concept to the site which would normally require shutting the business down ("going dark") and making the improvements on the property. This does not mean the rent obligation is abated, but that "going dark" will not result in a default. As a corollary, the lease should not require landlord consent for certain franchisor required capital improvements to the premises.

6. Lease extension periods. Pay attention to the extension periods. In many cases a 15- to 20-year lease will have three or four five-year extensions, with a vague reference as to what the rent will be during the extension period. It is important the extension period rent be well defined and not left to a market rate. A reasonable CPI increase during the term of the lease is acceptable, but in all cases it is important the extension provisions explicitly provide for a stated rent.

7. Acquisition rights. Many leases will provide for some type of limited right of first refusal for the tenant if there is a transfer of the property by the landlord (particularly in the first few years of the lease). Even though this right of first refusal can be fairly limited and have tight timeframes, it is still useful. Additionally, it is good to ask for and obtain a buyout right after the 10th year of a lease (under 10 years is difficult to get). The buyout right is usually at fair market value with a floor equal to something greater than 100 percent of the original cost. The fair market value is normally determined by a selection of neutral appraisers, possibly one by each side and a third selected by the two originally chosen appraisers.

8. Lease buyout. What happens if you want to get out of the lease and do not want to own the property? Make sure the lease has a buyout provision that allows you, the tenant, to walk away from the lease. Buyouts are costly, but negotiating even a costly buyout is better than having no buyout provision at all in the lease.

9. Acceleration rights. Avoid acceleration rights. This means if there is a default, then all of the lease payments can be accelerated. There are several ways to mitigate acceleration rights: (i) make sure acceleration applies only to monetary defaults after a reasonable cure period; and (ii) use a high present value number (15 percent) to compute the discounted lease stream.

1**0. Corporate changes**. Provide for appropriate corporate changes as they relate to ownership of the tenant entity. These would include name and ownership changes that do not result in a change in overall voting control.

11. Personal guaranties. If personal guaranties must be given, there should be appropriate burn-offs for these guaranties after a reasonable period of performance. Also, consider a last loss guaranty where the guaranty is only called once after all other remedies are exhausted.

12. Default. Defaults are always a touchy issue. If there is a non-payment default, there should be a reasonable cure period and ways for disputes (as to whether or not there is a default) to be resolved short of terminating the lease. As to a payment default, there should also be notice and cure rights (e.g., five to 10 days) in the lease.

13. Master leases and cross-defaults. If the sale/leaseback transaction involves multiple properties, avoid a master lease arrangement and cross-default provisions among individual leases. The tenant needs to be able to address issues on a site by site basis without having all of the leases tied together. In the extreme, master leases limit the ability to restructure the business in bankruptcy.

Keep the above points in mind as you contemplate a sale/leaseback transaction, and realize there are more than economics to consider in using a sale/leaseback type of financing. Using sale/leasebacks in a smart and judicious manner can be an effective financing tool and help preserve capital in your company to grow and improve your business operations.

Next month's column will give an update on key tax issues to help you. FT