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Dealing With Problematic Sale/Leaseback Transactions

By Dennis Monroe

The restaurant industry has been one of the most prolific users of sale-leaseback financing. Over the last few years, cap rates have been favorable. That means the price the potential tenant gets for their property has been high, with some cap rates in the 5%-plus range, which means someone is getting 15 to 20 times the rent for a purchase price. Most cap rates are more likely to be in the 6% to 7% range for major concepts or between 8% and 9% for non-franchise, smaller multi-unit groups or independents. In all cases, the market has been robust for the restaurant industry.

Casual dining, especially, has taken advantage of sale-leasebacks as a financing vehicle. When you get a high price with a favorable cap rate, sellers often agree to pay high rents. The prices sound good until sales are flat or declining. We saw the same scenario in the securitization financing era around 15 years ago, when loan amounts to theoretical value were 100% plus. This worked as long as sales went up; but when sales began to decline or stayed flat, operators got into big trouble and the whole securitized lending industry came crashing down.

Well, the same problem may be here again: too high a ratio of rent to sales and negative cash flow as a result of declining sales. Many owners, particularly in casual dining, are approaching landlords for relief. So let's look at renegotiating problematic leases. How do you get rent in line with an appropriate percentage of sales? I spoke to two industry experts:

Navin Nagrani, EVP of Hilco Global, has tremendous experience renegotiating and restructuring all types of lease transactions. He is also a national expert on major workouts, specifically involving closed stores and the value of the sites.

He emphasized it is important the person seeking any type of relief under a sale-leaseback transaction: 1. fully understand the transaction; 2. provide solid financial information; and 3. create a win-win situation (e.g., extending leases and providing other incentives for the landlord to make a deal). With the shortage of real estate and other opportunities, this needed relief is not easy to sell.

Nagrani also suggested leases need to be looked at as a whole before focusing on the troubled ones: Look at the natural clustering of stores and who the landlords are, and then make a strategic determination as to the best way to renegotiate. It is easier to renegotiate with the one-offs, particularly the non-professional investor landlords versus institutional owners. The one-offs want rent (return is not as important to them as pure cash flow), so Nagrani recommends operators provide some upside to the one-offs in exchange for lowering current rent.

And, in his view, even operators with master leases should look at individual stores. The operator should find a way to get the collective stores at a lower lease rate with possibly even increasing some of the good leases under the master lease, getting significant concessions on the poor leases. Nagrani points out that a master lease makes bankruptcy a less viable option, but there is still room to get reasonable adjustments.

Says Nagrani: Find a way to provide the sale-leaseback group a win-win situation with an upside to the landlord.

Chris Kelleher, managing director with Auspex Capital, has been a banker and a financial consultant for years, serving on both the borrower and lender side. He's been involved in many large sale-leaseback sales and restructures, and says there are two important things for an operator to keep in mind: 1. Make sure the information is thorough and provides adequate detail; and 2. be fully transparent but forceful about your position, as you cannot expect the landlord to accept your initial proposal. Often the request for an initial rent adjustment is ignored, so an operator may need to take aggressive action to get the landlord's attention. He suggested it may be helpful to engage an insolvency attorney, so the landlords know you are serious.

Like Nagrani, Kelleher says working with non-institutional investors, people who have one-off leases, is easier than working with institutions. He also emphasized creating an accommodation for the landlord, but said operators should be prepared to go to the wall.

Below are six things I have gleaned from Nagrani, Kelleher and my own experiences when renegotiating leases:

1. Engage a professional, someone who can do a forensic analysis to tell you the state of the financial health of the company and the problematic stores.

2. Provide detailed pro forma financial information, reflecting trends for the cash flow, including the use of other company resources. The leases do not normally stand alone. This is not the case if a lease is in a separate entity and the company does not have blanket liability for a lease.

3. Before approaching landlords for concessions, evaluate the overall legal structure of the stores. Are they grouped by region or individually owned in separate entities? Is senior debt cross-collateralized? Can you segregate the entities

so you can paint a different picture for the landlord? These questions need to be answered, and it is crucial to ensure the operator understands the value or problems with the stores' legal structure.

4. Remember you have a better chance of renegotiating individually owned leases than your institutional group leases.

5. If possible, offer a win-win scenario for the landlord, like an upside with percentage rent, longer leases, and, if the store needs to be closed, an ability to operate the store until a new user is found. Another option would be to recommend additional investment by the landlord in the stores to help drive sales.

6. The key is tenacity. Delay in dealing with the issue works in the landlord's favor. And, not paying rent to get the landlord's attention usually exacerbates the problem. If for some reason you cannot pay the rent, or if your landlord has totally ignored you, that is a different story. Then the exacerbation may be a necessity. But do this only as a last resort.

We will see more of these workout transactions, but the key to a successful workout is being creative, transparent, having realistic plans and being tenacious.

Dennis L. Monroe is a shareholder and chairman of Monroe Moxness Berg PA, a law firm specializing in multi-unit franchise finance, M&A, and taxation in the restaurant industry. You can reach him at (952) 885-5999 or dmonroe@mmblawfirm.com.