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What Did I Learn About Real Estate?

At the recent Restaurant Finance & Development Conference, I had the good fortune of moderating a real estate panel with three experts: Victor Calanog, a Moody's economist renowned in the real estate sector; Glen Kunofsky, a sale/lease back expert; and Bill Lenehen, CEO of Four Corners Property Trust, a major restaurant real estate investment trust.

This conversation, combined with a slew of discussions I held with restaurant operators and finance experts throughout the conference, left me with a handful of observations about the state of restaurant real estate that I'd like to share with you in this column.

We all understand that the cap rates for triple net leases (i.e. sale/leaseback properties), are at extraordinarily low rates. There seems to be a shortage of good restaurant real estate leases right now, so those well-located properties leased to national brands will probably get multiple bids in the marketplace.

But this is partly a story of haves and have-nots. If you are a large, multi-unit operator with a nationally recognized concept, you are going to have multiple options. If you are making an acquisition of one of these national concepts, you also have the great advantage of using the sale/leaseback as a financing tool to pay for the deal, assuming the acquisition has a reasonable amount of real estate included. It seems fairly compelling for large operators in a growth mode to take advantage of the high prices being offered for restaurant real estate.

The smaller local or regional restaurant concepts are going to have a harder time accessing the national real estate investment groups. However, there are opportunities in the individual investor market, where individuals or small firms may even serve as developers and offer favorable lease rates, and perhaps some ownership participation. The cap rates for these transactions, however, will be higher, but historically speaking, they're still favorable.

Of course, the most pressing issue involves something I have written about for years: Should I sell my real estate and lease it back, or should I continue to own my real estate? My panel members certainly provided a compelling argument for taking advantage of the lease marketplace, plus the efficiency that they bring to the real estate transaction. Given these facts, the strategy looks pretty good.

The offsetting factor is the desire to hold the real estate, either for the flexibility (which some have said isn't all it's cracked up to be) or as a separate asset class for an individual operator's investment holdings. In fact, I can't tell you how many individual operators, particularly those in the franchise world, who've told me once they sell their stores, their major business is real estate. Real estate is something most operators say they understand.

The determining factor on the financial front, though, is whether bank leverage is available for real estate ownership. While I've touched on this topic in previous articles, the amount of leverage probably is not as great as you might hope. In fact, bankers have told me they just expect operators who want to own their real estate to write bigger equity checks, which is something to keep in mind as you go through the process.

Also, you might want to consider the tax issues, especially if you would be selling the property at a profit. At this point, we don't know exactly what is going to happen to capital gains treatment, and we certainly don't know what might happen with like-kind exchanges. It all looks positive right now, but that may change, and there is certainly a huge push at the end of this year to close on real estate transactions.

Perhaps it's worth considering, for example, an installment sale with the seller, meaning the seller would make payments to you in more than one year. There would need to be a small payment from the seller in 2021, and then the installment note could balloon in 2022. That way you could, in effect, straddle the year to see if capital gains taxes go up in 2022, which you should know by the time you file your tax return.

All that being said, there is another tax benefit to buying restaurant real estate by performing a cost segregation on the assets to accelerate the depreciation deductions and lower your taxable income. In 2022, GAAP will be fully invoked and almost every restaurant lease will be capitalized. That's something to keep in mind, particularly as it relates to your bank, since bank covenants may need to be looked at in light of the new treatment.

In summary, it's a great time to own real estate on both sides: the seller and the buyer (whether an institution, or an individual). Just remember a few tips: First, rent should never be inflated to get a higher price on a sale/leaseback. And second, keep leverage down if you decide to own your real estate. Operators need to be disciplined and utilize what amounts to reasonable rents or debt service for the long term.

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