

RE 618 / Fin 618 – Real Estate Investment Analysis

Homework – Sale-Leasebacks

Dr. Stanley D. Longhofer

- 1) Alcott, Inc. (AI) currently owns its corporate headquarters. It constructed this building 10 years ago for a total cost of \$12.5 million (this was AI's initial basis in the building); 80 percent of this value was attributable to the building for tax purposes. They financed this property with a 30-year, 75-percent LTV mortgage at 8.00% interest. Next year AI expects to spend \$1.7 million in operating expenses on the building; this cost is expected to rise by 2.50 percent per year.

AI is considering a sale-leaseback of this building. They have found a buyer willing to pay \$17 million for the property and lease it back to them on a 10-year lease with two 5-year options to renew. The initial base rent would be \$40 per square foot (psf) based on 85,000 square feet of gross leasable area, with the rent scheduled to increase by \$5.00 psf at each renewal date. The lease is a full-service (gross) lease. If AI sells the property, it will incur transaction costs of 4 percent of the gross sale price.

AI expects to use this facility for 20 more years. If AI does not sell the property, it expects that the property will be worth \$35 million 20 years from now, reflecting appreciation of approximately 2.88 percent per year. At that time, transaction costs from the sale would once again be 4 percent of the gross sale price.

AI's weighted average cost of capital is 15 percent and its corporate tax rate is 35 percent.

- a) Using the above information, analyze the cash flows from the sale-leaseback and continuing to own alternatives. What is the NPV of each of these alternatives?
- b) What is the IRR of the incremental costs of the sale-leaseback compared to continuing to own the property?
- c) What non-financial factors might also be relevant for AI to consider in deciding whether to do a sale-leaseback?
- d) Based on all of your above analysis, which alternative would you recommend for AI?

HINTS FOR COMPLETING THIS PROBLEM:

- In principle, a sale-leaseback is no different from the lease versus own decision. The only difference is that the company already owns the property.
- The up-front cash flow from doing a sale-leaseback would be the after-tax proceeds from selling the property. If it does not do a sale-leaseback but instead continues to own the property, AI's initial cash flow is zero.
- At the end of 20 years, AI will have proceeds from selling the property if it continues to own it today; if it does a sale-leaseback, the terminal cash flows will be zero.

- When calculating the annual cash flows from continuing to own the property, make sure you consider the initial basis at the time the property was put into service and what the depreciation allowances and interest expenses would be today and for the next 20 years. Also consider whether AI is responsible for operating expenses under each alternative.
- You will certainly want to do this problem on a spreadsheet. Make sure you format your spreadsheet to print your output nicely before you print in and turn it in.