

Selling their real estate is nothing new to franchisors, but now may be the right time for franchisees to consider doing the same. Here's why—but better yet, how to do it.

## Do the math

### Getting real estate off the books opens doors

By Sean Hickham

Over the past decade, most large franchisors in the restaurant industry have made the strategic decision (sometimes pressured by shareholders) to remove real estate from their balance sheet. Executives have decided long-term growth and profitability are in conflict with large amounts of real estate on the books.

Companies like Jack in the Box, Wendy's-Arby's, Yum! Brands, Applebee's, and others have all tapped into the pent-up equity of their real estate holdings to redeploy capital. A couple of years ago this capital would have been used to expand the business by opening new stores or funding the remodeling of existing stores. In today's market the proceeds are often used to pay down debt.

For illustrative purposes, take the average restaurant company which looks for an return on investment in the range of 15 to 18 percent. Passive capital in the form of real estate has an opportunity cost attached to it. By selling their property and then leasing it back, restaurant companies can yield a higher return than from owning their real estate. For example, if a company had \$20 million of real estate on its balance sheet and that property appreciates at a rate of 5 percent annually (certainly not what recent performance has shown) over a 10-year period, it would be worth approximately \$31 million. However, if that same \$20 million in passive capital were redeployed via sale lease-back transactions and the proceeds used to open new stores the income and value generated would far exceed the real estate holding model. As illustrated:

- \$20 million proceeds = 15 new stores at \$1.33 million per store
- 15-percent annual return on that invest-

ment on 15 stores  
= \$2.99 million/  
year

- 10 years = \$29.9 million.

The significant consideration is that you still own these new stores. If we assign a 0-percent appreciation from the day they were built and say they are worth the original investment of \$20 million, you now have approximately \$50 million in value instead of the \$31 million from the "hold my real estate/do nothing strategy."

This is a simplified example and does not include items such as taxes and the additional return on investment on incremental cash flows, but the idea remains the same. Put more capital into your core operations and owning real estate is not core to operations.

Here are some of the top reasons to consider sale-leaseback:

- Re-deploy passive capital
- Works well with financing
- Can fund 100 percent of land and building for growth
- Eliminates financial covenants
- Off-balance-sheet treatment for GAAP
- Can offer a lower contractual payment obligation than conventional debt solutions—no amortization of principal

#### Current World View

This is an extraordinary time in our economy and subsequently the franchise sector. Our financial markets are insisting on



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the reduction of leverage and risk. One of the best ways to accomplish this is to use a company's real estate.

Sale-leasebacks will continue to be completed. The market has far fewer providers of sale-leaseback capital today than it did even a few years ago, but they are out there ready, willing and able to do deals. One of the biggest challenges in the current market is the disparity between the sellers' expectations and the market pricing. Cap rates have moved up over the past six to nine months to a range that is 75 to 150 basis points higher. Although there has been a significant increase in cap rates, they remain below historical highs. At the same time, most owners still have the "go-go" 2004-2007 rates ingrained in their mind. It is time for operators to recognize the days of the 6-percent cap rate are gone—at least for now.

People like to ask me where "my" cap rates are and I give the same answer to

everyone. If it is good dirt and a strong corporate credit it could be in the —(you fill in the blank) range, and if it is a smaller franchisee in the rust belt it could be well north of a—cap. The cap rate is always derived by the sometimes ethereal process of: Where is the dirt and who is the tenant? This also includes (at least for our company), an understanding of the tenant beyond the standard fiscal exam. How long have they been in the concept? How successful have they been? Have they been successful in other concepts? What are their goals, and other considerations? The underwriting of deals has become more conservative. The structure of deals can also be more creative than in the past, e.g., credit enhancements.

On a regional basis, real estate has remained fairly consistent, the Southwest and Southeast remain relatively strong, while the Midwest and Ohio Valley are slightly weaker. Some DMAs have been

insulated from the real estate downturn and remain attractive, and tenant credit will still overcome most issues.

The most important aspect of getting deals done in this market will be tenant credit, an acceptance of the move in cap rates and your relationship with the sale-leaseback capital provider.

Partner" is a term that is often overused in our industry, but it should always be the desired goal in a relationship that can have such a high impact on your business. Choose your capital partners carefully and in the long term you will be in a better position to take advantage of the opportunities that will surely be coming. [FT](#)

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