TITLE: Pros and Cons of Sale-Leaseback Financing for Urgent Care

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URGENT MESSAGE:

A growing urgent care operation has a constant need for working capital to open centers, expand existing centers, scale processes and technology, recruit providers and staff, and to support sales and marketing. While urgent care entrepreneurs have historically relied upon personal savings, bank loans or the equity investment of third parties, they may be less familiar with the ready source of capital underneath their feet—the equity in their center's physical plant.

What is a Sale-Leaseback Transaction?

A "sale-leaseback," illustrated in Figure 1, is a means of financing that entails selling an asset (building, land or equipment) to an investor, who immediately leases that asset back to the seller, with the lease payments set by the sale agreement. Leases are typically structured as "triple-net," which means the lessee is responsible for paying all recurring expenses relating to the sold asset—the same as if he/she continued to own it. Common expenses for physical facilities include real estate taxes, insurance, utilities, repairs and maintenance. Although the seller/lessee no longer owns the asset, he/she does retain autonomy in the business operation and management of the building.

Although sale-leaseback has been in practice for decades, its profile has recently increased within urgent care circles as a way of growing operations to free capital tied up in illiquid assets. There are many advantages to this type of financing, including tax savings, an improved balance sheet, and more efficient utilization of equity in delivering revenue-producing services.[1] However, there may also be drawbacks when the terms of the sale hinder future flexibility and operations or result in higher long-term costs than conventional financing.

Figure 1: Illustration of a Sales-Leaseback Transaction

	Pre-Transaction	Post-Transaction
Urgent Care Operator (Seller)	• Owns property minus any mortgages or liens • Property is asset on balance sheet • Responsible for property maintenance and expenses • Deducts depreciation reducing income tax obligations • No tax on unrealized gain from property appreciation • Flexibility to close, sell, or relocate the practice	• Sells property and signs long-term lease with investor • Lease obligation increases liabilities • Responsible for property maintenance and expenses • Pays rent reducing earnings from operations • Pays taxes on any realized gains from sale not re-invested in like-kind exchange • Landlord permission and possible fees to terminate or assign lease
Investor (Buyer)	• Cash on hand (or raises cash from others) for a low-risk, long-term investment that will produce a reliable stream of income	• Buys property and signs long-term lease with urgent care operator • Receives rent from seller creating "annuity value" for the property • Can choose whether to renew lease or change lease rate and terms with seller • Can make changes to the property including co-tenants within the lease terms • Can sell property to a third party investor

Potential Benefits of Sale-Leaseback for Urgent Care

The most common reason to enter a sale-leaseback agreement, from the seller's perspective, is to convert an illiquid asset into cash. For most urgent care entrepreneurs, owning property is neither a core competency nor their primary means of generating income. For these same reasons, other location-based businesses—including hospitals, retail stores, hotels, and restaurants—have sold many of their facilities in sale-leaseback arrangements. It frees capital to improve or expand their operations, to pay down more expensive existing debt, or to make an acquisition. The idea is that with good strategy and management, a seller should earn a higher return on their "core business competency" than he/she would from any appreciation on the real estate.

For urgent care centers, a sale-leaseback better aligns operating expenses with revenue. This is because the agreement converts a capital asset into cash, and rent payments become an operating expense that is funded by revenue from patient visits.[2] Before the sale, only interest and depreciation were tax deductible from earnings, so with rent expense being deductible, companies can realize tax benefits.

Many large public corporations utilize this financing technique to improve their balance sheet and financial ratios, notably return on assets and debt-to-equity ratios, which can improve their stock's value.[3] Most independent urgent care centers are independent and privately held, but an improved balance sheet can help them obtain loans at more favorable rates and increase their valuation in event of a future sale.

Why would an investor want to buy a property and leave all of its management up to the tenant? Because a sale-leaseback represents a steady, long-term stream of income—in the form of lease payments—to an investor. Not only are these arrangements low-risk, but they are also hedges against inflation, because the value of property almost always increases over time.

Drawbacks to Sale-Leaseback Financing

There are, however, important disadvantages to sale-leaseback arrangements that should be understood and addressed before entering a deal. For example, the seller loses some operational flexibility. After selling the property and entering a long-term lease, typically 10 years, the urgent care operator is essentially locked into that location until the lease is up. This makes relocations or even center closure very expensive, because it involves early termination and accelerated payments of the lease.

There is also less flexibility with renovations of the building because it is now owned by a separate entity that may not want changes made to the property. And a seller may also face the possibility of losing tenancy at the end of the initial lease period. If the terms of the sale-leaseback arrangement do not provide for a future repurchase option or a preferred lease extension, then the center could find itself looking for a new site if the purchaser has other plans for its building or if the buyer re-sells the building to a third party.

When selling an appreciated asset, under certain circumstances, federal tax law allows sellers to defer taxes on their net gains if they reinvest the proceeds in a similar asset (called a "like-kind exchange"). Using the proceeds of an asset sale to pay off debt could trigger an immediate tax bill for the seller that would otherwise be deferred if the seller held on to his/her asset for the longer-term.

In addition, the seller forfeits any future appreciation in the value of the property. Should the market value of the property rise, the investor would realize the appreciation, not the seller. So the buyer ends the lease with an asset that's likely worth more than what was sold to him/her, he/she and gets all of the deferred tax benefits of being a landowner. Because sale-leaseback can lower a center's "Earnings Before Interest Taxes Depreciation and Amortization" (EBIDTA) because rent expense is deducted from operating income but depreciation is not[4], having engaged a sale-leaseback transaction can also diminish the future value of the center's operation as valuation is typically based on a "multiple of EBIDTA."

From the perspective of an investor, the present value of a commercial lease is the sum of discounted future cash flows. So the amount an investor is willing to pay a seller for his/her asset is directly proportional to the size of the lease payment the seller is willing to commit. To optimize the value of his/her asset—the cash received in the transaction—conceptually a seller must sign a longer-term lease for the maximum viable rental rate. But signing a higher-than-market lease will dilute the seller's future earnings from operations. In addition, a buyer may be hesitant to close a deal with too high a rental rate because that introduces credit risk and may make it difficult for the buyer to sell the building in the future.

Signing a lease with lower rent payments can help the seller's profit and loss in subsequent years but reduces the amount of cash from the transaction and can also result in dramatic rent increases at the end of the initial lease term as the buyer seeks to bring rental rates "to market." Likewise, if market rent rates go down, then the seller can, again, be locked into a higher-than-market lease. In effect, a seller can be "held captive" by a landlord in a building they once owned.

Unlike mortgages that typically lend 70% to 80% of an asset's appraised value and constrain a borrower's capacity for taking out additional credit, sale-leasebacks are typically for 100% of an asset's value.[5] For large corporations with hundreds of millions in revenue, these agreements are usually on very favorable terms because the investment by the buyer has very low risk—for the buyer, a long-term lease represents a steady income stream and they realize any future appreciation of the purchased asset. On the other hand, sometimes sale-leasebacks are the only option for prospective borrowers with a short operating history, prior adverse lending experiences, or other factors that classify them as a "poor credit risk." Because they get a physical asset that can be repurposed or sold, sale-leaseback investors will accept this additional risk in exchange for a higher rate of return.

Evaluating the Viability of a Sale-Leaseback Transaction

With the proper analytic approach and thorough due diligence, urgent care centers can determine whether a sale-leaseback is a good option for them. These arrangements can certainly be beneficial, but only if the proper controls are in place to avert the potential disadvantages.

The first condition to consider is being locked into a certain location. Because sale-leasebacks usually involve a 10-year lease agreement, the urgent care operator must decide at the outset how long they are willing to remain in the same location.[6] If the center has been considering a strategic relocation, then a sale-leaseback is not the best option for financing. On the other hand, if the building to be sold is essential to the center's operations, then there must be a preferred renewal option at the end of the lease. If this safeguard is not in place, then the center risks losing tenancy at the end of the lease.

Sale-leaseback agreements can be very complex, and the transaction can have important tax, accounting, and legal implications. It is essential that any urgent care operator considering a sale-leaseback consult an expert in each of these three areas. A tax consultant can help explain the changes a sale-leaseback would cause to a center's tax obligations, including real estate taxes associated with the actual sale, and changes to tax deductions from income due to the new operating lease. A CPA could similarly explain the financial implications of a sale-leaseback, such as changes to the balance sheet, changes to financial ratios, and help with analyzing and weighing alternative means of financing. Finally, an attorney and realtor can help the seller ensure that the agreements terms are favorable and align with the center's long term strategy.[7]

When considering a sale-leaseback, an urgent care operator should ask key questions to determine if proceeding is the right strategy. Most importantly, the organization should analyze and compare alternative actions. This should involve a detailed financial analysis of costs and benefits over multiple years associated with the sale-leaseback, the status quo, and traditional financing techniques (such as a mortgage). Once these reports have been compiled and the necessary metrics weighed, the center should be in a better position to make a strategic decision that will improve its operating performance in the future. In addition, the seller should consider whether the investor will reimburse or at least contribute to any planned renovations in the future. This information should be included in the analyses.

Executing the Sale-Leaseback Contract

If an urgent care operator decides that a sale-leaseback is the proper strategy, then he/she must formulate a proper approach to arranging the agreement. The rate of return that any investor will seek is related to the credit risk posed by the selling entity. Thus, any seller must focus on presenting minimum risk to an investor to ensure that the cost of the deal is as low as possible. To accomplish this, the seller should communicate his/her commitment to remain in the same location for at least the duration of the lease, and to remain profitable. The main risk to the investor in these agreements is the potential for default and subsequent inability to find a new lessee. Thus, if the seller plans to remain in the space, that presents less risk to the investor, which should result in a lower rate of return and cheaper rent payments.[8] In summary, to lock in advantageous pricing in the agreement, it is critical to clearly present to investors all the important information about the seller/lessee’s business, its industry position, its financial condition, and business plan, as well as the details of the proposed lease, the real estate itself, and the property’s market.

Because most potential urgent care sellers wishing to enter a sale-leaseback agreement would not have investment-grade credit ratings, they present more risk to investors and consequently command a higher rate of return and sometimes less favorable contract terms. However, there is good news for urgent care operators. Currently, investors are very interested in sale-leasebacks as a low-risk, long-term source of income with good returns. This can be an advantage to companies seeking to enter a sale-leaseback arrangement because the investor market is dense with competition. Considering that the only major drawback of these agreements is in the terms of the deal, sellers can capitalize on this competition by seeking a deal that complies with their desired terms. This may include, for example, a future buy-back option, an option to renew the lease at the end of the term, etc.

Conclusion

When properly executed, a sale-leaseback can be a viable financing strategy for urgent care operators seeking additional working capital at a lower cost than traditional financing. It can help clean up the balance sheet and restructure capital investments from non-revenue-generating assets to their core business. In most cases, a sale-leaseback provides more capital and less cost than traditional mortgage financing. With the proper due diligence, a sale-leaseback can be a win-win scenario for both parties involved, provided that each has done their due diligence and determined that it is the proper route to take—that it aligns with the overall strategy and has been weighed against other alternatives.

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