SPOTLIGHT ON

SALE-AND-LEASEBACK TRANSACTIONS

IF YOU ARE NOT A LANDLORD, DON'T BE A LANDLORD

What is a Sale-and-Leaseback ("**S&LB**") transaction?

The simplest explanation of a S&LB transaction is when a business owner ("Seller") sells a property/portfolio of properties to another party ("Buyer") and then leases it from that party by way of a lease agreement. The Seller becomes the Lessee and the Buyer the Lessor.

What are the benefits of a S&LB transaction for both the Seller and the Buyer?

Real Estate is a capital-intensive asset and does not generally form part of the core operations of businesses like retailers, logistics companies, aviation, or energy companies.

A S&LB transaction is an attractive strategy for companies (**Sellers**) to raise capital by disposing of properties and utilising the proceeds to re-invest in their core operations, typically increasing the company's return on equity ("**ROE**"). **In the context of South Africa, a disposal of a property to an empowered investor could also improve the company's BEE scorecard.**

From a property company's perspective (especially REITs), the acquisition will be in line with its core operations of owning and managing investment properties, and shareholders will benefit from a predictable rental income stream over the life of the lease.

Notable S&LB transactions in the Global market

One of the largest S&LB programs globally was undertaken by Tesco, which raised £5.5 billion (R115 billion) via S&LB transactions over the period 2004-2011[1].

In the office sector, numerous corporates have sold and leased back their headquarters, which includes HSBC's HQ in Canary Wharf, which was sold in 2007 for £1 billion (R21 billion)[2] as well as Goldman Sachs' London-based HQ, which was sold in 2018 for £1.2 billion (R25 billion)[3]. The French energy firm, ENGIE, also sold its global head office in Paris to Swiss Life Asset Managers in 2020, for a staggering €1 billion (R17 billion)[4]. As numerous office occupiers question their long-term office requirements, it appears that S&LB transactions could be an attractive exit towards flexibility.

In the industrial property sector, two significant S&LB deals concluded to date are Iron Mountain's disposal of 13 distribution centres to Blackstone for $358 million (R5.5 billion)[5] and the disposal of six distribution centres owned by Aldi (Australia) for a total transaction value of A$929 million (R10 billion), to a partnership between Allianz Real Estate and Charter Hall[6]. There is also speculation that DHL is exploring a S&LB transaction for its pan-European logistics platform, which could see a ticket size in excess of €500 million (R8.6 billion)[7].

Demand drivers for S&LB transactions

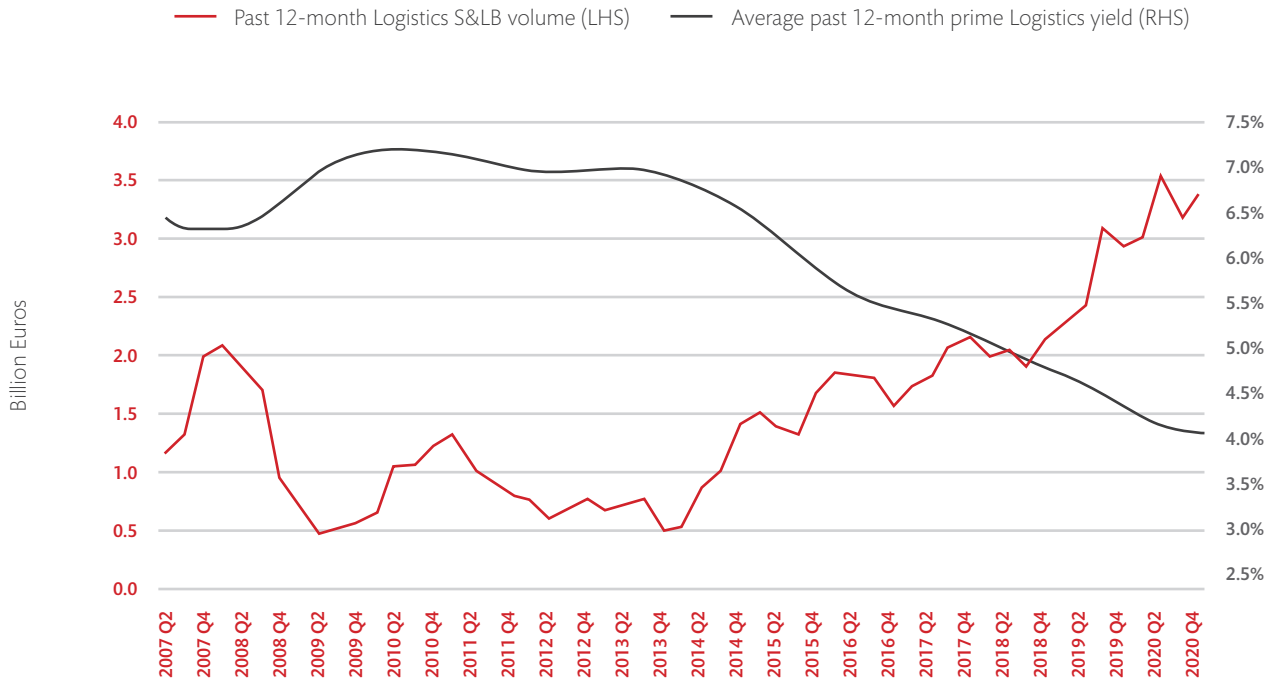
The pandemic has had a devastating impact on most businesses globally, with only a few types of companies thriving over the last two years. These include food delivery businesses, e-commerce platforms, and video conferencing platforms.

However, for businesses that suffered during the pandemic, S&LB transactions have been on the rise, as business leaders have been forced to:

1. explore alternative sources of raising capital;
2. investigate initiatives to increase returns to shareholders,
3. release capital for distressed acquisition opportunities; or
4. to strengthen balance sheets and improve liquidity.

Another driver of S&LB transactions appears to be related to an increase in real estate values, especially in the logistics property market. In Europe, for example, corporate disposals in the logistics property sector have grown exponentially over the last five years as yields continued to compress, affording occupiers an excellent "exit" opportunity to dispose of their properties and lease them back (see Figure 1 below).

Figure 1 : Strong correlation between logistics property yields and S&LB volumes in Europe



Source: Savills Research, RCA

Examples of S&LB transactions in South Africa

In South Africa, S&LB transactions are most common in the industrial property sector (logistics and manufacturing) and telecoms industry (towers). A key factor driving the success of S&LB transactions in the industrial property sector is that most of the properties are occupied by a single business owner. In SA's retail and office sector, very few properties are owner-occupied.

We summarise the largest sale-and-leaseback transactions in South Africa's industrial property sector in Figure 2 below, demonstrating that there has been more than R8 billion in sale-and-leaseback transactions over the last five years in the industrial property market. In the telecoms sector, MTN Group Ltd. is embarking on a similar strategy, where they reached an agreement to sell and lease back almost 6,000 towers to IHS Towers, in a deal worth R6.4 billion.

The key rationale for MTN's transaction was to reinvest the proceeds into strategic initiatives and to provide them with additional balance sheet flexibility.

Nampak has communicated a similar rationale for their S&LB transaction with the Collins Group in 2016: "***The transaction has significantly improved the group's gearing ratio through a boost to equity and a substantial reduction in interest-bearing debt with a clear focus to now deploying capital for the highest return. In addition, a portion of the proceeds is earmarked to reduce other liabilities, further strengthening the balance sheet***".

The S&LB transaction between Equites and Shoprite allowed the retailer to optimise its return on invested capital and to release capital that is being deployed into higher-yielding retail projects and technology, as well as to provide operational and capital flexibility.

Figure 2 : S&LB Transactions in SA's Industrial Property Market

Year	Seller (lessee)	Buyer (lessor)	Transaction value	Lease term	Lease renewal options
2021	DSV	Equites (51%) and EPPF (49%)	R2.0 billion	10 years	Two three-year periods
2020	City Logistics	Boxwood Property Fund	R0.5 billion	10 years	Not disclosed
2020	Shoprite	50.1% Equites (49.9% Shoprite)	R4.1 billion	20 years	Three ten-year periods
2016	Nampak	Collins Group	R1.7 billion	15 years	Two five-year periods
2014	Macsteel	Redefine Properties	R2.7 billion	12 years	One five-year period

Source: Company Data

Return on equity

Return on Equity achieved by direct industrial real estate

In South Africa, A-grade properties should deliver a return on equity of at least 13% over the long term, which is typically achieved with a yield of 8.0% and capital growth on a geared basis of at least 5%. This is in line with the average estimated geared return of 13.1%, which was achieved by SA's industrial property market over the period 2010 to 2020.

Estimated ROE of direct industrial real estate:
= property yield + geared growth in asset value
= 8% + 5%
= 13%

Return on Equity achieved by SA retailers

Retailers typically deliver ROEs of between 25% and 40% - see Figure 3. For these businesses, it could be attractive to implement S&LB transactions as the proceeds realised from the disposal of the property portfolio could be redeployed in far more accretive investment opportunities.

We illustrate the difference between the average ROE of eight SA retailers and compare this to the average estimated total return of industrial properties in SA on a geared basis, in Figure 3.

The opportunity cost of owning the properties is therefore significant, as the underlying equity that is locked up in the business could be reinvested into the business's core operations.

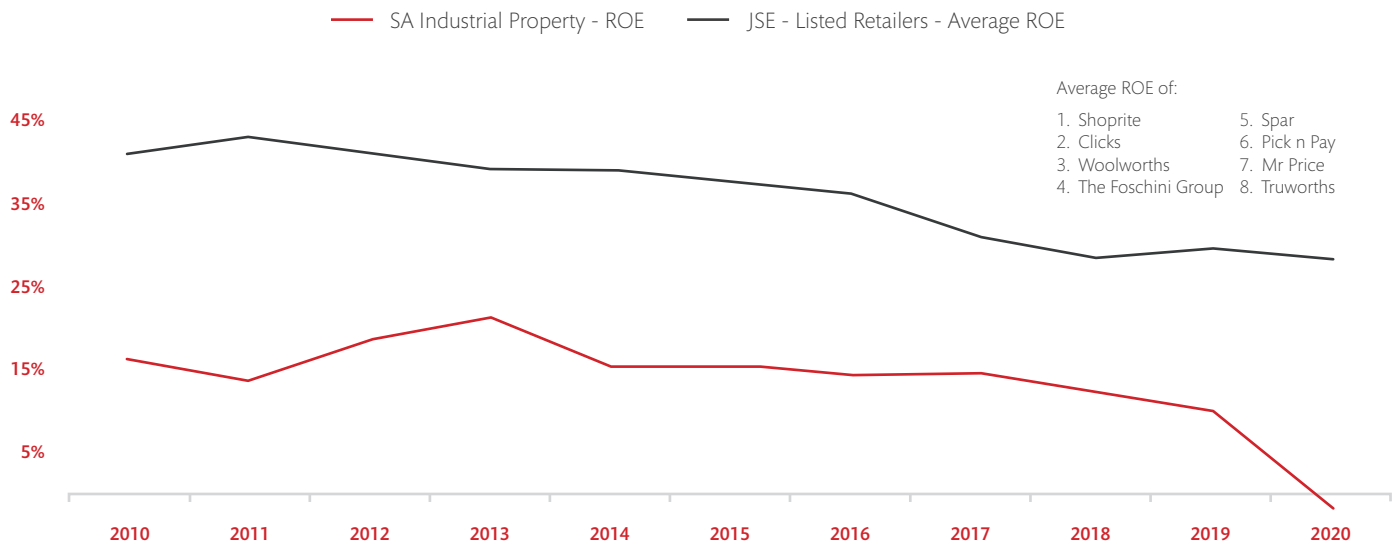
Furthermore, SA REITs are valued on a dividend yield basis, whereas SA retailers are typically valued on a PE ratio basis / discounted cashflows basis, where Headline Earnings Per Share ("HEPS") and strong growth in cashflows will drive a much stronger company valuation.

The reinvestment opportunity

The second benefit of a S&LB transaction, which is equally important, is the continuous reinvestment of cashflows, thereby creating a compounding effect over a 10-to 20-year period.

Alternatively, the company could use additional cashflows to reduce borrowings, buy back shares or to pay or increase dividends to shareholders.

Figure 3 : ROE comparison between direct property and SA retailers



Source: Refinitiv, Equites Research

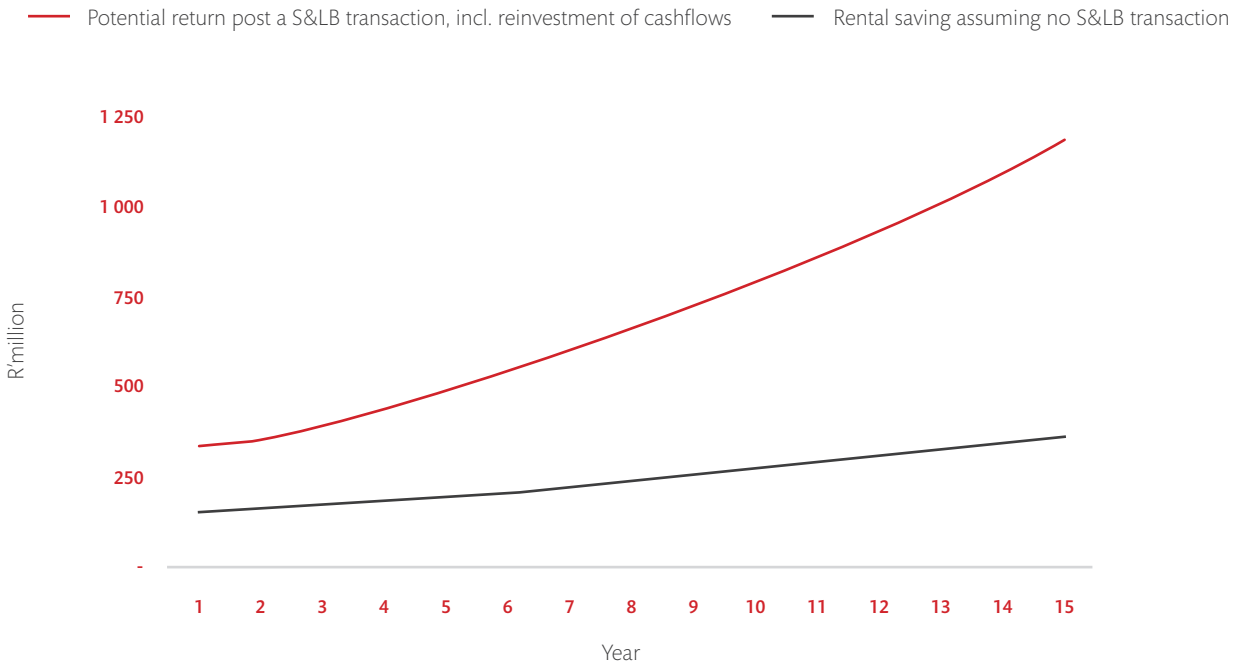
Reinvesting cashflows

As we demonstrate in Figure 4, returns could be significantly enhanced if the proceeds realised from the disposal of the property portfolio is redeployed in accretive investment opportunities, further benefitting from a continuous reinvestment of cashflows.

The calculation is based on the following key assumptions:

1. Fair market value of property portfolio of R2 billion. Equity released from the disposal of the properties is R2 billion, as it is assumed that the portfolio is not geared.
2. Initial ROE of the new investment is 25%, of which 60% is free cashflows that can be reinvested (the remaining 40% is assumed to be unrealised gains/ non-cash). Growth in net earnings is assumed at 6% per annum.
3. Reinvestment rate (ROE) of 15%.
4. Property portfolio cap rate (rental income) equates to 8% of the asset value and escalates at 6% per annum.

Figure 4 : Enchancing returns via S&LB transactions



Accounting treatment for the Lessee / Seller

Owner-occupied properties form part of Property Plant & Equipment ("PPE") and are carried at cost, whilst being depreciated over a specific period, typically 20 years. Post the S&LB transaction, the business will need to comply with IFRS 16. This lease standard has replaced IAS 17 from 1 January 2019, to improve the transparency on companies' lease assets and liabilities, as it was estimated that over 85% of lease commitments of listed companies globally, did not appear on balance sheets before IFRS 16.

With S&LB transactions, the accounting treatment under IFRS 16 is similar to a finance lease under IAS 17; recognise Right-of-use ("ROU") asset and lease liability; depreciate ROU asset and incur an interest expense as a result of amortising the lease liability over the life of the lease. This improves the standardisation of financial statements when companies introduce debt to buy properties as opposed to when companies enter long-term lease obligations.

In summary, the accounting treatment (especially the balance sheet impact) is similar whether a company owns - or rents properties.

Conclusion

Covid-19 has forced business leaders in various industries to reassess strategies to improve returns to shareholders, strengthen their balance sheets and undertake initiatives that could provide capital flexibility.

However, we are of the view that S&LB transactions will not only be beneficial to companies that are facing balance sheet headwinds but also to performing companies, where returns could be further enhanced.

JSE-listed retailers are good examples of companies that we believe could benefit from S&LB transactions. Although they are currently well-capitalised with robust balance sheets, it could be an attractive source of capital if new investment opportunities are identified in future.

Contact

Feel free to engage with us for any questions, comments, or insights with regards to our Thought Leadership piece on Sale & Leasebacks.

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Figure 5 : Distribution warehouse strategies of a select sample of SA businesses

Predominantly owners of distribution centres in SA	Hybrid	Predominantly leasing distribution centres in SA
mrp	SHOPRITE Checkers	takealot.com
WOOLWORTHS	Pick n Pay	DSV
CLICKS	PEPKOR Holdings Limited	Massmart
SPAR	TFG	DHL
	Dis-Chem PHARMACIES Pharmacists who care	digistics

Source: Equites Research

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Endnotes

1. https://www.bloomberg.com/news/articles/2011-02-09/tesco-completes-685-million-pound-sale-leaseback-transaction
2. Financial Times.
3. Financial Times.
4. https://www.jll.co.uk/en/trends-and-insights/investor/how-companies-are-changing-strategies-on-their-corporate-hqs
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7. https://propertyeu.info/Nieuws/DHL-arouses-investor-interest-in-pan-Europe-logistics-portfolio/32e54d21-68e2-449f-8974-26a8141eb914

About Equites Research

Equites Research focuses on global themes impacting the logistics property market. The key function of the Research Team is to support the investment decision process of the firm, as well as the long-term strategic planning of the business. The team also publishes Thought-leadership pieces on an ad-hoc basis, with a spotlight on trends, market dynamics and news in the broader logistics property market.

About Equites

Equites Property Fund Limited is a South African real estate investment trust, with a definite focus on being a market leader in the logistics property market by developing and acquiring A-grade, modern logistics facilities in prime locations in South Africa and the United Kingdom. Equites listed on the Johannesburg Stock Exchange on 18 June 2014 with a portfolio value of R1 billion and has since grown to a portfolio value of R21.2 billion at 31 August 2021. The group continues to grow its portfolio through a significant development pipeline and high-quality acquisitions. Equites is SA's only listed, exclusively logistics-focused REIT on the JSE to provide shareholders with pure exposure to prime logistics assets.

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