

The Hidden Lever in M&A: Strategic Sale-Leaseback Financing

In the competitive environment of mergers and acquisitions, innovative financing solutions frequently determine whether a transaction successfully closes or falters at the negotiating table. Among these solutions, sale-leasebacks have emerged as a particularly effective but underutilized method. By strategically deploying a sale-leaseback, companies can convert real estate assets into immediate cash, significantly enhancing financial flexibility and reducing equity requirements.

Drawing from the insights of experienced professionals including Richard Murphy (Avison Young Net Lease Group), Daniel Macks and John Wolf (Stream Capital Partners), and Stephen Cheng (SLB Capital Advisors), this white paper provides an overview of how sale-leasebacks function, their strategic benefits, and key considerations for effective execution in an M&A context.

What Is a Sale-Leaseback?

A sale-leaseback involves a company selling its owned real estate, typically mission-critical property, while simultaneously agreeing to lease the property back under a long-term agreement. This transaction effectively transforms property equity into liquid capital that can fund acquisitions or other strategic initiatives.

“For all practical purposes, a sale-leaseback transaction is really just a debt transaction ... If I’m going to sign a 20-year absolute triple-net lease, it’s really no different than getting a loan with a 20-year amortization. The advantage, obviously, is you can get a 100% LTV loan with a sale-leaseback versus maybe a 70% LTV loan from a bank.”

— **Richard Murphy (Avison Young)**

Unlike traditional bank financing, which generally limits loan-to-value ratios to around 70–80%, sale-leasebacks frequently achieve close to 100% loan-to-value and sometimes more, substantially increasing accessible capital without the constraints typically associated with senior debt. This structure is especially beneficial for middle-market and lower-middle-market acquirers, as it can substantially reduce the equity capital required upfront while providing predictable, fixed lease payments with built-in escalations, effectively insulating them from volatile interest-rate environments.

“It’s simultaneously selling and leasing the property back. The benefit, of course, is that there is often an arbitrage ... you get predictable, fixed monthly payments, and typically 2–3% annual escalators. It’s not like if interest rates go up 150–200 basis points, suddenly your cost of capital changes.”

— **Daniel Macks (Stream Capital)**

Strategic Advantages in Acquisition Financing

Enhanced Liquidity and Reduced Equity

Sale-leasebacks can materially reduce the capital required to complete an acquisition. By converting real estate equity into cash, buyers can often avoid or reduce external equity and minimize their reliance on mezzanine financing. This strategic use of real estate assets frequently results in a lower effective acquisition multiple.

In a notable example provided by Daniel Macks of Stream Capital, a buyer acquired a manufacturing business for approximately \$16 million. As part of the transaction, the company's mission-critical real estate, originally appraised at \$5 million, was structured into a sale-leaseback and sold for \$10.5 million. This structure allowed the buyer to unlock substantial liquidity from the real estate, significantly reducing the equity required to complete the overall acquisition.

No Personal Guarantees and Predictable Costs

Unlike traditional bank loans, which often demand personal guarantees and contain financial covenants, sale-leasebacks generally do not require personal guarantees from business buyers. This significantly reduces personal financial risk and aligns well with the goals of buyers aiming to preserve personal assets.

Moreover, sale-leasebacks typically feature fixed lease payments with annual escalators of approximately 2–3%, providing predictable, long-term visibility into occupancy costs and safeguarding buyers from interest rate volatility inherent in variable-rate financing.

Value Arbitrage

Another strategic benefit arises from the arbitrage between a property's value under a stable triple-net lease and its lower value if sold vacant. This "bond-like" structure, as described by Richard Murphy, frequently results in significantly higher property valuations, enhancing transaction proceeds and improving the financial structure of acquisitions.

Stephen Cheng illustrates this with a scenario in which a client purchased vacant industrial property for \$3 million, subsequently secured a 20-year lease with a robust operating tenant, and sold the property for \$9 million—effectively creating substantial additional value to support the acquisition.

Key Underwriting Considerations

Balancing Coverage Ratios and Market Rents

Structuring a successful sale-leaseback involves carefully balancing tenant affordability with investor attractiveness, typically achieved by setting rent at a level supported by the tenant's financial health

and market comparables. Industry benchmarks generally recommend rent levels where the tenant's EBITDA provides at least 2–3 times coverage of annual lease payments.

“Some deals work at 1.5× coverage, others need 3×, but as a rule of thumb, the rent shouldn't exceed what the market would bear. It's usually the lower of (1) a comfortable 2–3× rent-coverage ratio or (2) standard market rents for that property.”

— **Stephen Cheng (SLB Capital)**

Thus, while strong EBITDA coverage is crucial, it's equally important that rent aligns closely with market standards. Institutional investors and sale-leaseback buyers typically avoid underwriting leases at above-market rents, as doing so risks diminishing the asset's long-term value and attractiveness. Therefore, optimal rent levels usually reflect the lower of either a safe EBITDA coverage ratio or prevailing market rents for comparable properties.

Lease Structure and Terms

Sale-leaseback agreements commonly follow a standardized structure designed to appeal to institutional investors and ensure long-term stability. Key terms typically include:

- **Lease Term:** Generally 15–20 years is common, especially in secondary or tertiary markets. Shorter terms (under 15 years) may result in lower valuations due to higher cap rates.
- **Triple-Net (NNN) Structure:** The tenant is responsible for all property-related expenses, including taxes, insurance, and maintenance. Shifting any of these to the landlord often reduces investor proceeds.
- **Annual Rent Increases:** Typically fixed annual increases of 2–3% per year.
- **Closing Timeline:** When coordinated efficiently, sale-leasebacks can close within 60–90 days, contingent on timely completion of environmental and property condition reports.

Integrating Sale-Leasebacks with Other Financing Sources

Sale-leasebacks complement other financing methods effectively, including:

- **Senior Debt:** Often used alongside traditional bank financing, enabling higher total leverage.
- **Mezzanine or Equity Financing:** Can significantly reduce reliance on external equity or mezzanine debt by providing a substantial portion of acquisition capital.
- **SBA Financing:** Sale-leasebacks can be strategically integrated with SBA loans, allowing acquirers to reduce the total acquisition cost below the SBA's maximum threshold. This approach makes it feasible to purchase larger businesses than typically possible, using a combination of SBA financing and traditional equity contributions.

Examples of Effective and Ineffective Sale-Leasebacks:

While this paper focuses on the strategic advantages of well-structured sale-leasebacks, it is important to recognize that not all transactions yield successful outcomes. The long-term viability of a sale-leaseback often depends on the quality of its structuring and execution. Readers interested in further study may wish to examine both exemplary and cautionary case studies:

- **Successful Example:** In Stream Capital's example, the real estate was sold at double the seller's initial valuation, allowing the buyer to avoid outside equity and personal guarantees—demonstrating the transformative financing potential of a properly structured leaseback.
- **Challenging Example:** By contrast, high-profile cases such as Red Lobster and Zips Car Wash highlight the risks of poorly executed sale-leasebacks. Common pitfalls include setting lease payments that exceed sustainable operating cash flow, failing to conduct adequate environmental or market due diligence, or locking into lease terms that lack flexibility and impair exit options. In these cases, excessive lease obligations have contributed to financial distress and, in some instances, insolvency.

Other Common Pitfalls in Sale-Leaseback Transactions:

In addition to misaligned rent levels and inadequate structuring, several other recurring issues can undermine the success of a sale-leaseback in the M&A context. These include:

1. **Overlooking Reinvestment Strategy:** Failing to align leaseback proceeds with the broader acquisition or growth plan can dilute the strategic benefit. Without disciplined capital deployment, liquidity from the transaction may be misused or fail to generate expected returns.
2. **Inflexible Lease Terms:** Entering into leases with overly restrictive terms—such as no early termination rights, overly long duration, or excessive penalties—can reduce operational agility and hinder future restructuring, refinancing, or exit options.
3. **Insufficient Environmental and Title Diligence:** Environmental liabilities or unclear title issues discovered late in the process can delay or derail the transaction, or shift unexpected risks back onto the seller or tenant.
4. **Misalignment with Investor Expectations:** Structuring the lease in a way that deviates from what institutional real estate investors typically require (e.g., shorter lease terms, landlord obligations, or lack of rent escalators) can result in discounted pricing or failed placements.
5. **Failure to Integrate with Broader Deal Timeline:** Sale-leaseback closings must be synchronized with other transaction elements—particularly senior lender approvals, SBA processes, and acquisition timelines. Poor coordination can cause cascading delays or financing shortfalls.

Practical Guidance for M&A Attorneys

Attorneys advising clients on transactions involving a sale-leaseback should consider the following best practices to ensure a smooth and strategically sound process:

- **Engage Early:** Involve sale-leaseback advisors early—ideally before signing the Letter of Intent—to assess real estate value, lease structuring options, and potential deal impact.
- **Address Environmental Diligence Proactively:** Order Phase I (and, if needed, Phase II) environmental assessments early in the process to avoid surprises or delays near closing.
- **Structure with Sustainability in Mind:** Ensure that proposed lease terms—particularly rent levels—align with both market benchmarks and the tenant’s long-term EBITDA coverage. Avoid over-leveraging the operating company.
- **Coordinate Closing Timelines:** Carefully manage the sequence and timing of all closing components, including real estate, acquisition financing, senior lenders, and transaction sponsors to ensure a synchronized and efficient transaction close.

Conclusion

When thoughtfully structured, sale-leasebacks offer an attractive strategic financing alternative in M&A transactions. They enhance liquidity, reduce equity requirements, minimize the need for personal guarantees, and provide long-term cost predictability through stable lease structures.

Success hinges on careful rent calibration, alignment with both market realities and operating performance, and proactive management of transactional complexities. For M&A attorneys, understanding and navigating these dynamics can be a critical differentiator—unlocking value for clients and facilitating more efficient, financeable deals.

For additional information or assistance:

- **Matthew Hartranft:** mhartranft@brutlaw.com
- **Daniel Macks:** dmacks@stream-cp.com
- **Stephen Cheng:** stephen@slbcapitaladvisors.com
- **Richard Murphy:** richard.murphy@avisonyoung.com