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TO
LEAVE

OR

That is the question corporate managers must answer.

NOT
LEAVE?

by Christopher H. Volk

A principal goal of corporate management is to make a business worth more than the cost of its underlying assets. To create such shareholder wealth, management has three levers at its disposal: asset efficiency, operating efficiency, and capital efficiency.

Asset efficiency is the ability to limit the amount of assets that have to be funded with shareholder equity. It primarily entails managing fixed asset costs and working capital levels. Operating efficiency is the ability to improve operating profit margins, which is accomplished by finding ways to increase sales, raise prices, and control expenses. Capital efficiency is the ability to reduce the weighted cost of debt and equity capital. Managers must harness equity in concert with various forms of outside capital to lower corporate costs of capital.

Combined, the three efficiency levers work together to generate shareholder returns. Companies that can produce the highest returns with the least financing drag on cash flows tend to create the highest percentage gains in shareholder wealth, not to mention higher current equity cash flow yields.

The Role of Real Estate

The decision to lease or own real estate is centered on capital efficiency, which is measured by pretax rates of shareholder return. To be sure, there are tax implications to real estate financing decisions. The benefits of real estate depreciation, which can shield income from taxes, can be alluring. However, such benefits are nominal, since buildings are depreciated for tax purposes over a lengthy 31.5 years, and land has no depreciation.

Moreover, the tax benefits are merely a tax deferral, since real estate sold after a long holding period is subject to gains from the recapture

of accumulated depreciation. The many public companies that are shackled by the potential for severe tax consequences from imbedded real estate gains serve as a reminder that the better route is to focus on pretax equity return maximization.

Equity rates of return cannot be properly computed from a financial statement: They are a financial, as opposed to an accounting, concept. If a company invests \$1 million into a building and finances 70 percent of the cost, then the percentage of equity is 30 percent. The equity percentage never changes unless the debt is paid down, in which case the mix of debt and equity shifts. This is what happens when real estate is owned and related mortgage debt is repaid. As the percent of the real estate funded with loans declines, the amount of equity rises, which has an adverse impact on shareholder equity returns over time.

Apart from depreciation, there is a second allure to real estate ownership, which is the potential for appreciation. Without question, this is a subject worth considering, but not in concert with the proper means of corporate capitalization. Business leaders are rewarded first for focusing their attention on optimizing the three corporate efficiencies. Real estate appreciation, which is a part of real estate returns, is not a business activity; it is an investment activity. The attractiveness of real estate as an investment for companies will be addressed later in this article.

Computing Equity Returns

The V-Formula is a simple shortcut to compute current pretax equity returns. The formula harnesses all three of the corporate valuation levers.

The financial model based upon the V-Formula illustrates the

Model Assumptions

<i>Income Statement</i>	
Sales	\$1,500,000
Annual sales growth	2.00%
EBITDAR* margin	20.00%
<i>Real Estate Lease</i>	
Cap rate	8.50%
Rent-to-sales ratio	8.00%
Annual lease escalations	1.50%
<i>Real Estate Debt</i>	
Loan to value	70.00%
Interest rate	6.00%
Amortization	20 years
<i>Expansion Capital</i>	
Working capital/Real estate value	15.00%

*Earnings before taxes, depreciation, amortization, and rent

impact of real estate financing decisions on corporate valuation. The V-Formula calculates pretax rates of return on equity, which means that the relative return comparisons are the same, irrespective of the dollar values of the real estate and business. That said, the model assumes location revenues of \$1.5 million for the purposes of demonstrating the magnitude of the capitalization decisions on corporate cash reserves.

The model inputs are self-evident, perhaps with the exception of the expansion capital input. That figure represents the amount of company capital that has to be invested in start-up or other costs associated with the location financed. Many businesses also require capital for equipment related to new locations. For simplicity, the model does not take such investments into account, nor does the model include an allowance for ongoing replacement capital expenditures.

Model results were prepared for both the first year and the fifth year. This is because returns on equity change over time as a result of anticipated sales and profitability growth and as a result of changes in corporate capitalization as debt is repaid.

Based on the model assumptions, corporate pretax equity rate of return in the first year is 85 percent if the location is leased. (See V-Formula sidebar for computations.)

The model results illustrate that the current pretax returns from

the decision to lease real estate are more than 2.2 times greater in the first year and rise to nearly 2.7 times greater by the fifth year. The magnitude of the difference is significant and the company is immediately able to conserve more than \$423,000 in equity in the first year. Moreover, to the extent the company can apply the equity saved to further growth, an additional two leased locations can be added.

Over five years, the three combined locations would provide nearly \$1.7 million in pretax equity cash flows over and above the cash flows that would be realized from the alternate decision to own real estate in a single location.

What could be done with that extra \$1.7 million? Well, after taxes are paid, another five locations could be opened, which would generate even more extra cash flow and more opportunities to expand shareholder wealth.

While 100 percent financing can create a drag on cash flows, the drag is less than the added percentage funded because leases have lower payment constants than any other source of outside capital. Plus, since leases conserve precious corporate equity, more equity can be applied to

Model Results

Year 1		
<i>Pretax Equity Yields</i>	<i>Lease</i>	<i>Own</i>
Current pretax yield on equity*	85.00%	37.89%
Pretax cash flow equity yield**	85.00%	33.85%
Sales:investment ratio	0.924	0.924
Investment % funded with equity	13.04%	39.13%
% More financed	26.09 = \$423,529	
Leasing multiple advantage	2.24x	
Year 5		
<i>Pretax Equity Yields</i>		
Current pretax yield on equity*	93.20%	34.98%
Pretax cash flow equity yield**	93.20%	30.56%
% More financed	35.28% = \$572,757	
Leasing multiple advantage	2.66x	
Five-year cash flow lease advantage with growth investment	\$1,693,223	

*EBITDA ÷ amount of cash equity invested (which rises through debt repayment)

** (EBITDA – loan principal payments) ÷ amount of cash equity invested

The V-Formula

$$\frac{(\text{Sales : investment} \times \text{operating profit margin} - \text{percentage financed} \times \text{interest rate} - \text{annual capital investments})}{\text{Percentage of equity}} = \text{Current pretax return on equity}$$

Using Model Assumptions

$$\frac{(92.40\% \times 20.00\% - 86.96\% \times 8.50\%)}{13.04\%} = 85.00\%$$

$$\frac{(\text{Sales : investment} \times \text{EBITDAR margin} - \text{debt funded portion} \times \text{cap rate})}{\text{Equity funded portion}} = \text{Pretax equity rate of return}$$

growth, which can reduce corporate risk and add to corporate cash flows through greater location diversity.

In today's credit markets, leasing real estate will almost always be preferable to real estate ownership. The principal determinant of the relative desirability of leasing versus owning is the percentage of financing and the loan terms available from debt providers.

The 2010 passage of the Dodd-Frank Act and the added lending constraints imposed on banks by the Basel Accords have combined to make the extension of real estate credit restrictive for the foreseeable future. In this current light, where debt providers are generally limited to advancing between 60 percent and 80 percent of project cost, leasing is not simply a debt substitute, but a debt and equity substitute, because the landlord provides 100 percent of the real estate capital. As a result, real estate leasing allows business leaders to avoid the costly options of infusing added equity capital or constraining corporate growth.

A Wise Investment?

The preceding analysis overlooks the question of whether corporate real estate ownership is a wise investment for companies to make. However, the answer is fairly clear: Real estate investing tends to be nowhere near as lucrative as corporate investing. This is the basic reason why companies that own their real estate tend to post lower equity returns and create less shareholder value; strong business rates of return are depressed by the lower rates of return from real estate investing.

In the previous model example, the five-year average returns from corporate investing (assuming locations are leased) would actually be more than seven times those for the landlord who owns the leased locations. The implication for companies having surplus cash flow is that investing in real estate will tend to lower returns and erode

shareholder wealth. As a result, the corporate valuations of businesses having surplus cash flows tend to be better supported by paying out the cash in dividends or by buying in shares, rather than by directing free cash flows to real estate investments.

One look at a cross-section of public companies laden with real estate will bear this point out. For closely held LLC or Subchapter S companies, shareholders may desire to direct their surplus free cash flow into real estate ownership in lieu of other personal passive investments, which is fine. Here, the catch to watch out for is trapped equity. On one hand, it is always smart to undertake long-term real estate debt so as to avoid floating rate risks and lock in spreads. On the other hand, long-term loans can be subject to severe prepayment restrictions, as well as restrictions on assignment or assumability. Such restrictions can, at the least, lower property valuations and, at the worst, limit the potential to freely sell real estate.

Real estate leasing is just one of many tools that are at the disposal of corporate leaders to minimize corporate costs of capital. As demonstrated above, the advantages of this tool include:

- an ability to conserve equity capital that can be directed into growth;
- an ability to lock into a wealth-creating capital structure for a long time; and
- a lower payment constant compared to other external capital alternatives.

Combined, the three advantages of leasing spell a lower cost of corporate capital. The result is greater shareholder value created through capital efficiency.

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