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REAL ESTATE

Real Estate Leasing: The Answer in Today's Financial Markets

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Since the mid '80s, I have provided billions of real estate mortgage and lease capital to chain restaurant companies and have come to know the benefits of each. My litmus test to determine the benefits of corporate capitalization decisions—whether to buy or lease—has always been the amount of shareholder wealth that can be created.

In my opinion, the goal of any business leader should be to create a company that becomes worth more than it cost to put in place. Absent this accomplishment, one is just "buying a job" without the benefit of building wealth from business value creation.

Business value creation results from harnessing three efficiencies: Operating Efficiency—the control of costs and the ability to increase sales; Asset Efficiency—the ability to control asset costs that are funded by borrowings or equity; and Capital Efficiency—the ability to combine equity with outside funding to minimize the cost of capital.

Together, the three efficiencies work in concert to generate equity returns that determine the degree to which a company can be worth more than it cost to put in place. 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 creation.

The decision of whether to lease or to own real estate locations rests on the last efficiency. Weighing the benefits of leasing or owning is not complicated. First, business leaders should maximize their long-term funding first. This is essential to lock into a capitalization structure over the long term. The aim should be to focus on a capitalization that will maximize equity returns over time. With this in mind, the decision of whether to lease or own rests principally on the percentage of financing available for real estate in the debt markets and, to a lesser extent on the financing terms available.

Today, a restrictive financing climate, anchored by the Dodd-Frank law and Basel Accords, has combined to limit the amount of real estate debt financing available. In that light, if the choice is between 70 percent financing from a lender or 100 percent financing from a lessor, then the latter becomes, not just a debt substitute, but a corporate debt and equity substitute.

While 100% financing can create a drag on cash flows, the drag will be 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 growth, which can reduce corporate risk and add to corporate cash flows through greater location diversity.

Model Assumptions

Income Statement	
Sales	$1,500,000
Annual Sales Growth	2.0%
EBITDAR Margin	20.0%
Real Estate Lease	
Cap Rate (RE)	8.5%
Rent-to-Sales Ratio	8.0%
Annual Lease Escalations	1.5%
Real Estate Debt	
Real Estate Loan-to-Value	70%
Interest Rate	6.0%
Amortization (Years)	20
Expansion Capital	
Working Capital/Real Estate Value (%)	15.0%

[1] EBITDA ÷ Amount of Cash Equity invested (which rises through debt repayment)
[2] (EBITDA - Loan Prncipal Payments) ÷ Amount of Cash Equity Invested

Model Results

Year 1			
Pre-Tax Equity Yields	**RE Lease**		**RE Own**
Current Pre-Tax Yield on Equity[1]	85.00%		37.89%
Pre-Tax Cash Flow Equity Yield[2]	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			
Pre-Tax Equity Yields	**RE Lease**		**RE Own**
Current Pre-Tax Yield on Equity[1]	93.20%		34.98%
Pre-Tax Cash Flow Equity Yield[2]	93.20%		30.56%
% More Financed	35.28%	=	$572,757
Return Multiple Advantage	2.66x		
Five Year Cash Flow Lease Advantage With Growth Investment	$1,693,223		

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The following brief financial model illustrates the clear advantage offered by leasing in today's financial markets:

Based on the inputs above, corporate pre-tax equity rate of return in the first year is 85 percent if the location is leased. The rate of equity return was computed using the V-Formula. For a more detailed review of how to compute and use this simple formula, please visit our website at www.storecapital.com.

(Sales:Investment x EBITDAR Margin x Debt Funded Portion x Cap Rate)
Portion Funded with Equity
or
(.924 x .20% – 86.96% x 8.5%) = 85%
13.04%

The result of the model inputs is that the current pretax returns from the decision to lease real estate are over 2.2 times greater in the first year and rise to nearly 2.66 times greater by the fifth year. The magnitude of the difference is significant and the company is immediately able to conserve over $423,000 in equity. Moreover, to the extent that 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 pre-tax 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, another five locations could be opened, which would generate even more extra cash flow and more opportunities to expand shareholder wealth.

Companies that elect to own real estate are making a commitment to both an operating business and a real estate investment activity in which they serve as their own landlord. The landlord return in the above example would be about a seventh of the return from the operating business, which is harmful to corporate returns and shareholder wealth creation.

On the other hand, real estate leasing provides:

- 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.
- 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.

Prior to forming STORE Capital in 2011, Chris Volk co-founded Spirit Finance Corporation, a real estate investment trust that he took public on the New York Stock Exchange in 2004. Prior to co-founding Spirit Finance Corporation, he served over 16 years in numerous capacities with Franchise Finance Corporation of America and its successor, GE Capital, Franchise Finance. You can reach him at (480)-256-1100 or cvolk@storecapital.com.