Tax Reform Gives Rise to New Business Strategies

Recently enacted restrictions on business interest deductibility are leading more firms to pursue sale-leaseback agreements to unlock property value and grow operations, according to Marcus & Millichap's Dean Giannakopoulos.

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Under the old tax rules, many companies favored owning the real estate they operated from – it offered considerable operational latitude and the interest on the loan used to buy the property was often entirely deductible, subsidizing the cost of business locations. This **paradigm changed under the new tax rules** for companies with gross receipts in excess of $25 million, as new restrictions on business interest deductibility were enacted. Under the new rules, a company can only deduct interest, including any loans, mortgages, etc., totaling 30 percent of earnings before taxes, depreciation and amortization can be deducted on taxes.

As a result, many companies that want to maximize their business interest deduction will opt to sell their real estate locations to investors and lease the property back with a favorable long-term lease. This eliminates the interest expense of the mortgage tied to the real estate and transforms that cost into a lease, which is generally fully deductible. Because sale-leasebacks often have extended lease terms and allow the seller-turned-tenant to maintain the property, there are few operational differences. This process also unlocks the equity of the property, providing additional capital to grow operations.

SINGLE-TENANT RETAIL PROPERTIES WELL-POSITIONED FOR SALE-LEASEBACK

Numerous **retail sector companies** own the locations they operate from, particularly businesses in single-tenant locations such as restaurants, pharmacies and banks. Investors like single-tenant net-leased retail locations because of their high visibility, ease of management and steady returns. Sale-leaseback transactions of single-tenant retail buildings last year were greatest in the 1,000- to 5,000-square-foot range, trading for an average price of $306 per square foot. As a result, private investors were provided with a wide span of assets for less than $5 million. Yields on assets in this segment varied greatly and were largely dependent on location, lease term and tenant creditworthiness. Cap rates for single-tenant retail sale-leaseback transactions generally ranged from 5 to 7 percent last year.

NASCENT INDUSTRIAL SECTOR OFFERS RANGE OF NEW OPPORTUNITIES

The extended growth cycle and emergence of e-commerce has spurred demand for industrial space nationwide, pressuring vacancy rates to their lowest levels on record. At the same time, industrial property values have risen substantively, offering property owners significant profit potential that can be reinvested into their businesses. Sale-leaseback transactions of industrial buildings last year were greatest in the 20,000- to 50,000-square-foot range, trading for an average price of $93 per square foot. This offers private investors a wide range of assets priced under $5 million. As with the single-tenant retail properties, yields on assets in the industrial segment varied depending on location and tenant creditworthiness. Cap rates for these assets trended higher than most other property types, ranging from the upper-6 percent to low-8 percent band.

INVESTOR DEMAND REMAINS ELEVATED

Single-tenant sales activity has moderated slightly this year across all asset classes as buyers and sellers contend with a rising-interest-rate climate. Because of their bond-like investment characteristics, single-tenant asset transactions tend to have a higher sensitivity to rising interest rates. That said, private investor activity has accelerated as aging Baby Boomer investors use 1031 tax-deferred exchanges to migrate their capital out of more management-intensive real estate assets. This trend will likely continue or possibly accelerate as a wide range of beneficial new tax provisions are better understood and begin to **impact investor decisions**. A convergence of increased for-sale asset availability spurred in part by owners looking to enter a sale-leaseback agreement, together with an influx of capital targeting these types of properties, has the potential to boost investor activity over the next year.

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