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2:00 PM – 3:15 PM

Workshop 4

Found Money!
Creative Methods for Monetizing Underutilized Real Estate

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Monetizing Strategies

- Pop-Ups
  - Pop-up stores are temporary retail projects that allow new retailers to test the market and established retailers to generate additional sales or better define their brand
  - The pop-up industry as a whole is already valued at $50 billion in North America

- Food Halls
  - A food hall is a collective dining area featuring several mini-restaurants offering quick-service meals
  - A food hall can fill a shopping center “dead zone” and drive traffic to less frequented areas of the center

- Entertainment Uses
  - There are several players in the market looking to offer consumers experiences such as indoor skydiving, axe throwing and virtual reality gaming alongside their shopping
  - These new entertainment players can back-fill a major footprint of a shopping center and generate additional income for a landlord

- Performance Stages
  - Performance stages can be small and simple, with little additional technology, or full-blown concert-ready spaces
  - Rental fees and ticket sales can offer a new source of income generated by an area of their shopping center that would otherwise remain underused

- Markets
  - A market set up in the parking lot or outdoor area of a shopping center can be a great way for existing tenants and other retailers to sell items to consumers that aren’t looking to shop in a traditional shopping center
  - By creating these markets, retailers are able to reach a greater number of consumers and landlords able to generate income on a space that would otherwise not be profitable

- Easement and Operating Agreements
  - An easement and operating agreement is an agreement between two or more landowners whereby the parties agree to share certain rights and obligations pertaining to their respective lands
  - By sharing certain rights and obligations (and potentially doing so for an additional fee), a landlord can monetize its outdoor land

- Conservation Easements
  - A conservation easement is a device whereby a landowner relinquishes certain rights or opportunities in order to protect the conservation values of a portion of its land
  - By granting a conservation easement, an environmentally conscious landlord can protect the environment while obtaining additional income

Legal Considerations

- Governing Document
  - The most common forms of agreements used to govern the Monetizing Strategies are a lease, a short-term lease, a license, or an occupancy agreement
  - The answer to the question of which document best suits the circumstances generally depends on three factors: the length of the term of the deal, the complexity of the business arrangement (including its rent structure), and the use to be carried out

- Governing Document (cont.)
  - Lease
    - A lease transfers an interest in land to the tenant and confers on the tenant a right of exclusive occupation
  - Short Term Lease
    - A short-form of lease is an abbreviated form of lease that has been pared down to contain only essential terms

- Governing Document (cont.)
  - License
    - There are at least three significant distinctions between a lease and a license: exclusive possession, revocability and transferability
  - Occupancy Agreement
    - An occupancy agreement may be drafted as a form of month-to-month license

- Rent or Fee Structure
  - Net Rent
    - Under this structure, the other party will be required to pay the landlord rent and any additional costs associated with that party's share of the Monetizing Strategy
  - Gross Deal
    - In situations where a landlord is able, with reasonable certainty, to quantify costs of operation, including amounts such as realty taxes, it may be more willing to enter into a gross deal or a deal with fixed rates for certain cost items

- Rent or Fee Structure (cont.)
  - Percentage Deal
    - In a pure percentage rent structure, a party pays the landlord a percentage of the party’s gross sales, generally after sales are generated

- Construction and Design
  - A landlord will want to review and approve all of the plans and specifications
  - The parties will want to ensure that any construction related to the Monetizing Strategies does not interfere with the rights of its existing tenants
  - Even after construction is complete, the parties need to be mindful of noise and vibration issues that can arise

- Construction and Design (cont.)
  - If a Monetizing Strategy involves the serving of alcohol or having exclusive access to the premises (i.e. for ticket-holding customers only), the parties may need to consider how consumers will enter the premises
  - Entertainment and gaming related uses and large capacity venues usually have very specific government-imposed exiting and access requirements, which must be addressed

- Construction and Design (cont.)
  - If the tenant requires exclusive rooftop space for satellites, antennae and other transmission equipment, the landlord may consider requiring the tenant to enter into a license agreement with the landlord and pay an additional fee for this use

- Parking and No Builds
  - Parties will want to ensure that the Monetizing Strategies do not conflict with any other tenant’s parking ratio requirements or no-build areas
  - Parties do not only need to consider the parking ratios imposed by the leases with existing tenants at the shopping center, but also with the parking ratios imposed by the governing municipality
  - Parties must ensure that the shopping center (and particularly its parking facilities) can handle any additional volume created by a Monetizing Strategy

- Use Clause and Existing Restrictive Covenants
  - When drafting the use clauses it is important to remember that many of the Monetizing Strategies are particularly susceptible to market trends and demands
  - Parties must be particularly mindful of existing exclusive covenants and prohibited uses when curating Monetizing Strategies
  - Landlords will also need to study existing easement and operating agreements to ensure that they are not offside any exclusive or restrictive covenants, or prohibited uses contained in those agreements

- Permits, Approvals, Zoning and Municipal Requirements
  - Parties should be aware of what the applicable shopping center is zoned for and confirm that any Monetizing Strategy is allowed within that zoning area
  - A liquor license will be required for any Monetizing Strategy that involves the sale of alcohol
  - Parties may be required to obtain and maintain various other permits and approvals, such as a license for games, assembly or valet parking

- Insurance
  - All parties involved in any Monetizing Strategy should still be required to carry all standard forms of insurance, as well as any insurance unique to that Monetizing Strategy

- Hours of Operating
  - Monetizing Strategies may be more successful when they operate on a unique daily schedule that is outside of normal shopping center hours
  - Where the Monetizing Strategy is connected to an enclosed shopping center, the parties may want to address access issues
  - The parties may need to consider who will be required to contribute to any of the additional costs and expenses incurred by the landlord as a result of the unique operating hours of the Monetizing Strategy

- Security and Crowd Control
  - The parties may want to agree that the landlord is required to maintain proper illumination of the parking facilities and provide security for the shopping center past the operating hours of the Monetizing Strategy
  - The parties may want to consider hiring private security personnel to monitor the premises
  - The parties will also have to consider fire code restrictions and how they will ensure that only a limited number of customers are present in the premises

- Noise
  - The parties may want to install some form of noise attenuation in the premises (if applicable)
  - The parties may also want to initially address who is responsible for any noise complaints made by other tenants in the shopping center

- Termination Rights
  - Due to the inherent risk associated with some of the Monetizing Strategies, parties should ensure they have the ability to move quickly to end the Monetizing Strategy in the face of a default or failure

Structuring Sales/Leasebacks for Retail Property Owners/Ground Lessees

- Sale/leasebacks are an alternative to financing for retail property owners and ground lessees who want to take advantage of financing the entire cost of the development or value of their properties at advantageous rates, without landlord markups
- The parties who can best benefit from these transactions are public or private investment grade company owner, but they can also be used by non-credit tenants with solid financials
- Sale/leasebacks can be used for single-site or multi-site sale/leaseback portfolio transactions

Advantages of Sale/Leasebacks

- Economic Advantages
  - One of the primary advantages of sale/leasebacks is the ability of a property owner or ground lessee to recoup cash from real estate for operations or expansion
  - A seller should be able to exploit the spread between traditional lease rental rates and senior secured debt rates
  - These transactions have very high loan/value ratio vs. asset based financing (can include 100% of cost)

- Accounting/Tax (Former Tax Treatment and for Some Tenants Until the End of 2019)
  - For non-public companies, until the end of 2019, the real estate would not be treated as an asset on a tenant's books.
  - The leasehold obligation is not treated as indebtedness on the company's balance sheet and is considered a true lease for tax purposes
  - Because of this, a tenant is able to optimize its lease payment stream through the use of Section 467 IRC.

- Accounting/Tax (Current – Pursuant to 2016 FASB-ASC 842)
  - For public companies with a fiscal year after Dec. 15, 2018 and for other companies with a fiscal year after Dec. 15, 2019, 2016 FASB-ASC 842 applies to sale/leaseback accounting and tax treatment
  - Assuming the sale doesn't permit the lessee to repurchase the property at the end of the term or have a less than fair market purchase option (among other criteria), the lease will be classified as an operating lease
  - Parties have to be watchful as to whether or not this would affect debt covenants in financings
  - In the end, sale/leasebacks will still retain many of its current benefits

- Operations/Control over the Real Estate
  - One important consideration for a property owner or ground lessee in deciding whether to enter into a sale/leaseback transaction is that such party will continue to control the property and its improvements
  - A consideration to be aware of in a ground lease transaction is that the tenant should reserve the right to convey its leasehold interest in a sale/subleaseback transaction, to avoid later arguments with its ground landlord
  - Any lease in a sale/subleaseback will generally be required to meet the following criteria: (i) assignment/subletting should be broadly permitted, (ii) any lawful use should be permitted, (iii) property alterations and expansions should be under the tenant's control, (iv) tenants should have the right to "go dark", (v) a seller/tenant should retain long-term control of its property via favorable renewal options

Potential Concerns/Considerations for Sale/Leasebacks

- Bond-type Lease
  - This form of lease is not as familiar to many practitioners, as more traditional space leases, and given the rating agency requirements for ground leases and some difficult accounting issues that are often embedded in these leases, they are difficult to negotiate, unless the attorneys on both sides have significant experience in handling them
  - The form of lease used in these transactions is often as much of a financial document as it is a lease, to comply with accounting rules for what are generally passive investor landlords

- Failure to Complete Construction
  - In some instances in which the seller is a credit tenant with a large portfolio of properties, buyers and/or lenders will accept what is called a “rejectable offer”
  - In addition to traditional remedies, it is not uncommon for the closing of a sale/leaseback to be delayed until construction is completed to avoid any risks attendant to incomplete construction and some large, retail chains only improve fully built properties in their sale/leaseback transactions, to avoid these issues

- Casualty/Condemnation Issues
  - Casualty and condemnation issues often are key concerns for buyers, but most of leases in sale/leaseback transactions require the tenant to rebuild unless it is impossible or economically unfeasible to do so. In some instances, this also includes a rejectable offer concept to protect the interests of the lender and/or buyer
  - In a ground leased transaction involving a sale/subleaseback, careful attention must be paid to these issues in the original ground lease and one way to deal with this is to use the rating agency requirements as a template

- Potential Upside to the Purchaser after the end of the Term (Reversionary Interests)
  - Although the term of a sale/leaseback lease is generally long, the buyer ends up with a reversionary interest at the end of the term that it can market to third parties
  - Depending on the value of the property, at that time, it may be able to re-lease, sell or redevelop the property
  - Many buyers look at this from the perspective of buyers of replacement properties in an IRC Section 1031 tax-free exchange, and view this as something to pass along to their heirs, who will have the right to sell or redevelop the properties at some far future date, with a stepped up basis

Description of the Sale/Leaseback Transaction

- Parties
  - Company that wants to sell its property and lease it back, who will be both a seller and a lessee
  - Buyer, who will be both a purchaser and lessor
  - Investment banker, which often guides these transactions and finds qualified buyer/lessors
  - Trustee and possibly debt certificate purchaser
  - Rating agency
  - Qualified Institutional Investors for 144A Offering
  - Accounting Firm
  - Potentially multiple law firms

- Documentation
  - These transactions involve a number of documents that can be expected in any sale or lease transaction, but also documents that may be out of the ordinary experience of many practitioners
  - Many of these transactions start off with the search for qualified bidders and an RFP and once a qualified bidder is chosen, the negotiation of purchase and sale agreement, a form of lease, a guarantee, loan documents and the various closing documents involved
  - The documents can be difficult to negotiate, especially for buyers who have not negotiated these transactions before and have differing expectations as to their rights as landlords and owners

- Additional Issues to Consider When Dealing with Sale/Subleaseback of Ground Leased Properties
  - There are a number of additional issues to be mindful of, including:
    - rating agency requirements,
    - the impact of any potential default under the underlying ground lease on valuation, and
    - the importance of leasehold mortgagee protections

- Process/Timing
  - Given the complex nature of these transactions, parties should be aware of the additional time that will be necessary and not have unrealistic expectations of the time it will take to finalize a sale/leaseback
  - Elements that may impact timing:
    - Document drafting and negotiation
    - Real Estate/Environmental Due Diligence
    - Identification and addressing of issues raised in due diligence
    - Identification of, and negotiation with, financing sources
    - Timing of Securities Filings
    - Closing

- Post-Closing Issues
  - Like any transaction, sale/leaseback transactions can include a number of post-closing issues that must be addressed prior to the closing, to limit any later disputes
  - For the seller/tenant, if construction has not been completed by the closing, the parties need to agree about what, if any, security will be required to be provided to guaranty completion of the construction
  - The lease should address the payment of taxes, common area expenses and the like, as well as property maintenance, which are the tenant's obligations under the resulting triple net lease
  - Buyers/landlords should make sure that the transactions allow subsequent re-sale of their fee estates without penalties or obstacles from lenders

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