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# Real estate sale and lease backs in a COVID-19 world

Key considerations for sellers and buyers

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As the Australian property industry comes to terms with the economic impact of the COVID-19 pandemic, we are seeing market conditions emerge that are favourable to certain types of real estate transactions.

In particular, market conditions are aligning to make sale and lease back transactions increasingly attractive to both seller / tenants and buyer / landlords. In this publication, we outline the key considerations for both of these groups.



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## Overview of market conditions

High on the agenda for many corporates, particularly those facing increased financial pressures in the COVID-19 environment, is shoring up the balance sheet. Sale and lease back transactions allow companies that own and occupy real estate assets to free up capital for other uses by monetising the asset, while continuing to run their business from it.

The Australian equities market has shown a greater willingness to equity raise in this environment than a number of other developed markets (including the US, UK and Japan), and there is still large amounts of foreign and domestic capital chasing the right assets.

The pre-COVID-19 market had seen a growing demand from institutional investors and fund managers for long-term and predictable income. This trend has continued into the COVID-19 market and sale and lease back transactions can present an attractive option for this class of investor.

While sale and lease backs are not new, a resurgence emerged pre-COVID-19, with a number of major deals completing in late 2019 and early 2020. Sale and lease back transactions are not restricted to particular asset classes, but we are seeing growing activity in the manufacturing, industrial, logistics and data centre spaces.



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## Structuring sale and lease backs

Sale and lease back transactions are usually structured so that the lease is granted by the seller to a related entity prior to settlement and the property is then sold subject to the lease. This structure is typically adopted so the parties can obtain the benefit of the GST going concern exemption on the sale.

However, the bifurcation of the seller and tenant does raise some issues, particularly around the financial substance of the tenant and the liability regime under the contract and lease.

Some of these issues are explored further in this publication.



## Considerations for seller / tenants

Asset owners looking to sell and lease back an asset should consider the following points to ensure the benefits offered by this structure are maximised.

### 1. Know the asset

Sellers benefit from conducting a physical, financial and legal due diligence on the property before going to market. This enables them to flush out (and potentially resolve) any issues that buyers may identify during their own due diligence and attempt to use to their advantage in negotiations.

Conducting a vendor due diligence also gives sellers the opportunity to consider their risk appetite before going to market. A property isn't just the land and building on it – it is a package of liabilities and opportunities, and sellers are best placed if they are clear on their position on risk before going to market. Passing all risk to a buyer / landlord may result in value leakage, particularly where a risk is better borne by the seller / tenant.

### 2. Whole of land lease?

Seller / tenants should also consider whether all the land is required to be leased back under the lease or whether part of the land can be carved out of the premises to be leased back and sold as a development asset instead. This may result in both increasing the purchase price attainable on the sale and reducing the rent payable under the lease.

If land is carved out in this way, sellers should ensure that the lease includes appropriate landlord covenants to ensure the balance of the land is used in a way that is compatible with the tenant's use of the premises under the lease.

In many jurisdictions, part of land (as opposed to part of building) leases will trigger technical subdivision requirements. Sellers will need to be live to the technical subdivision triggers when considering whether to carve out part of the land from the lease in this way.

### 3. Terms of contract and lease

Sellers setting up a lease prior to sale should be careful to balance the competing interests of securing lease terms and conditions that are favourable to the tenant while at the same time maximising asset value.

Some key considerations include:

- **The lease term and options.** The flexibility allowed by a shorter lease term with a number of options will be attractive to tenants, but of course creates a shorter weighted average lease expiry (WALE) for landlords.
- **Whether a triple net lease is adopted.** While there is no standard definition of 'triple net lease', this structure will typically see the tenant assume responsibility for all property outgoings and capital repair and maintenance obligations on the building. It is often paired with greater operational management and control with a right for the tenant to carry out upgrades to the building to ensure that it continues to meet the tenant's needs as its business develops and evolves. A triple net lease is particularly attractive for specialised facilities that are management intensive such as data centres, custom built manufacturing facilities and automated distribution centres.

Triple net leases typically attract a wider spectrum of buyers. A landlord under a triple net lease will usually have very few (if any) liabilities in relation to repair and maintenance or obligations around management of the property. This 'hands off' approach to property ownership is attractive to a number of classes of investors. Coupled with these benefits, if the tenant is a highly rated tenant, strong yields are more likely to be achieved on a sale and other funding options are opened up such as tenant credit leases through the US private placement market.

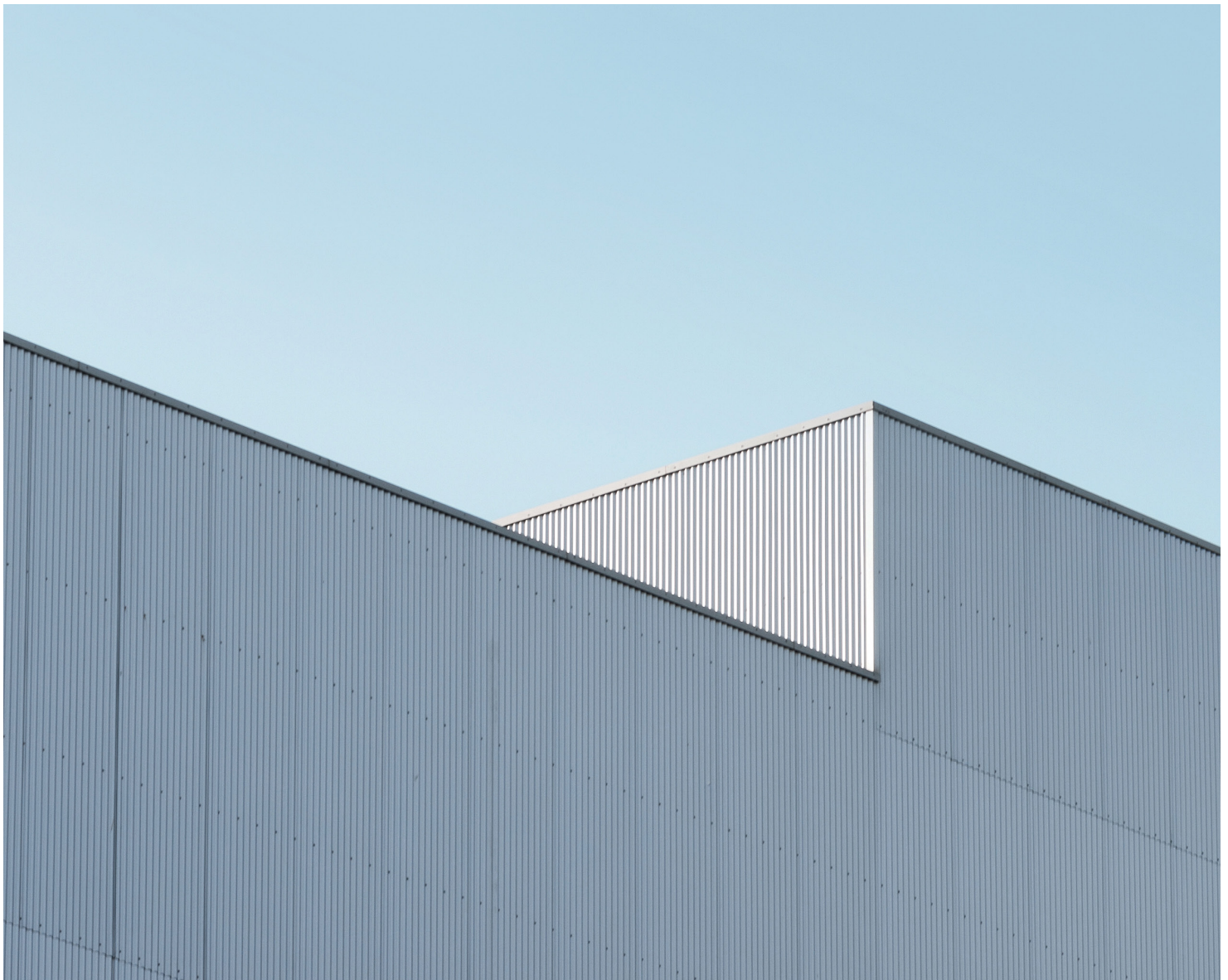
- **Risk allocation.** While passing all risk under the contract to the buyer and under the lease to the landlord may be appealing to the seller / tenant, a one-sided contract and lease is likely to impair the price achievable on the sale. Risk allocation around environmental liability is often a major area of concern for both seller / tenants and buyer / landlords. We expand on this issue below.
- **Permitted use.** Tenants should be careful to ensure their permitted use is broad enough to allow them flexibility to use the site for alternative or additional purposes throughout the term, as the tenant's business evolves. This is particularly important for leases of a long duration.

Obtaining professional valuation advice is also key for seller / tenants to ensure that the right balance is struck.

## 4. Income tax treatment

Sellers should be careful to ensure that the terms of the sale and leaseback result in it being characterised for income tax purposes in the way intended by the parties.

Where property is not your core business, think through the tax treatment of the property. For example, holding a property long enough to achieve a rezoning can sometimes characterise the property as trading stock for tax purposes.



# Considerations for buyer / landlords

When looking to purchase the property under a sale and lease back arrangement, investors should consider the following points.

## 1. Buyer due diligence

As it is for any acquisition, due diligence on the asset will be critical to the buyer. The due diligence should include legal, technical, environmental and environmental, social and governance (ESG) investigations, and will be crucial to inform the buyer's willingness to accept risk in key areas, both under the contract of sale and the lease.

If the property is in need of significant structural or capital works, it will be important that a buyer does not inadvertently take on these liabilities by accepting an unqualified obligation in the lease back to carry out pre-existing structural or capital repairs.

Where a seller due diligence report has been prepared, buyers should also seek to obtain reliance on that report.

## 2. Seller warranties

Seller warranties (both the warranties given and the caps, thresholds and time limits to claims) will inevitably be heavily negotiated between the parties. Of course, any warranty is only as valuable as the financial standing of the party providing it and buyers will need to consider what stands behind any warranties given by the seller.

It is not uncommon to see buyers require part of the purchase price to be retained at settlement as security for performance of the seller's obligation to pay out any warranty claim. Warranty and indemnity insurance is becoming more prevalent in real estate transactions and may be a more favourable option in the sale and lease back scenario where the buyer and seller (or their related bodies corporate) will have an ongoing relationship, as landlord and tenant under the lease, making legal proceedings and or claims even less commercially desirable.

## 3. Tenant solvency and security

Not only is due diligence on the asset important, but in the COVID-19 environment, there will be increased focus on the solvency and financial strength of the tenant entity. Due diligence on the entity, its debt burden and balance sheet will be critical.

Buyer / landlords should carefully consider their requirements for security (either by way of bank guarantee or corporate guarantee) under the lease and whether, in this market, greater security is required. One option for landlords to consider generally in a falling market is whether to require additional security if the financial position of the tenant changes during the term of the lease.

In a sale and lease back, issues around tenant solvency may be heightened in circumstances where the tenant is a special purpose vehicle (typically with limited substance) established so that the lease can be granted by the seller prior to settlement of the sale, in order to obtain the benefit of the GST going concern exemption.

Risks around tenant solvency are also exacerbated if the site is heavily contaminated and the sale and lease back is on the basis that the tenant remediates the land at the end of the term.

## 4. Use of the asset post lease

The potential uses of the asset after expiry of lease is another factor to be considered by buyers.

Sale and leasebacks are often seen in the industrial space where premises can be highly specialised and require significant works to be carried out for the premises to be used for a different purpose or a different tenant.

Zoning of the land is also a factor here, and buyer / landlords should consider the zoning (and in particular restrictions imposed by that zoning) when assessing potential redevelopment of the land after expiry of the lease.

# Mutual considerations

Both seller / tenants and buyer / landlords should also consider the following points in relation to any sale and lease back scenario.

## 1. GST treatment

GST treatment on the sale is a consideration that both sellers and buyers should take into account.

The GST treatment on the sale in a sale and lease back scenario will largely depend on the timing of the grant of the lease. Sellers should consider whether they can legitimately put the lease in place before settlement of the contract of sale to obtain the benefit of the going concern exemption. This requires the seller to have an alternative operating entity that can be the tenant under the lease. In these circumstances, the seller grants the lease to the tenant before settlement and the buyer purchases the property subject to that lease.

If there is no alternative operating entity to whom the lease can be granted, the lease will instead need to be granted from the buyer to the seller immediately after settlement. In these circumstances, the going concern exemption will not apply and the supply of the property will be taxable.

The main benefit of the going concern exemption in these circumstances is that stamp duty is payable on the GST inclusive price, which in turn will typically increase the purchase price attainable for the asset.

## 2. Environmental risk

As noted above, environmental risk is often the most contentious risk allocation issue in sale and lease back transactions, particularly in relation to industrial sites that may have pre-existing contamination. The most favourable position for a seller is to pass all environmental risk to the buyer (including by obtaining releases and indemnities from the buyer under the contract of sale in relation to environmental liabilities) and for that liability for contamination existing at the commencement of the lease to remain with the landlord under the terms of the lease.

While a seller-friendly position may, on its face, be appealing to sellers, asset owners preparing for a sale and lease back should consider adopting a more nuanced approach to environmental risk to reflect the seller's knowledge of the site. This will help maximise the price achievable for a transaction and can avoid a large price reduction to reflect the acceptance by the buyer of uncertain remediation liability.

'Baseline' environmental reports are often adopted by the parties to record the site condition at lease commencement. In practice, these often cause as many disputes as they avoid where:

- technical scopes of work are deficient;
- sampling grid patterns are non-compliant or inadequate;
- emerging contaminants are subsequently identified; or
- more often, pre-existing contamination, such as groundwater plumes, worsen over the term of the lease without clear evidentiary parameters for assessing the change.

This is not to mention changes in environmental legislative regimes, including reporting obligations.

From a commercial perspective, buyer / landlords are incentivised to identify contamination types or levels which exceed those in the 'baseline' report. This dynamic is often exacerbated where ownership of the site has changed hands during the term of the lease so that the original relationship between buyer/landlord and seller/tenant no longer exists.

## 3. Restrictions on dealing with lease

Both sellers and buyers should closely consider their positions in relation to landlord and tenant rights to deal with their interest under the lease.

While this consideration is relevant in all leases, it's often elevated in sale and lease back arrangements, where leases are frequently triple net and for a long duration, and not easily re-leased on equivalent terms when vacant.

### Seller / tenant considerations

- A tenant may look to restrict the landlord's rights to sell the property to particular classes of buyer. This is particularly relevant in certain industries (such as technology, manufacturing and pharmaceuticals) where tenants may have heightened concerns about protecting their IP or simply where a tenant does not want a competitor or an inexperienced party as their landlord. An alternative to a restriction is the grant of a right of first refusal in favour of the tenant should the landlord look to sell the property. Regardless of the approach taken on any restrictions on a landlord dealing, tenants



should also consider how they will enforce any breach by a landlord. Typically, a caveat will be the only way of preventing a transfer of land in breach of the lease.

- Rights of first refusals are typically resisted by institutional grade buyers as they can inhibit an effective sale process.
- Any restriction on a landlord's right to sell or transfer the land should be coupled with a restriction on the change in control of the landlord.
- In jurisdictions where nomination is permitted, sellers should consider requiring that a buyer obtains the seller's consent to any nomination, as any nominee will ultimately become the landlord under the lease.

#### Buyer / landlord considerations

- While restrictions on tenant assignment and change in control are common place in leases between sophisticated parties, landlords of long term triple net leases should pay careful attention to the detail in these provisions. For example, many leases will provide that the landlord must act reasonably in considering whether to provide its consent to an assignment when certain criteria are satisfied. In a long term, triple net lease scenario, the financial strength of the tenant is crucial to landlords. Landlords should be careful to ensure that the financial thresholds that an assignee is required to meet are sufficiently high and that the landlord has rights to impose additional security if required.
- A change in control of the tenant is typically deemed an assignment of lease, requiring landlord consent. Again, the landlord should pay careful attention to the change in control provisions to ensure that any change in control of the tenant (including at a company group level) does not diminish the tenant's financial standing.

## 4. Ownership of fixtures and fittings.

Having clear terms on ownership of fixtures and fittings is important to avoid disputes at lease end, particularly concerning fixtures, fittings and equipment acquired by the tenant post-commencement.

For new fixtures, fittings and equipment, ownership and therefore depreciation rights can give rise to disputes at the end of the lease and parties should carefully consider their position in relation to ownership.

## 5. Changed accounting standards

Both seller / tenants and buyer / landlords need to consider how the sale and lease back will be reported on the balance sheet when structuring transactions.

There have been recent and material changes to the International Financial Reporting Standards (IFRS), implemented by IFRS 16, that affect how and when sales and leases are recognised on a company's balance sheet.

Prior to IFRS 16 (which has applied since 1 January 2019), leases of premises were included under operating leases, a form of off-balance-sheet financing. However, from 2019, IFRS 16 eliminated the classification of leases as either operating leases or finance leases and created a single accounting model for all leases for tenants, which requires it to be reported on a company's balance sheet.

Typically, the key drivers affecting balance sheet reporting in sale and lease back transactions relate to the timing of passing of risk, whether the contract of sale is conditional, and the point at which the tenant takes control of an asset. Engagement with the relevant parties' finance teams at an early stage of negotiations is critical to ensure that the requirements in respect of reporting are satisfied.

## 6. FIRB approval

In the current COVID-19 environment, if the parties are foreign persons, FIRB approval may be required for both the acquisition of the freehold by a foreign buyer and to the grant of a lease for over five years to a foreign tenant, regardless of the value.

There will be heightened scrutiny from FIRB where the asset is one that affects 'national security'. The concept of 'national security' is constantly evolving and includes data centres and 'critical infrastructure'. In the COVID-19 world, 'critical infrastructure' may include key manufacturing sites and supply chain infrastructure, including key distribution sites. These are areas in which we are seeing increasing numbers of sale and lease back transactions take place.

FIRB is a process that needs to be managed by the parties at the outset of the transaction in order to minimise approval times. The potential conditions that FIRB may be likely to impose should also form part of the parties' consideration of the relevant transaction parameters early in the process.

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