

In this section

- 6 Sale and leaseback report continued
- 7 Dominic Walsh on an acquisitive M&B
- 8-9 Corporate Britain is going green
- 10 Music: the sweet sound of success
- 11 Mixing alcohol with social responsibility
- 12 A dangerous cocktail of celebrity and restaurants
- 13 Peter Martin: navigating the health jungle

Insight

Abundant finance and robust investor appetite for property assets have underlined the importance of sale-and-leaseback structures for pub property portfolios, writes **Jim Fallon**

A lease of life for pub companies?

Property-backed valuations have risen markedly in recent years, leading to an increase of more than 30% in freehold-backed pub company valuations over the last two years.

The recent trend in the UK pub industry towards sale-and-leaseback agreements has followed the hotel industry model, which has often separated the property assets from the operating company, allowing the firm to lease back the assets (known as a PropCo/OpCo structure).

This has the advantage of removing the properties from the balance sheet, freeing up capital for other uses and, therefore, improving shareholder value.

The attractiveness of the structure is enhanced by the significant amount of capital available for property investments – a result of a low interest rate environment – thereby making the leasehold rental yield modest and especially attractive in the early years.

Precedents in the UK leisure sector

Sale-and-leaseback financing has had a profound impact on the UK leisure sector in recent years, in many cases fundamentally altering investors' perspectives on the prices they are prepared to pay for companies.

More significantly, it has also paved the way for financial buyers (private equity and property investors) to trump strategic (trade) buyers in competitive auction processes, despite the absence of synergies.

In effect, the property dynamic has, to a large extent, decoupled the valuation of companies with rich asset-backing from multiples of underlying earnings.

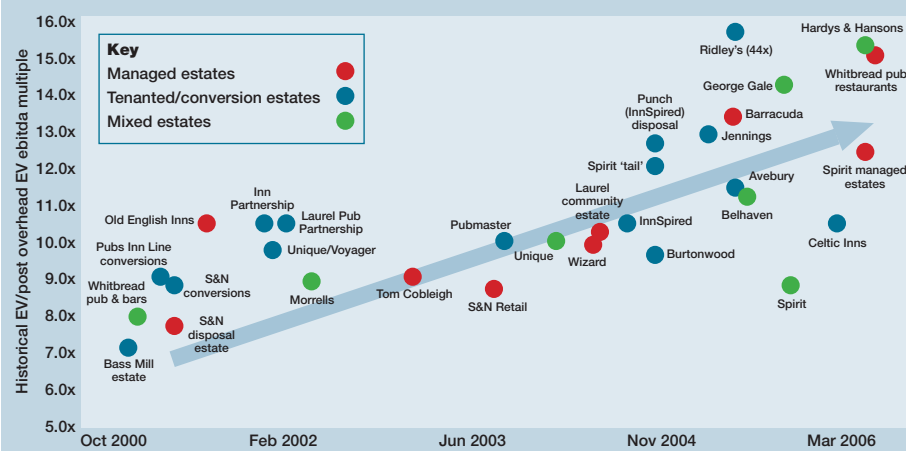
As table 1 indicates, there has been considerable sale-and-leaseback activity in the UK leisure sector of late, not to mention the UK retail sector – see table 2 – which has embraced the benefits of OpCo/PropCo structures with enthusiasm.

In particular, sale-and-leaseback has underpinned the financing structures in several recent major leisure transactions, notably the MidOcean Partners and LA Fitness offer for Crown Sports.

In addition, leisure operators are beginning to receive unsolicited approaches from property investors to implement PropCo/OpCo arrangements.

In some cases, virtually all of the cost of the acquisition has been recouped by a sale-and-leaseback deal, effectively giving the operating company to the purchaser for no cost. ▶

The evolution of property-backed pubco valuations



Notes

- 1 Ebitda multiples shown are company (not outlet). Ebitda multiples pre-synergy benefits.
- 2 Celtic Inns Ev/ebitda acquisitions multiple assumes an overhead of £300K for the business.
- 3 Spirit managed estate and Whitbread pub restaurants Ev/ebitda acquisition multiples assume an overhead of £50K per pub.

1. Recent sale-and-leaseback activity in the UK leisure sector

Date	Seller	Buyer	Value	Comment
Oct 2004	Travelodge	Prestbury	£400m	The first UK hotel chain to sell-and-leaseback its entire property portfolio.
Nov 2005	(Harbour Club) Next Generation	Consensus	£30m	33-year lease. Next Generation itself was later sold to London and Regional for c£200m.
Mar 2006	LA Fitness/Crown Sports (Dragons)	R20 Vehicle	£50m	Sale-and-leaseback of 15 Dragons health clubs, acquired by MidOcean. PropCo/OpCo structure, with 35-year lease.
July 2006	Rank Group	Earth and Solarus Estates	£172m	Sale-and-leaseback released £53m gain for Rank; properties leased back for 15 years at £11.2m per year, an initial yield of 6.5% per annum.
July 2006	Vue	Process currently underway	£80m*	6 cinemas to be sold following management buy-out. Anticipated initial yield of 5.5%; 15-year leases, apart from flagship in London (30 years). Fixed increases and open-market reviews every 5 years.

2. Recent sale-and-leaseback activity in the UK retail sector

Date	Seller	Buyer	Value	Comment
Mar 2005	Debenhams	British Land	£495m	23 freehold properties sold-and-leased back for 35 years, option for a further 25. Initial yield of 5.6% with annual rises of 2.5-3%. Review in March 2019.
Mar 2005	Tesco	Consensus	£366m	Sale-and-leaseback of 12 stores and 2 distribution centres. Initial term of 27 years with 15-year break clause.
Aug 2005	Boots	REIT Asset Management	£298m	312 stores sold at initial yield of 5.3% (£16m rent). Fixed increases of 1.5% per annum. Initial term of 15 years. 20 expressions of interest.
Nov 2005	Tesco	Morley Fund Management	£270m	Structured as a joint venture.
July 2006	Kingfisher	British Land	£198m	Disposal of 7 large-format B&Q stores. Lease lengths are 20 years with the option to break at 15 years. Protection from above-inflation increases.

► Sale-and-leaseback facilitates high valuations

The financial engineering involved in a sale-and-leaseback deal allows seemingly heady valuations of property-backed businesses, as illustrated in the hypothetical example in table 3 where financial engineering increases the valuation by more than 30%.

The sale-and-leaseback mechanism facilitates valuations far in excess of what would be expected through standard valuations based upon multiples of ebitda and goes part of the way to explaining the high prices recently realised in the sector and the ability of financial buyers to compete with strategic buyers – and win.

Though there is the potential to unlock significant value and to release cash to be deployed in the core pub business, careful attention needs to be paid to the structure of the sale-and-leaseback.

Unlike the hotel industry, where rent is typically based upon a percentage of turnover on a management contract basis, pub sale-and-leaseback structures tend to benchmark the rental charge as a percentage of pre-overhead ebitdar (ebitda plus rent) as a starting point (typically in a range of 50% to 60%).

Thereafter, rent is usually structured to increase at a fixed rate over time.

The implication is that care needs to be exercised to ensure that growth in the underlying business can sustain the rent increases and that the structure is sufficiently flexible through, for instance, rights to substitute or to vacate property.

Managing a pubco is increasingly linked with careful management of a portfolio of real estate

3. How sale-and-leaseback lifts value

£m	Standard	S&LB
Ebitdar ¹	12.0	12.0
Central overheads	(2.0)	(2.0)
Rent ²	-	(7.2)
Ebitda	10.0	2.8
PropCo valuation ²	-	120.0
OpCo valuation ³	100.0	11.2
Firm value	100.0	131.2
Implied ebitda multiple	10.0x	13.1x

1. Earnings before interest, tax, depreciation, amortisation and rent

2. Rent = 60% of ebitdar; rental yield = 6%

3. Assumes blended multiple of 10x ebitda;

OpCo only: 4x ebitda

Underlying profitability growth is required to sustain fixed rent increases

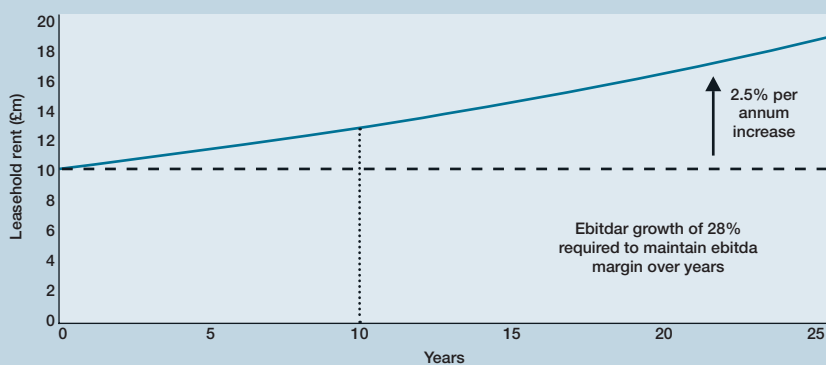
As fixed rental uplifts form part of the sale-and-leaseback structure, it is important to consider carefully the future profitability position (see table 4). This structure is better suited to higher-growth businesses.

Impact of IFRS – a presentational disadvantage for public companies?

The accounting treatment of the sale-and-leaseback structure requires careful planning to ensure the property sold can be kept off the balance sheet and that the rental payments remain fully deductible for income tax purposes.

Structures involving fixed rental increases over the life of the lease pose particular issues in view of the requirement under International Financial Reporting Standards (IFRS) to apportion the full known rental charge over the life of the lease on a straight-line basis.

4. Underlying profitability growth is required to sustain fixed rent increases



This treatment results in a significantly higher charge to profits in the immediate accounting period than under UK accounting treatment and a reduction in distributable reserves.

The impact of this was strikingly illustrated in the case of Center Parcs, which sustained an additional rental charge of £9.7m in the year to April 2005, coupled with a £13.9m reduction in retained profits on transition to IFRS.

The effect is to penalise companies immediately for rental increases that should be underpinned by enhanced profitability over time.

This makes it difficult to convince the equity markets of the merits of such structures and affords private companies a distinct presentational advantage in terms of structuring sale-and-leaseback vehicles – at least until UK GAAP converges with IFRS.

Looking to the future – can the good times last?

Perhaps the most pressing issue preying on the minds of pub executives is the extent to which the availability of cheap asset-backed finance exposes them to unsolicited takeover bids.

It is difficult to see current market conditions prevailing indefinitely, particularly in an environment of likely interest rate increases. However, there continues to be a significant level of funding available to support such structures.

Separating the property and operating assets of a pub company necessarily exposes the OpCo to higher perceived risk: any downturn in trading performance immediately and significantly erodes profitability in the context of fixed rental obligations.

Whatever happens, it is clear that managing a pub company is increasingly linked with careful management of a portfolio of real estate.

Low interest rates, coupled with significant levels of funds searching for property assets, have created an arbitrage opportunity between the public and private markets.

This has led to a large number of acquisitions funded by innovative financing techniques.

The net result of this is an increase in leverage and, therefore, operational gearing within the sector.

Time will tell who the winners and losers are but one could expect to see a few businesses getting into difficulties through excessive gearing.

In summary, sale-and-leaseback structures should be viewed as a form of financing and care should be exercised when putting financial gearing on top of operational gearing.

Jim Fallon is a partner at McQueen, the corporate finance specialist that advises Wolverhampton & Dudley Breweries and Fuller's

M&Creport

GUIDE TO UK BRANDED RESTAURANTS 2006



WILLIAM REED BUSINESS INTELLIGENCE

The essential guide to the UK branded restaurant industry

To order your copy call +44(0)1293 846579