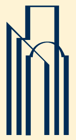

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Southland Businesses Explore New Real Estate Option

BY BARRY SAYWITZ

As real estate markets around the country continue to tighten and as the rapid recovery and upswing of the commercial real estate cycle continues, many markets are experiencing vacancy rates in the single digits — which makes finding available product difficult for many tenants. In Southern California in particular, desirable properties often have multiple bidders, both for acquisition and for lease. In many submarkets there are even bidding wars for available space.

As the economy recovers and companies continue to expand, many users of commercial real estate find themselves in need of new and/or additional facilities to not only upgrade systems and equipment but to meet future expansion needs as well. In many instances, tenants find themselves looking to build-to-suits to accommodate their expansions due to the lack of available product. These build-to-suits can come in the form of a developer constructing a new facility that the company would lease or buy at its completion. The ultimate cost to the user in this scenario is a function of the price of land, cost of construction, and the cost of money available to the user and/or developer. In many cases, these costs are in excess of current market rents for existing product and, although such an arrangement gives the user the ability to expand, additional financial commitment is required.

Exploring an Alternative Option

Recently, The Saywitz Company, a national commercial real estate brokerage and consulting firm headquartered in Orange County, found itself facing several scenarios in which clients were looking to expand their operations throughout Southern California. However, like other areas around the country, many of the markets in Southern California are extremely landlord-oriented and, as a result, available product is scarce and rental rates continue to climb.

> "Should a company employ an entrepreneurial strategy... rewards can increase the company's bottom-line performance..."

To accommodate its clients' expansion plans and control real estate costs, the real estate firm implemented an innovative concept called the Purchase Partial Lease Back (PPLB). Essentially, the PPLB combines the concepts of both the build-to-suit, purchase, and leasing scenarios all into one transaction which goes something like this: the user will either purchase or construct a new facility to accommodate its requirements. However, because the company is uncertain about its growth rate and may not want to commit to additional cost, it will construct a facility that exceeds its immediate square footage requirements. The company then owns the facility and can lease back the portion of the facility that it doesn't currently need to another tenant. The idea is that the rental income generated from the new tenant will offset — in part or in full — the company's financial obligations for the new facility, thereby giving it the flexibility to gradually grow into the facility and reduce overall real estate costs.

Of course, the dynamics of the marketplace, the financial stability of the user, and future projections for the market and the user's growth must all be considered in formulating this transaction.

Rewards and Risks

As in any real estate transaction, there are both rewards and risks associated with PPLBs. The major benefits include ownership, flexibility, and cost savings. First of all, ownership of a property provides tax incentives to the principals of the company, and projected appreciation of the asset as a whole offers an additional upside. Secondly, a PPLB arrangement gives the owner flexibility to control future growth. The user can rent out the excess space for short-or long-term leasing to coincide with its future growth plans and gradually ease into the overall size of the building. Finally, companies can realize significant cost savings. For example, when financial analyses are performed on a build-to-suit lease transaction versus the PPLB, the overall expense of the latter can result in a 30 to 50% bottom-line cost savings to the company.

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Another plus: the lease signed with the tenant for the excess space in the building will typically have annual increases, while the user's mortgage will stay fixed for the length of the mortgage. In time, the monthly expense to the user decreases as his rental income increases.

Of course, as alluded to earlier, PPLB transactions are not without their risks. Such transactions are, for instance, vulnerable to future downturns in the real estate market. Although today we are certainly in the "up" cycle of the real estate market, should the real estate market take a downward turn, the user may be left with an asset that could be worth less than what it paid for the property. However, as long as the user continues to utilize the facility, the cost will still be cheaper than renting.

Another potential negative to the PPLB is that the user must assume ownership responsibilities. The user is now responsible for maintaining the facility and resolving any issues with its tenant. After all, in this arrangement the user is, in effect, the landlord. While this "risk" can be alleviated by hiring a third-party manager to oversee those responsibilities, it is still an issue that must be considered.

A third risk relates to finding a tenant. As would be expected, additional costs may be incurred by the user if a portion of the facility remains vacant for a period following completion. This could certainly alter the financial analysis and require additional up-front costs until a tenant is found. It should be noted, however, that the typical PPLB involves new construction, giving the user a minimum of 6 to 12 months to market the property prior to its completion.

Assuming this transaction is structured in a market that has decreasing vacancies and increasing rental rates, there should be no difficulty in finding a tenant prior to completion of the building.

In summary, the risks involved with these transactions relate to the future stability of the real estate market and the business projections of the user. Should a company employ an entrepreneurial strategy to take advantage of the current real estate market, favorable lending practices, and increased rental rates, the rewards can increase the company's bottom-line performance and give it control of its own destiny with respect to its real estate use.

Cases in Point

Several Southern California companies are already considering whether PPLB transactions are the way to go for their businesses. One Saywitz company client, for example, recently acquired a manufacturing/distribution facility in Oceanside to meet its expansion requirements. After a thorough analysis of the marketplace, executives realized that the increasing rents made it more expensive to occupy additional space than to actually own the property themselves. The PPLB afforded them the ability to not only acquire a larger property that will ultimately accommodate their future growth plans, but also provided an end result in which leasing out approximately 50% of the building will reduce overhead expenditures to 20 to 25% below the cost of leasing a similar facility. Since the company opened escrow on the property less than six months ago, the rental rates in that market have already increased 10 to 20%. The company expects the value of their property to increase in excess of $1 million within the next 12 months.

Another potential success story may be found in an international manfacturer and distributor of haircare products headquartered in L.A. County. The company's current international headquarters consists of three buildings, but the firm is exploring the advantages of the PPLB. The preliminary analysis indicates a potential savings of $2-4 million over the next 5 years by employing this process.

Similarly, another manufacturer and distributor headquartered in L.A. County is exploring the possibility of constructing and owning a 450,000-square-foot facility to accommodate its new corporate headquarters and distribution needs. A facility of this size located in Los Angeles will allow the user to take advantage of economies of scale and significantly reduce construction costs by utilizing the size of the facility. The net mortgage cost in this case could be as much as 50% lower than leasing a comparable facility.

While each of these companies' motivations and desires are different, one thing remains true for all: PPLBs not only allow them to control their own growth in the future but also offer the opportunity to reap the benefits of a rising real estate market and the tax benefits associated with ownership. In fact, it's such an appealing concept that The Saywitz Company itself is practicing what it preaches: The company recently purchased its own building in Newport Beach for its headquarters.

The Bottom Line

The user who understands the risks and rewards associated with PPLB transactions and employs a solid investment analysis combined with future growth projections will be able to either acquire or construct a new facility that allows them to incorporate better efficiency and use of space, along with technological change. Such users will be able to place an asset on their balance sheets rather than a rent expense and significantly reduce overall real estate costs.

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