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Net Lease Forum: The Unstoppable Rise of SLBs

By Jennifer LeClaire
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When Stern Group set out to expand its Mercedes-Benz dealerships across the Netherlands last year, the automotive company capitalized on its real estate by signing sale-leasebacks for 10 of its retail and service sites with W. P. Carey for $62.9 million.

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When Stern Group set out to expand its Mercedes-Benz dealerships across the Netherlands last year, the automotive company turned to an alternative financing strategy that is seeing strong momentum in the commercial real estate industry. The Dutch company sold 10 of its retail and service sites to W. P. Carey,

a REIT specializing in corporate sale-leaseback financing and single-tenant net lease acquisitions, for $62.9 million.

As part of the strategy, Stern immediately leased back the retail portfolio in a 17-year triple-net deal with WPC. Thanks to the newfound liquidity through the sale-leaseback—a form of financing that allows companies to maximize the value of real estate assets—Stern reduced expensive bankrolling and is funding new growth of its Mercedes-Benz dealerships in Europe.

“A long-term sale-leaseback was the logical decision to free up illiquid capital tied up in our real estate holdings to fund strategic growth initiatives,” says Henk van der Kwast, chief executive officer of Stern, noting that the SLB-net lease deal allowed him to “advance strategic components” of the company’s business plan.

Stern is one of many corporations selling its facilities and entering into long-term net leases with the investors as an alternative for managing and financing the buildings they occupy. The upside—from unlocking the full value of the asset in a cash equivalent, to lease structures that qualify as operating leases so the expense stays off the company’s balance sheet, to optimizing lease payments to keep rents lower—is too appealing for many corporate real estate users to pass up in the current economy.

Although SLBs aren’t right for every company, activity has been rising since 2010. In fact, SLB activity jumped from more than $4 billion in 2012 to $12 billion the following year, according to Stan Johnson Co. Transactions dipped to $10 billion in 2014 but the firm estimated sales would hit $12 billion again in 2015. Industry watchers say SLB-to-net lease deals can be challenging but they expect to see more corporations leverage this financing model to extend their financial power in 2016.

SLB Momentum Rising

Even though pricing in terms of cap rates is up 25 basis points on average, Jason Fox, president and head of global investments at WPC, reports “significant activity” in SLBs in the net lease market. He’s witnessing more value placed on the certainty of a deal closing and execution over pure pricing.

“We see this as a function of weakness in the CMBS market as well as less capital flowing into the market from established investors and the volatility and uncertainty of the financial markets in general,” Fox says. “Europe remains at a different point in the cycle with cap rates continuing to compress as US investors are becoming increasingly more comfortable with the risks associated with investing in that region, creating capital inflows. However, given the lower cost of debt, attractive investments with large spreads are still available.”

"The quantity of sale leasebacks has risen dramatically, but the quality has also been significantly reduced."—Paul Domb, United Trust Fund

The multimillion-dollar question is: What's driving the momentum?

Paul Domb, vice president of asset management at net lease investment firm United Trust Fund, points to the Federal Reserve and the global monetary policy of holding rates artificially low for such a long period as two key drivers. These factors, he says, have left many institutional and individual investors chasing yield. "A well-structured SLB or a net lease has provided the market with an opportunity to structure or buy into an excellent investment alternative," Domb says. "The quantity of sale leasebacks has risen dramatically, but the quality has also been significantly reduced."

As of Feb. 11, 2016, the 10-year treasury had dipped to 1.66%, far below the long-term average. According to Joseph Yiu, managing principal of real estate private equity firm Elm Tree Funds, that makes now an opportune time for corporations to enter into long-term SLBs with lower rents. He also sees proceeds and the concept of reinvestment as catalysts spurring the momentum.

"If the corporation decides to own real estate, the asset on its balance sheet is constrained by its lenders' loan covenants that limit leverage, and the it has to allocate expensive equity that could otherwise be reinvested into its operations," Yiu explains. "Through an SLB, the corporation can unlock equity and get credit for 100% of the asset's value today at multiples that are accretive to its operations. The value of the asset is determined by the corporation's credit, location and type of asset."

ElmTree is actively sourcing sale-leaseback transactions that have a value-add component through construction or renovation. Last year, one of ElmTree's corporate clients identified a 67,000-square-foot office building in Birmingham, AL that fit its specifications for a customer care facility. ElmTree acquired the facility and immediately signed a long-term lease with the corporation. Concurrent with closing, ElmTree provided the tenant with a $6-million dollar allowance and provided construction oversight for the renovation of the facility.

The SLB-to-Net Lease Challenge

Competition is rising for quality SLB opportunities that ultimately morph into net lease deals, which is only one of the challenges in this sector. Indeed, both corporate property owners and SLB investors face obstacles to getting these deals done.

Fox suggests investors ask themselves a series of questions before entering into a sale leaseback deal: Are you buying the real estate at the right price relative to its physical replacement cost and to other properties in the market? Is the asset critical to the tenant's business? If the tenant vacates the property, could it be easily adapted to the needs of new tenants? Do you have a strong asset-management team that maintains an ongoing relationship with the tenant, stays up to date on the market and is aware of opportunities to enhance the value of or expand a property? In the case of vacancy, is the team positioned and equipped to release or sell the asset at a price that maximizes value for the portfolio?

"The amount of domestic real estate sitting on non-real estate corporate balance sheets is estimated to be between $3 trillion and 5 trillion. We believe the low interest rate environment will trigger $10 billion to 20 billion dollars of sale-leasebacks in 2016."—Joseph Yi, Elm Tree Funds

"The challenges can sometimes be in the actual papering of the agreement," says Gordon Whiting, managing director of privately held investment advisor Angelo, Gordon & Co. and the founder and portfolio manager of the firm's net lease real estate strategy. "While the parties may agree on the financial terms of a deal, at the end of the day, these are very long-term contracts with a number of detailed provisions that need to work for all parties."

On the flip side, Fox says corporate sellers occupying and maintaining critical operations in the facilities they sell to investors need to ask two key questions before inking a deal: Will the basic financial terms and structure of the lease give the seller liquidity and support its growth and operational strategies? Is the buyer—the new landlord—a well-capitalized entity with a solid history of working with tenants to

address ongoing needs in the facility, including funding any necessary improvements and future expansion?

"Sellers are generally getting close to their wish list but it's because the demand-supply ratio is currently so one-sided," says Domb. "The supply side, however, will remain weak as so many companies have in some form or another taken advantage of this low interest rate policy created by the Fed. When rates do go higher, it will then thin the massive herd of net leased investors."

Will The Trend Continue?

That, it seems, is the big question of the moment. Certainly the interest rates play a part in sustaining the momentum. Nevertheless, Yiu is betting budgetary pressures facing corporate real estate users are likely to accelerate the shift by corporations away from owner-occupied facilities and increase demand for net leased space.

"Most businesses do not specialize in owning real estate, so why have capital tied up in an asset that is not part of the core business?"—Gordon Whiting, Angelo, Gordon

"Given the appreciation of stabilized real estate over the past cycle, corporations are financially incentivized to monetize their real estate holdings especially if they have exhausted the depreciable benefits of real estate ownership," Yiu says. "The amount of domestic real estate sitting on non-real estate corporate balance sheets—both public and private—is estimated to be between $3 trillion and $5 trillion. We believe that the low-interest rate environment will trigger $10 billion to $20 billion of SLBs this year."

Fox also sees demand for SLBs continuing as companies look to lock in lower lease rates and enter into financing transactions to support their plans to invest in facilities, technology and equipment to grow their business.

“In the current environment where increasing interest rates seem to be a foregone conclusion and timing and pace of increase are the major unknowns we see this increasing,” Fox says. “Another factor relates to government scrutiny of REIT spinoffs, which has led some companies and activist investors to look at SLBs as an alternative.”

Whiting insists that the SLB is not a fad in the net lease industry. There are too many benefits, even when interest rates rise, that make SLBs an attractive proposition for corporate real estate owners. “Sale leasebacks can be used to pay down debt or if a company needs capital to expand,” he says. “Most businesses do not specialize in owning real estate, so why have capital tied up in an asset that is not part of the core business? It is more efficient to pursue a sale leaseback and use the proceeds to invest in the core business.”

Still, Domb is proceeding with optimistic caution and offers some strategic advice for investors. He argues the industry is in a bubble because of artificially low interest rates, investors chasing yield, the use of floating rate debt to maximize yield, poor due diligence by some investors and the mass utilization of OPM. His final word: “Those who conduct appropriate due diligence will be in the best position to weather the storm when rates do go higher.”

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