Sale-Leasebacks Back on Track

By Allison Landa

California's fall sale of an 11-property, 7.3 million-square-feet office portfolio for $2.3 billion put cash in its empty coffers, a solution in the face of so many state governments' financial woes. But the enormous sale-leaseback deal with California First L.L.C., a group of institutional investors headed by private real estate firm Hines and international private equity firm Antarctica Capital Real Estate, portended something else for commercial real estate.

The deal served as a prime indicator of the sale-leaseback's slow re-emergence this year. While sale-leasebacks have been accepted as a viable strategy in U.S. corporate real estate for more than 20 years, the credit crisis and proposed changes in accounting treatment for leases cooled corporate enthusiasm for these structures over the past two years, noted Craig Tomlinson, an investment sales director with Stan Johnson Co. As the sale-leaseback begins to regain ground in 2010, he said, the most notable deals belong to investment-rated tenants with short-term liquidity needs—tenants such as the Golden State.

Bruce Westwood-Booth, an executive vice president with Jones Lang LaSalle Inc., said he is seeing much more demand for sale-leasebacks than at this time last year. "They were very big in 2005, 2006 and 2007, and there were a lot of residual transactions that even occurred in 2008, but in 2009 everything pretty much froze up, where we didn't see a whole lot of activity," he said. "This year is the reverse."

Cash Flow with Continued Use

Since the first quarter, he said, there has been a palpable amount of discussion around sale-leasebacks—combined with more execution and more flow. He believes the drivers are significant demand as well as equity on the sidelines seeking to employ funds. That equity, he said, is better used for sale-leasebacks than in the basic bond market, which offers a very low yield, or for other fixed-income opportunities.

According to Tomlinson, the two main advantages of sale-leasebacks are that the cash generated by the deal can usually be used to drive a company's revenues or that it can solve a liquidity problem that it may be facing.

"If rents (will) increase substantially ... and the lease is relatively short, (risks may) outweigh the benefits."

—Jeffrey Rogers,
Integra Realty Resources

Steve Lurie, an attorney with Greenberg Glusker Fields Claman & Machtinger L.L.P., added that sale-leasebacks can allow a company to raise capital quickly, realize the full market value of otherwise illiquid assets, retain the right to use and occupy the property that is sold, increase borrowing capacity through an improved balance sheet, avoid the burdens of conventional mortgage financing and create potential tax savings.

"A company considering a sale-leaseback must determine whether the transaction will be economically benefi- *(continued on page 20)*

Economist's View

Another Economic Crisis?

By Ken Rosen

The big economic news is that the Federal Reserve announced plans to buy another $600 billion of Treasury bonds between November and the end of June 2011, with the explicit goal of lowering long-term interest rates and raising inflation expectations. Federal Reserve policymakers have expressed dissatisfaction with the slow rate of GDP growth, the high rate of unemployment and the low level of inflation. They think that by buying $600 billion worth of longer-dated Treasuries, they will stimulate economic growth and inflation.

While the massive balance sheet expansion of the Fed in 2008-2009 was essential to avert a complete meltdown in the financial system, we think the additional intervention announced Nov. 3 has a potential to create another economic crisis. Stimulating bubbles in commodity prices and bond and stock markets could push investors into unsustainable investments that will eventually correct and cause massive losses. In addition, a currency war started by the Fed policies could well spin out of control and destabilize the world's economies by causing massive capital inflows to emerging markets and badly damage the euro and Japanese economies as their exchange rates appreciate.

So the question arises: How does the Fed think its policies will cause the economy to improve? The traditional mechanisms by which monetary policy works are as follows: 1.) Lower interest rates stimulate the housing market through increased home sales, housing starts and home mortgage refinancing; 2.) lower interest rates cause more capital investment by

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companies; and 3.) lower interest rates reduce the value of the dollar and so increase the competitiveness of U.S. exports.

In terms of housing, we believe lower interest rates will have little further impact on a market that has excess inventories, a huge foreclosure hangover and a large number of households that have underwater mortgages that cannot be refinanced.

We think interest rates are not the problem, and a set of targeted policies aimed at the foreclosure and underwater mortgage problem can do far more to help the housing market and the economy than slightly lower mortgage rates. Large companies are already stuffed with cash, so lowering their borrowing cost will do little to stimulate new investment. Small businesses and marginal households are unable to access the easy money the Fed is trying to provide, as credit is still tight in the banking system for those types of borrowers.

The Fed might be successful in causing investors to move out of dollars and into other currencies, commodities, stocks and higher-yielding bonds. But the surge in commodity prices in the past several months in anticipation of QE2 should quickly translate into higher food and energy prices and overall inflation rates that will undermine households' real income and weaken consumer spending without producing new jobs. The plunge in the dollar may create a little more export activity but will at the same time create competitive currency devaluations and higher import prices for U.S. consumers. Higher stock and bond prices could create some additional spending by households as they feel wealthier, but may create far more harm for the economy when they correct to more normal levels after QE2 ends. In fact, the biggest beneficiaries of QE2 are financial market speculators and the U.S. Treasury, which can fund our massive deficits at lower rates.

Economic history is replete with the false belief that printing money can produce gain for an economy. The Fed's bold experiment may provide a small short-term benefit for the economy, but at huge risks to the long-term health of the world financial system.

Meanwhile, the real economy continues to show slow but substantial recovery. Real GDP grew at 2 percent in the third quarter, in line with our forecast of 2.2 percent for the year. We expect growth to accelerate a little in 2011 but still to be in the 2.5 percent range. Private-sector employment growth continues to show a slow but steady improvement. In October, we added 159,000 private jobs. We expect that we will have added 1.2 million jobs in 2010 and that job creation will accelerate to the 1.5 million to 1.8 million level in 2011.

This modest economic growth will not move the unemployment rate much lower and will leave policymakers dissatisfied. U.S. inflation is contained for the moment, making the Fed feel more comfortable in its policies. However, within the next six months, commodity and import inflation will start showing up in various measures of inflation. In addition, rental housing is on the cusp of a rent spike, which will also show up in the next several years. The Fed could certainly get its wish, and inflation will accelerate to the 3 to 5 percent level over the next decade.

The REIT sector has responded to the promise of QE2 with a massive rally. The MSCI U.S. REIT Index was up 31.6 percent on a year-to-date basis through Nov. 5. While fundamentals in the commercial real estate sector are bottoming and are actually improving in the apartment and hotel sectors, we believe it is the extremely low capital market interest rates that are driving the rally.

There is no question that the capital markets have become disconnected from fundamentals. With fundamentals likely to improve only at a modest pace in the next several years, REITs have become quite rich compared to the private real estate market and the overall stock market. REITs are now trading at a 21 AFFO multiple, near the highest valuation since right before the 2007-2008 crash. REITs are trading at a 22 percent premium to private real estate values, near the highest premium of modern times.

The Fed's QE2 initiative is increasing this disconnect. If the Fed can keep long-term Treasuries at 2.5 percent for a long period of time, then REITs and private real estate values may have further upside potential. However, when the inevitable capital markets correction occurs, these valuations will be adversely affected. CPE

—Ken Rosen is chairman of Rosen Real Estate Securities Inc.

Sale-Leasebacks

cial," he said. "Important factors that impact this determination include the sales price, the amount of rent—which will naturally be impacted by the sales price and the seller/tenant's credit rating—and the uses to which the net cash proceeds from a sale will be put."

Westwood-Booth believes that currently the greatest advantage of sale-leasebacks is that benchmark rates are extremely low. "And that's really what's driving companies to do it right now," he said. "It's a good way for them to lock in low-cost, long-term funds. … It (provides) economic appeal plus a diversified form of capital."

The most serious current challenge, he said, lies in potential changes to lease accounting. The Financial Accounting Standards Board in August released an exposure draft that requires companies to record almost all leases as "right to use" on their balance sheets, meaning operating leases would essentially be eliminated. This portends a significant effect on both existing and planned leases. *(For more on this proposed change to the leasing code, see M. Aaron Paris' column "Winds of Change for Leasing Codes" on page 21 of the November 2010 issue of* CPE.*)*

Sale-Leaseback Disadvantages

Lurie warned that there are several possible disadvantages to sale-leasebacks, including a potentially lower EBITDA, loss of flexibility due to terms of the lease and the loss of the right to retain occupancy once the lease term ends, along with the attendant risks of incurring moving costs and unanticipated increased occupancy costs once the term ends. In addition, sale-leasebacks can incur a potentially negative tax impact if the basis in the property is low compared to the sales price.

He added that disadvantages relating to the right to retain occupancy at the end of the lease term can be eliminated by providing the seller/tenant with the right to repurchase the property in the future. However, this right could have a negative impact on the price a buyer/landlord would be willing to pay in the transaction.

Jeffrey Rogers, president & COO of Integra Realty Resources, said that the main challenge of sale-leasebacks comes from the need for sellers to make sure that they are not paying too much for the liquidity upfront.

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> – Steve Lurie, Greenberg Glusker Fields Claman & Machtinger L.L.P.

"For example, if rents increase substantially in the long run and the lease is relatively short, there is an element of risk that the company's rental payments over the long run will outweigh the benefits of having the capital upfront," he said.

Tomlinson asserted that "the classic tension" when it comes to sale-leasebacks is that the companies that most want to do the deals are typically the least attractive candidates, since their credit will not carry the debt on the asset.

According to Westwood-Booth, the companies that benefit most from sale-leasebacks, as well as the low-cost pricing seen in the current market, are those with a solid property in a desirable place and attractive terms and credit—in other words, the characteristics lenders seek in borrowers.

Those benefiting least, he said, are those with shorter-term leases of 10 to 15 years, as well as those in tertiary markets. The lack of a credit rating or poor credit might also doom them. *(For a discussion of benefits to net lease deals in secondary markets, see "Greener Pastures" on page 40.)*

"Really, we've got a situation where you've got the haves and have-nots," he said. "If you have, you get a lot. If you don't, you get nothing."

Rogers added that any entity seeking to raise capital, reduce tax liability or improve its balance sheet represents a good candidate for a sale-leaseback transaction. He believes companies benefit least when the increased long-term costs outweigh the upfront benefits.

Tomlinson noted that most companies consider sale-leasebacks a financing arrangement or a method of remaining flexible in their real estate allocations. "Companies with relatively static space needs and acceptable access to short-term capital usually don't consider these structures compelling," he said.

Favorable Conditions

Today's market could be considered opportune for sale-leasebacks. Rogers said that these transactions are most effective when companies are having a tough time accessing the capital markets—sale-leasebacks allow them to use their assets to generate significant capital immediately, in exchange for a stream of future payments. Additionally, sale-leaseback transactions are more likely to happen when cap rates are low and conventional mortgage financing is difficult or expensive to obtain.

"For the right property, right place, right terms, right credit, we're seeing cap rates that rival 2007," Westwood-Booth said. "So we're seeing very low cap rates … which means the pricing is extremely low."

Tomlinson observed that the most favorable economic conditions are when short-term borrowing rates are high compared to long-term rates—or the inverted yield curve.

In this environment, he said, companies can essentially finance their real estate through a sale-leaseback transaction for a much lower cost than their working capital is otherwise costing them. He added that sale-leasebacks may be in fashion at the moment but will not be forever.

"Such a borrowing climate is usually short-lived," he said. CPE

Still Better—But Noteworthy Absences

Recent discussions among the 10,000 property relevant sources CREOpoint tracks online peaked at 486 conversations the day Bruce Mosler, chairman of Cushman & Wakefield Inc., said rents would rise in 2011. Among the more specific CREObuzz™, "steady improvement" was finally talked about as much as "distressed," and "investment" is back on the radar screen significantly enough to show up. San Francisco was the second-most-talked-about market after New York, and Colliers International joined Jones Lang LaSalle Inc. in creating the most company buzz online. Do other professional service firms think that if they don't listen to online conversations about them, they didn't happen?

—JC Goldenstein, CREOpoint CEO

Source: www.CREObuzz.com, CREOpoint's proprietary data mining engine uniquely aggregating the online buzz about commercial real estate, drawing on more than 10,000 sources that mentioned commercial real estate or commercial property from Oct. 11 to Nov. 11, 2010. Word size and repetition correspond to frequency of references.