



CBRE

2012 SPECIAL REPORT
U.S. Sale/Leasebacks:
Unlocking Value

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EXECUTIVE SUMMARY

- Sale/leaseback transactions are equally compelling for both corporate occupiers and commercial real estate investors. For the majority of corporate, public sector and other institutional occupiers, the predominant appeal of a sale/leaseback transaction is to unlock value—the ability to invest raised proceeds into core businesses, generating a potentially higher return on capital.
- Over the past two decades, corporations have been increasingly executing sale/leaseback transactions—usually to better allocate capital, but also in many cases to manage residual real estate risk (vacant property risk). These decisions have typically not been driven by accounting considerations.
- At the same time, risk-averse institutional investors greatly appreciate the benefits obtained by leasing to higher-credit-quality tenants with longer-term leases.
- Moreover, many private equity firms that are acquiring companies with a large owned real estate component, particularly in the retail sector, are heavy users of sale/leaseback capital as a means to finance their acquisitions.

INTRODUCTION

Sale/leaseback transactions hold considerable appeal for corporate occupiers and commercial real estate investors alike. In a sale/leaseback transaction, the owner-occupant of a commercial property sells the asset it owns and occupies by executing a long-term lease with a real estate investor. Over the past twenty years, a wide variety of investment-grade—and below-investment-grade—corporations have viewed sale/leaseback transactions as a compelling corporate finance tool. Among these companies, there is no longer a rationale for directly owning and operating real estate, particularly given the investment appetite of third-party investors and advisors that can help monetize such assets. The change in corporate sentiment toward this strategy has led many Fortune 500 firms to sell regional and

national headquarters locations in such transactions. Industrial multi-nationals have also sold large distribution centers and portfolios of such assets.

Moreover, the sale/leaseback has evolved into an appealing financing alternative for corporations looking to unlock the value of their real estate assets and invest the proceeds in their core businesses. Similarly, well-located real estate with a credit tenant, which often characterizes sale/leaseback offerings, is very attractive to institutional and cross-border investors. In this Special Report, we focus on the rationale for sale/leaseback transactions from both a corporate occupier and institutional investor point of view, highlight the trends in the U.S. and discuss the outlook for this vehicle going forward.

THE CASE FOR SALE/LEASEBACKS: OCCUPIER AND INVESTOR PERSPECTIVES

Sale/leaseback transactions are equally compelling for both corporate occupiers and commercial real estate investors. The rationale for executing a sale/leaseback transaction is different in each case. Real estate is not part of the core business of most corporations, but is typically among a company's major expenses, along with compensation, health benefits and taxes. For a corporation that is in another line of business, owning real estate does not necessarily add to shareholder value, and its divestment frees up cash. Below, we document in detail the advantages of sale/leasebacks for both corporate occupiers and institutional investors.

SALE/LEASEBACK ADVANTAGES: OCCUPIER

- **Reallocation of Precious Capital:** Companies typically earn a higher return in their core business as compared to investing their capital in owned real estate. If a company is motivated to pursue this objective, the sale/leaseback vehicle provides 100% of the value of the property compared to traditional mortgage financing, which is currently capped at an approximate 65% loan-to-value ratio in the current lending market.

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Brian Scott Interview



Brian Scott, Senior Managing Director and Head of CBRE's Sale/Leaseback Group, provides his latest perspective on current conditions in the U.S. sale/leaseback market.

Q: How is the U.S. sale/leaseback market functioning at this time?

A: For transactions with good tenant credit, long lease terms, and good real estate fundamentals, pricing has returned to pre-recession levels. For transactions lacking in any of these areas, investors will provide a more restrained response. There is a limited appetite for risk, although given the oversupply of investment capital and lack of good investment opportunities, we expect to see investors stretching their criteria and pursuing deals that may be weaker in one or more of these areas. We find that, in order to lock in advantageous pricing, it is critical to clearly present to investors all the important information about the seller/lessee's business, its industry position, financial condition, and business plan, as well as the details of the proposed lease, the real estate itself, and the property's market.

Q: Multi-tenant property sale volume has rebounded recently from depressed levels during the recession. Is the same true of sale/leaseback volume?

A: Yes, although it remains well below the volume seen in the very robust 2005-2007 period. Sale/leaseback volume in 2011 did improve over 2010, and we are seeing many more inquiries from companies about monetization of real estate. One important factor that is helping the recovery of the sale/leaseback market is the recovery of the commercial real estate mortgage market. Unlike the 2008-2010 timeframe, debt capital is now readily

available and cheaply priced given historically low interest rates.

Q: Is monetization the right strategy for every company?

A: No. Every company has different financial objectives, operational circumstances, and philosophies on the ownership of real estate. A sale/leaseback won't be the right answer for every company. We take a consultative approach with clients and provide all available alternatives for their particular real estate situation. Sometimes, the correct answer is to do nothing, and we advise accordingly when our analysis leads us to that conclusion.

Q: What are common misconceptions about sale/leasebacks?

A: The most common misconception in my experience has been that some corporate executives feel that they will be giving up control of their property if they sell it in this format. In fact, the typical sale/leaseback buyer is a passive investor who wants no day-to-day involvement with the property and prefers to let the corporation continue to manage it exactly as they did when they owned it. The corporation controls the property in all important operational aspects, including a high level of autonomy with interior and exterior capital improvements and alterations. The corporation can also secure long-term occupancy rights through multiple renewal options, and can even maintain restrictive access for the owner for properties with confidential or proprietary operations.

Q: How are the proposed lease accounting changes impacting sale/leaseback decisions?

A: Accounting treatment of sale/leasebacks has never been a primary motivation for corporations to pursue these transactions. The typical reasons—freeing trapped equity and managing residual risk—are not accounting-related. In addition, credit rating agencies and investment banking analysts have been placing a company's operating leases back on the balance sheet for many years for credit analysis purposes. Further, the impact of one or even multiple sale/leasebacks on a large corporation's financial statements under the proposed changes should be minimal, given the size of these transactions relative to the company's total financial position.

(continued from page 2)

- **Financing Tool:** For below-investment grade companies, the sale/leaseback can be an alternative financing option, especially when commercial banks do not want to provide loans—similar to the period following the recent financial crisis.
- **Transfer of Risk:** The occupier can secure maximum value and occupancy rights based on a long-term lease, and at the same time transfer any residual value risk of an eventually unneeded property to a third-party operator.
- **Improving the Balance Sheet:** The gain realized from a sale/leaseback transaction can be amortized on the corporation's income statement, increasing reported earnings. This earnings impact can potentially improve the firm's financial ratios and margins.
- **Premium Pricing:** Empirical evidence shows that a sale/leaseback property sells for a premium of 13% relative to comparable non-sale/leaseback properties¹. The explanation for the premium is two-fold:
 - Expected cash flow for the sale/leaseback property may be greater due to the lack of periodic vacancy caused by tenant turnover which is typically observed in property markets.
 - The credit profile for the sale/leaseback tenant may be higher than that of the typical multi-tenant rent roll.
- **Tax Considerations:** Under a sale/leaseback structure, rental payments are currently 100% deductible against the company's taxable income, versus only the interest portion of a mortgage payment.

SALE/LEASEBACK ADVANTAGES: INVESTOR

- **Steady Performance:** Given broader volatility in the equity markets and rich pricing across fixed-income

1. C.F. Sirmans and Barrett A. Slade, "Sale-Leaseback Transactions: Price Premiums and Market Efficiency," *Journal of Real Estate Research*, Vol. 32, No. 2, 2010.

instruments, investor capital finds the steady and safe returns of sale/leaseback properties attractive. Sale/leasebacks also provide an immediate cash return on equity since leases are in place. Sale/leaseback leases behave much like a corporate bond, but also include a hedge against inflation depending on the lease term and the rental rate adjustments.

- **Appreciation Potential:** The investor can capture any appreciation in the real estate, particularly if the occupier renews the lease.
- **Lower Management Costs:** A sale/leaseback investment requires no or only modest property management activity given the single tenancy. The investor acquires a property occupied by a long-term tenant. Uncertainty associated with operating expenses and vacancy is muted, increasing the investment value to the buyer. As a result, premium pricing on such assets is justified because of the lack of anticipated periodic vacancy.

RISKS AND CONSIDERATIONS

Despite the advantages of sale/leaseback transactions for both investors and occupiers, there are certain considerations that should be taken into account:

- A corporation, healthcare institution, or public entity may come under increased scrutiny after undertaking a sale/leaseback.
- A change in strategy may occur over time that would have made it desirable to hold the asset, given the flexibility limitations inherent in a long-term lease.
- Changes in tax laws and/or accounting rules may impact how a sale/leaseback transaction is treated on a company's income statement and balance sheet.

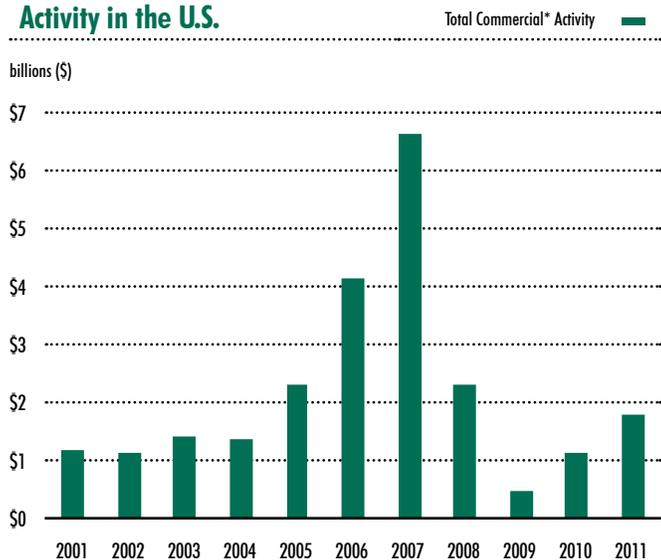
TRENDS IN SALE/LEASEBACK TRANSACTIONS: 2001 TO 2011

There has been widespread acknowledgement of the benefits presented by sale/leaseback transactions for companies whose capital needs and real estate portfolios closely match the costs and benefits of this

vehicle. Over the past two decades, sale/leasebacks have evolved into a viable corporate finance strategy. Historical U.S. transaction volume is presented in Figure 1, with data covering sale/leaseback volume from 2001 through 2011. The recent U.S. economic downturn resulted in a sharp slowdown in such transactions in line with a slowdown in all real estate transactions. After peaking at \$6.6 billion in 2007, sale/leaseback transaction volume fell to a historic low of \$450.9 million in 2009. Since that market bottom, sale/leaseback activity has increased significantly. By 2011, sale/leaseback transaction volume totaled \$1.8 billion, in line with levels achieved in the early 2000s.

Sale/leaseback transaction volume depicted in Figure 1 is based on Real Capital Analytics (RCA) data and includes office, industrial and retail property only. Hotels, the senior living sector, and healthcare leasebacks exist as well, but they are not the same, involving both property management and operating leases. RCA further disaggregates sale/leaseback activity into three categories:

Figure 1: Total Sale/Leaseback Activity in the U.S.



Source: Real Capital Analytics
 Data includes Full Sale/Leaseback Transactions valued over \$2.5 million.
 * Includes office, industrial and retail property only.

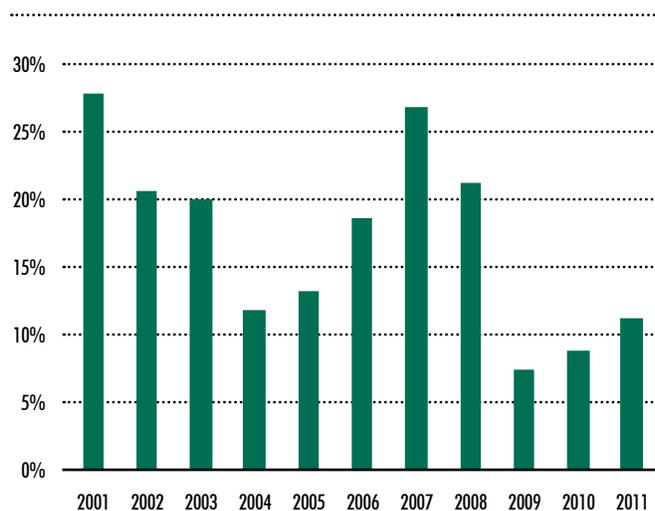
- **Standard Sale/Leasebacks:** Where the seller will lease back 100% of the property. This is considered a single-tenant property.

- **Short-term Leasebacks:** Where the tenant plans to occupy the property for a few months and up to three years after closing. In this case, the seller is typically planning a staged exit. If the leaseback is for more than one year, RCA also counts it as a single-tenant property.
- **Partial Leaseback:** Where the seller will retain occupancy in just a portion of the building. They may or may not have already leased some of the extra space. RCA considers partial leasebacks as multi-tenant property and does not include them as part of the single-tenant universe.

The data depicted in Figure 1 includes only full standard leasebacks and short-term leasebacks, which are a subset of all single-tenant transactions by volume. Figure 2 presents the ratio of U.S. sale/leaseback to all single-tenant transactions.

Over the past decade, about 25% to 30% of all single-tenant transactions were accounted for by full sale/leasebacks. Since 2009, however, the sale/leaseback share has fallen to just 8% to 10%. This underscores the sharper decline in sale/leaseback transactions relative to non-sale/leaseback transactions.

Figure 2: Ratio of U.S. Sale/Leasebacks to All Single-Tenant Transactions



Source: Real Capital Analytics

CBRE Sale/Leaseback Case Studies

CBRE works with clients across the credit spectrum, from high investment-grade corporations to well below investment-grade entities. We have found that there is not a “typical” profile for a company interested in monetizing its real estate. Although a common motivation is to reallocate trapped real estate equity into a core business, the specific circumstances differ with each company’s objectives, real estate, and credit profile. Below we summarize two distinct sale/leaseback assignments:

Investment-Grade Corporation: For one Fortune 500, investment-grade client, CBRE undertook a large monetization program that unfolded over three years and generated \$1.3 billion in sale/leaseback proceeds in multiple distinct transactions. Despite the fact that this client already had a large cash position on its balance sheet and considerable unused borrowing capacity, it felt that the billions it had tied up in owned real estate was a wasting resource that could be better used to fund specific capital needs,

including a share buyback program and large capital expenditures needed to protect its market position. This company was also able to visualize a day in the future when it would not need these properties for its business, and saw monetization as a way to transfer to a real estate investor the potential large problem of vacant properties with little value.

Below Investment-Grade Corporation: On the other end of the credit spectrum, CBRE worked with a private equity portfolio company to arrange a sale/leaseback on the company’s large headquarters/manufacturing/warehouse campus in a tertiary real estate market. The parent firm recognized that the value assigned to the portfolio company’s real estate in the acquisition was very conservative, and that there was an opportunity to sell the real estate for a much higher value based on a leaseback, with no detriment to the operating requirements of the business. CBRE solicited multiple offers for the campus, and closed a transaction which reimbursed the private equity firm for virtually all of its equity investment in the portfolio company.

The sharp decline in sale/leaseback transactions in 2008 and 2009 was largely due to the sharp economic downturn of 2007 through 2009, which impacted all buy/sell activity. During this downturn, corporations that typically use a sale/leaseback strategy to finance expansions stayed on the sidelines. Lower sale/leaseback activity can be attributed to three factors:

1. The non-functioning debt markets during that period prevented buyers from obtaining financing on sale/leaseback acquisitions.
2. A large number of corporations were facing other challenges relating to their core businesses during the downturn, and were unable to focus on the monetization of their real estate.
3. Potential changes in accounting standards added a degree of uncertainty. The Financial Accounting Standards Board (FASB) has released an exposure draft (ED) proposing that corporations be required to record all leases as “capital leases” on their balance sheets, meaning all operating leases would

be eliminated. The ED has not been approved and the timing of any finalization is still unclear. The potential lease accounting changes, however, did add a cloud of uncertainty surrounding sale/leaseback transactions.

Historically, the office sector has dominated the U.S. sale/leaseback market. Figures 3a and 3b disaggregate the total sale/leaseback activity by product type: office, industrial and retail. In 2007, a boom year in commercial real estate transaction activity, office product accounted for the lion’s share of sale/leaseback transactions. By 2011, sale/leaseback volume across office, industrial and retail favored the retail sector. This suggests that office property accounted for the largest decline in sale/leaseback volume over this period. High office vacancy rates, declining rents and falling values impacted both total transaction activity and sale/leaseback transactions during this time.

For investors, the stumbling block in entering a sale/leaseback transaction has been a shortage of attractive

opportunities over the past few years. Buyers have been increasingly focused on properties in major markets that are occupied by investment-grade tenants with 10- to 15-year lease terms.

Figure 3a: Sale/Leaseback Transactions by Sector | 2007

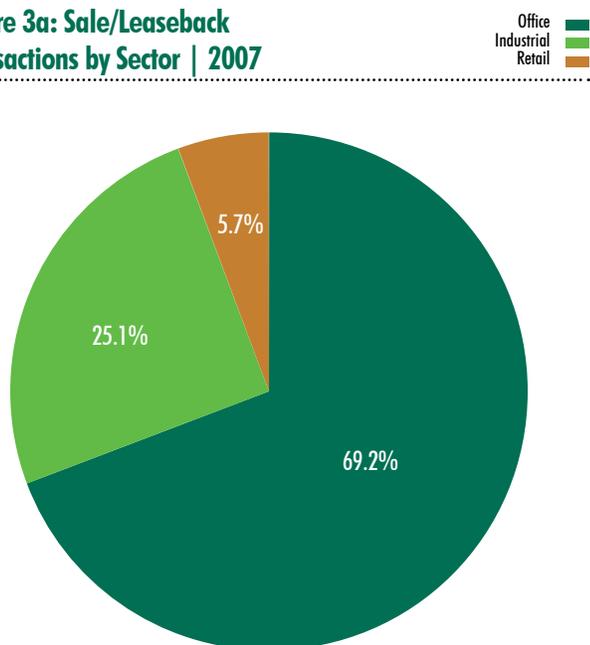
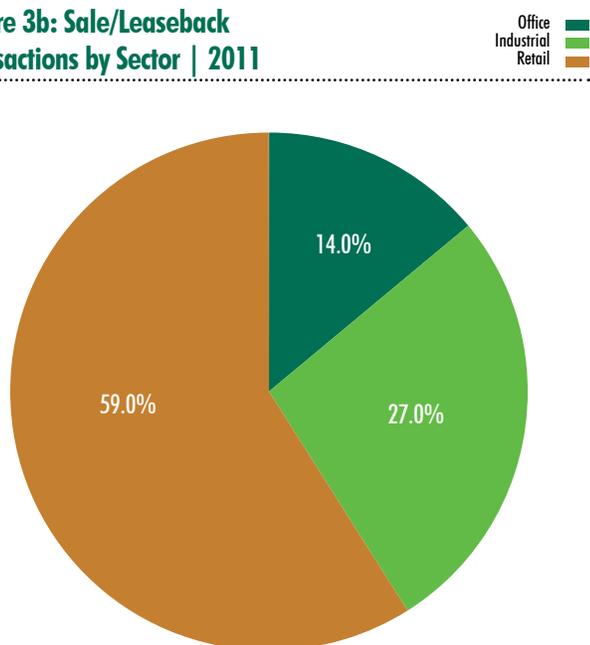


Figure 3b: Sale/Leaseback Transactions by Sector | 2011



Source: Real Capital Analytics, Full Sale/Leaseback, transactions over \$2.5 million

THE OUTLOOK FOR SALE/LEASEBACK TRANSACTIONS: 2012 AND BEYOND

A large number of U.S. corporations continue to directly own their real estate. Anecdotal industry reports estimate that as of 2007, U.S. corporations owned 46% of their real estate and leased 54%. According to CBRE's estimates of our occupier client database, these shares vary considerably by sector:

- Technology: 49.8% owned vs. 50.2% leased
- Financial Services (retail): 44.1% owned vs. 55.9% leased
- Financial Services/Insurance (non-retail) 36.6% owned vs. 63.4% leased
- Pharmaceuticals: 92.6% owned vs. 7.4% leased

Overall, in the U.S., 40% to 45% is a reasonable approximation of the percentage of a typical company's occupied real estate that is owned. A 2010 study by the CoStar Group estimates that the size of the U.S. commercial real estate market, including office, industrial and retail assets, is \$4.3 trillion². Corporations still own a sizeable share of such assets. Given the benefits of sale/leaseback transactions to a corporation's bottom line, we think that a large number of firms will continue to sell their office, industrial and retail facilities to investors, unlocking the value of the underlying commercial real estate.

Why now? A large volume of institutional capital is sitting on the sidelines wanting to invest in real estate assets. At the same time, companies still face a challenging operating environment, and leasing potentially provides greater flexibility in matching real estate needs to existing corporate footprints. Also, despite a nascent recovery in the U.S. economy, smaller U.S. businesses that cannot access the corporate bond market as easily

2. Andrew Florance, Norm Miller, Jay Spivey, and Ruijue Peng, the CoStar Group, "Slicing, Dicing, and Scoping the Size of the U.S. Commercial Real Estate Market," Draft, April 26, 2010, Exhibit 3.

as larger corporations continue to find sale/leaseback transactions to be an attractive alternative financing tool.

There are a number of fundamental factors that should drive an increased number of sale/leaseback transactions going forward:

- Real estate rents are on an upward trajectory. Investors are underwriting real estate deals much more aggressively given the expected upswing in economic growth. The tough real estate market of the past few years contributed to the slowdown in sale/leaseback activity, but the market is firming up. A lack of new supply and traction in demand is leading to declining vacancy rates across the major property sectors. The market is transitioning from one that was tenant-driven to one where landlords are gaining more pricing power.
- Pricing for real estate has become more attractive. Cap rates on most real estate assets have bottomed.

Pricing has become very attractive for quality assets located in prime locations. Favorable real estate values and low cap rates should spur a rebound in U.S. sale/leaseback activity.

- As the U.S. economy gains traction, interest rates are expected to rise. The environment is currently attractive for locking in low-cost sale/leasebacks.

CONCLUDING REMARKS

The inherent benefits of sale/leaseback transactions should continue to render them viable tools for raising equity for any corporation that wants to focus capital on its core business. At the same time, intense institutional investor interest in single-tenant sale/leaseback assets has led to rising values on such assets. As a result, we expect that sale/leaseback transactions will rebound this year and beyond. In addition to the private sector, the fiscally strapped public sector may potentially look to the sale/leaseback market as a way to monetize its illiquid commercial real estate assets.

ABOUT CBRE CORPORATE CAPITAL MARKETS

The CBRE Corporate Capital Markets ("CCM") group provides capital markets advisory and execution expertise for planned and existing single-tenant assets on behalf of corporate users, developers, and owners. Expertise within the group covers finance, accounting, capital markets, development and construction, to solve for GAAP, tax, cash, regulatory, delivery, and other objectives of our clients. CCM covers a full range of real estate and credit-based transaction structures.

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