Sale-Leaseback's Massive Surge

MORE COMPANIES ARE MONETIZING THEIR REAL ESTATE THROUGH SLB NET LEASES, WHICH IS GOOD NEWS FOR INVESTORS

By Kelsi Borland

Sale-leaseback opportunities are surging in the net lease market. The low interest rate environment and ultra-low cap rates are encouraging companies to monetize their real estate, and that's good news for investors. Sale-leasebacks result in an absolute net lease, which means the tenant pays everything associated with occupancy, from maintenance to property taxes.

"Many of our tenant relationships are utilizing sale-leasebacks to raise capital for store remodels and expansion," says Max Freedman, managing director of Sands Investment Group in the firm's Austin, TX office. "The compressed cap rates in the market allow them to keep their occupancy cost much lower than in past years and in comparison to build-to-suit projects. It's becoming a more popular method of raising capital and paying down debt."

Sands Investment Group specializes in net lease assets and has seen an increase in clients looking to do SLBs of a portfolio of assets. For example, the firm recently completed the 73-store SLB of Bush's Chicken, a Texas-based fast food chain. The properties sold for an average of $1.97 million each.

Jason Fox, head of global investments and president of W. P. Carey, agrees that the low interest rates and cap rates are leading to a surge of sale-leaseback activity, naming the drivers as companies seeking "to take advantage of lower lease rates and enter into financing transactions to support their plans to invest in facilities, technology and equipment to grow their business."

W. P. Carey is a major player in the SLB net lease space. In the first half of 2016, the REIT closed more than $384 million in sale-leaseback transactions. The deals include the $167-million purchase of three private preparatory school campuses from Nord Angila Education and a four-million-square-foot, 49-property North American industrial portfolio for $217 million from Forterra Building Products.

While the opportunities are increasing, so is investor demand, resulting in a very competitive market. "For investors, the US sale-leaseback market continues to be competitive, although from what we are observing cap rates appear to be reaching a bottom," adds Fox. "Widely marketed deals continue to attract aggressive bidding while less marketed, relationship-based transactions offer better opportunities, and this is where we continue to focus our efforts."

Yet the sector isn't any more competitive than most other areas of commercial real estate, where both domestic and foreign players of all stripes are seeking shelter in CRE opportunities. "Both public and private firms are pursuing a number of varied strategies," explains Shelby Pruett, co-chairman and CEO of Capri EGM. "We see competition throughout all sectors and asset types. However, the net lease sector, which includes the sale-leaseback market, is more fragmented than most presented opportunities for sophisticated investors with broad market relationships and experience."

"Steady, predictable cash flows and rent escalations, coupled with the strength of creditworthy tenants, are the key factors that drive our SLB acquisition strategy."

JASON FOX
W. P. Carey

Sands Investment Group recently completed a portfolio sale-leaseback sale for Bush's Chicken, a Texas-based fast-food chain. The 73 stores sold for just under $2 million each.

Having said that, he notes that many potential investors in the SLB arena face limitations due to a lack of relationships, experience or capital. "They either do not have the existing relationships to generate the sale-leaseback opportunity, have limited understanding of how to properly structure a sale-leaseback, and are not properly capitalized or creative enough to structure the opportunity," Pruett explains. Capri EGM's specialization in corporate sale-leaseback structuring and build-to-suit financing, as well as the acquisition of institutional-quality single-tenant net-leased properties, he adds, has given the firm a solid reputation with institutional investors and corporations within the market.

Not every investor thinks that the opportunities in the market are good ones. Paul Domb, VP of asset management at United Trust Fund, says that he hasn't seen an increase in SLB opportunities as much as he's seen diminished quality among the deals available. "UFT is extremely conservative when it comes to underwriting the companies with which we do business," explains Domb. "Because of Fed policy and because of the current interest rate environment, many companies have gone to the market already and either raised capital or monetized real estate. This environment has been going on for so long that, generally, what's left over is a deterioration in credit quality. Most of the 'investment grade' companies going to the market to monetize their real estate today are not companies we want to do business with because they either have a dubious financial statement or are limiting in credit quality."

One of the largest investors in the corporate SLB space, UFT has been in business for 45 years and its investment strategy can be best described as austere. The firm may be operating in a market that's being flooded with SLB offerings, but Domb stresses that many of those deals and, more importantly, the companies performing the SLBs, are not viable investment opportunities. "That isn't to say that opportunities aren't out there," he says. "Companies need to expand, and those are good companies. But overall, the level of quality has diminished significantly."

In the current SLB market, Fox says the characteristics of quality opportunities are creditworthiness of the tenant, fundamental value of the real estate and criticality of the asset relative to the tenant's business, which includes corporate headquarters, key distribution facilities or profitable manufacturing plants, critical R&D or data centers, or top-performing retail stores. "These factors determine how we structure and price a deal, including cap rate, lease bumps/escalations, rent relative to market and whether financial or operating covenants and security deposits are needed," says Fox.

For investors in the space, though, all these factors involved, and thr complexity of the SLB structure, pale in comparison to the tremendous benefits the asset class offers. W. P. Carey has focused on sale-leaseback investments since it was founded more than 40 years ago "because they can deliver consistent long-term value for our shareholders and fit within the framework of our established underwriting standards and investment criteria," says Fox. Like many of its counterparts, the firm's long-standing relationships and experience in executing compex transactions has given it an edge in the market. The properties in which the firm invests not only provide consistent cash flow," he says, but also "allow us to extend the average lease term, improve credit quality and increase the asset criticality of our net lease holdings. Steady, predictable cash flows and annual rent escalations, coupled with the strength of creditworthy tenants, are the key factors that drive our SLB acquisition strategy."

When correctly structured and when working with a stable tenant, these opportunities can produce phenomenal returns. According to Pruett, "A properly structured sale-leaseback can be a very safe and durable investment alternative providing both attractive current and total returns. These investments can generate consistent returns over long periods of time, eliminate the exposure to operating expense inflation, act as a powerful hedge against inflation and a buffer against rising interest rates as a result of historically wide margins and yield premiums to other real estate asset classes, including traditional core assets."

Domb agrees that with the right corporate partner and the right risk profile—and every risk profile is different—that these are great investments. "What's traditionally structured through SLBs is an absolute net lease," he says. "This transfers all of the risk of ownership to the tenant: taxes, insurance, roof structure—everything is paid by the tenant. So, we are in business to collect a rent check."

A properly structured lease should be a win-win situation for both investor and tenant. "The goal in structuring the leaseback is to keep the occupancy cost at a sustainable rent for the business and in line with the market for a fast-food restaurant," Freedman says. "This is a financial tool that allows the operator to structure a long-term solution for their business first and foremost."

And while all net lease transactions have the same benefits, in that the tenant assumes responsibility for the property, SLBs allow the terms to be set from the point of purchase. In other words, the investor in an SLB can structure the terms of the lease directly with the corporate occupant, whereas a third-party net-lease asset comes with a pre-existing lease.

"By entering into a mutually beneficial discussion with the corporation, each party is typically able to include what is important to them in the lease," says Pruett. "Additionally, the sale-leaseback represents a current need for the corporation and a new lease versus buying into an existing net lease asset that is already part of the way through its lease term." The long-term investments that Capri EGM targets, for instance, "are typically attractive because the real estate assets are operationally significant to the ongoing operations of the underlying tenants, have demonstrable demand drivers or are characterized by ownership fragmentation."

Further, many investors involved in the business will note that the transparency that SLB transactions offer is hard to find in today's arena. "In today's market, investors are chasing certainty," says Freedman. "And in many cases with triple net properties, certainty comes in the form of location, lease term, and credit. The sale-leaseback market typically offers a fresh long-term lease at closing and a clear picture on the financials behind the lease—that's something that is difficult to find elsewhere in the marketplace."

This trend is not region specific, and all of these investors are finding opportunities in different places, with different strategic focuses. Capri EGM provides forward-purchase commitments to corporations developing their own build-to-suit facilities for sale-leaseback, or provides financing for corporations' BTS financing and entering into a sale-leaseback with the corporation for a set price upon construction completion, according to Pruett.

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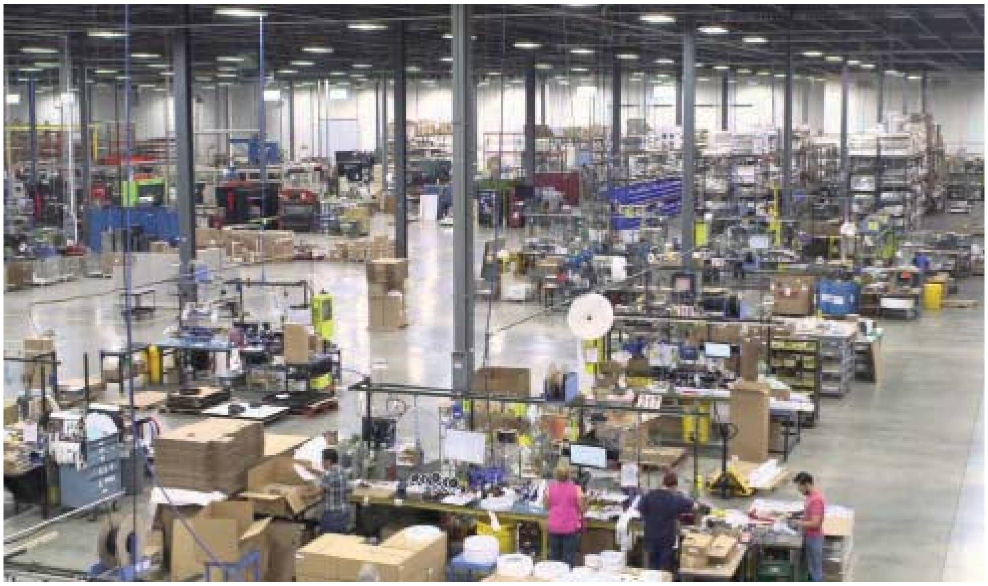
SHELBY PRUETT
Capri EGM

The firm also sources opportunities through its relationships with all levels of the real estate ladder. Both its top-down approach—involving senior management—and its ground-up approach—through relationships with property managers and investment sales teams—provides "access to a wide array of investment opportunities and local market intelligence in markets nationwide," says Pruett.

The factors converging to create the environment that's generating the surge of SLB opportunities will continue for the foreseeable future. Pruett, for one, believes these opportunities will remain plentiful as corporate occupier activity continues to strengthen. "From a macro perspective, global investment activity and demand within this sector will continue to expand," he says. "We believe sale-leasebacks will continue to grow in popularity with both corporate users and investors. For the corporation, the additional operational flexibility and the ability to extract significant value from its real estate while capitalizing on the extended period of low interest rates is highly compelling. Equally so for the experienced investor, the properly structured SLB provides an attractive and durable investment alternative that can generate consistent recurring returns over long periods of time." He adds that an SLB's ability to ride through economic cycles makes it "a highly compelling investment alternative in a period of economic uncertainty."

From a tenant perspective, Freedman also believes that more space users will seek SLBs as a real estate solution. "While the market stays strong, I believe-sale leasebacks will be a more common solution for tenants who are looking to develop and keep their occupancy costs as low as possible," he explains. "The market is strong and therefore bringing new sellers to the table. Low cap rates are forcing companies to rethink the reason for keeping the real estate on their books and examining ways to reinvest back in to their business."

In terms of interest rates and the other policy-related drivers of this trend, Domb believes that any increase in interest rates will actually exacerbate the issue by further motivating companies to strike now. "I think that if the Fed decides to do their job and increase interest rates, it will have a knee-jerk effect on a lot of folks that the party may be over, and some chief financial officers will view that as an indicator that they ought to monetize their real estate while we are still at historic lows," he says. "That will be the knee-jerk reaction because rates won't go up significantly very quickly. So, I think there will be more opportunities. Beyond that, it's probably going to be a couple of years before we see the kind of volume in SLBs that we saw 10 years ago." ◆



Kenall Manufacturing's new headquarters at 10200 55th St. in Kenosha, WI. It moved into the space in 2015 and plans a $30-million investment.

Although US industrial output softened a bit in 2015, according to a recent report from FTI Insights, that was after several years of strong growth. New orders and production have been expanding since then, and the Purchaser's Manufacturing Index, a national survey of purchasing managers by the Institute for Supply Management, hit 53.2% in June, its highest level since early 2015 and an indication of steady expansion.

Few industries got slammed harder during the recession than automobile manufacturing, and its near downfall cut deep into the economy of several Midwest metro areas. But the sector's revival did not just return employment levels in these regions to where they were in 2006. The big auto firms have poured billions into refurbishing aging plants, expanded production and attracted a host of new auto suppliers, many of which needed land and new facilities, both for production and distribution.

That revival has changed the industrial landscape of Kansas City. "We saw a lot of tightening in 2009," says Ashlie Hand, VP of the Kansas City Area Development Council. Due to the diverse nature of the regional economy, "we did not necessarily see as big a drawdown as other areas, but it's taken a long time to bounce back.

"It was in 2012 that the auto industry started to surge," she adds. "General Motors and Ford began reinvesting in their Kansas City plants and it's ballooned from there." In January 2013, GM announced that it would spend $600 million to upgrade its Fairfax Assembly Plant in Kansas City, KS, where it builds the Chevrolet Malibu. A few months later, Ford announced that it would add 2,000 workers to its Kansas City Assembly Plant to meet consumer demand for the Ford F-150 and produce the new Ford Transit.

"The Transit has been transformational," says Hand. And these moves have "brought some stability to the existing workforce, and brought a lot of new jobs into the region," giving Kansas City even more credibility as a manufacturing center.

Grupo Antolin, the largest auto parts supplier in the world, recently built an $18-million, 148,000-square-foot plant in Kansas City in response to the growing needs of the US car companies. The firm now employs about 300 people in the metro region.

And Antolin was just one of about a dozen suppliers to recently establish new operations in the area. Martinrea International, one of the largest global Tier 1 auto-parts suppliers, signed a long-term, build-to-suit lease for a 275,560-square-foot building in suburban Riverside's Horizons Business Park.

Other players in the region have also responded to Kansas City's growth. Rail companies, for example, have built huge intermodal facilities like BNSF's at Logistics Park Kansas City. And Hand says the local community colleges have done their part by adding new training courses that prepare workers for the jobs created by GM, Ford and their suppliers.

But it's not just longtime industrial powerhouses like Kansas City that are benefitting from the present recovery. Manufacturing has undergone several changes since the advent of the recession, and those changes could end up benefitting many areas once considered off the beaten path. At a time when many businesses are flocking to the nation's downtown cores, some manufacturers are headed in the opposite direction.

"The first and most important thing to these companies is access to low- and no-skilled labor," says Thomas Boyle, Chicago-based principal with Transwestern, especially ones that need seasonal labor. "Not having that access hurts their operating expenses."

But that access to labor has to be coupled with affordable land costs, affordable energy and great transportation networks that can move products from the manufacturing site to the customers, and that combination only exists in certain pockets of the Chicago metro area and the greater Midwest, adds the site selection expert.

With land costs hitting record highs in dense markets such as the O'Hare Airport region, that means many companies are taking peeks at these "overlooked areas," says Boyle. "It's the inverse of what is happening in the office sector."

And to bring manufacturing operations to once-overlooked areas, the competition can get intense, Boyle says. He recently helped Kenall Manufacturing, a commercial lighting company, relocate its headquarters and factory from north suburban Gurnee, IL, to a facility just over the Wisconsin border in Kenosha. Like many firms in the area, it needed to expand, but company officials wanted to preserve the workforce they had recruited, restricting possible locations to northeastern Illinois or southeastern Wisconsin.

"We negotiated a significant municipal incentives package," says Boyle, and that helped tip the balance to Kenosha, after starting with 25 to 30 feasible locations. The move allowed Kenall to expand from a 120,000-square-foot building to a 354,000-square-foot facility in the Business Park of Kenosha. "One of the things I do most is move companies from Illinois to Wisconsin."

A big factor that is helping US manufacturers expand is the intensifying demand from customers for quick delivery. That

M&M Mars leased this facility, located at 13133 Innovation Way in Victorville, CA, within the Southern California Logistics Centre, on a long-term basis as a warehousing and distribution center.

means more products have to be made in the US, as companies "don't have 10 weeks to wait for the boat to get here," says Boyle. And that desire from customers can help fuel even more employment expansion. "Every manufacturing job creates three other jobs," including some in the many new logistics and distribution buildings springing up across the US.

Towns primed to benefit from manufacturers' current needs include those on the periphery of metro areas such as Waukegan, IL, a far north suburb of Chicago near the Wisconsin border; Valparaiso, IN; and South Milwaukee, among others. "You can't go too rural; the workers just aren't there," says Boyle.

But communities that really want to be successful at attracting new manufacturing facilities also need to think about providing education to those existing labor pools, alongside the incentives and affordable land. Boyle says, for example, that Gateway Technical College, which has several campuses in southeastern Wisconsin, including one in Kenosha, has become an important source of skilled labor and customized training for Kenall and several other local companies.

New manufacturing is helping revive and even push out the boundaries of several key industrial markets. There's about 500 million square feet of industrial inventory just in California's Inland Empire, product which has long played a key role in speeding the flow of goods from West Coast ports to the rest of the US. "It's probably the most impactful industrial market in the country," but "in the recession it was hit hard, much like the housing market," says Brian D. Parno, COO for Stirling Development, an active builder and owner in the region. "Literally nothing was going on," and some of the company's buildings sat vacant for as long as 18 months.

"But the entire area has rebounded very strongly in the past five years," he adds, and has seen a growing demand for quality manufacturing space and distribution space. Stirling Capital Investments, a joint venture between Foothills Ranch, CA-based Stirling Development and Denver-based DCT Industrial Trust Inc., for example, recently secured a full lease-up of its new

447,740-square-foot industrial facility under construction at its Southern California Logistics Centre in Victorville.

Arden Cos., a leading US manufacturer of outdoor furniture, leased 211,000 square feet of the space, and Newell Brands, a long-time tenant at the Victorville development, took an additional 233,740 square feet. "Within three weeks of starting construction, we had offers for the balance of the space," says Parno.

GE Oil & Gas recently decided to fully occupy this 510,443 square foot spec in Jacksonville's Cecil Commerce Center, developed by Hillwood Development, and bring about 500 high-skilled jobs to the city.

Before the recession, few people talked about launching manufacturing projects in this high desert region, he adds, but developers in the past few years, not just Stirling, have shown a lot of interest. There is already more manufacturing in CA than any other state, he points out, and its huge population ensures it will continue growing. "It makes sense to be close to your customers," especially these days, when customers demand rapid delivery.

And for municipalities, attracting manufacturing operations will be a key component in deepening any economic recovery. "Manufacturing jobs are job creators themselves," says Parno. "It spins off multiple other jobs in warehousing and distribution." This is more important than ever, as companies increasingly prefer to cut costs by doing manufacturing, distribution and logistics under one roof. "We're really starting to fully grasp the impact manufacturers have. But developers need to do a better job of marketing strategy and thinking about ways to attract manufacturers and ensuring they have a sustainable model."

This northern portion of the Inland Empire "is still an emerging market," with about 17 million square feet of space. But the vacancy rate is next to nothing, and with demand in the submarket at a historic high, Parno expects to see a great deal of development in the future. "There are very compelling reasons to consider the High Desert," especially its abundant land and dramatically lower costs. He estimates the total cost of occupancy is about 25% to 30% lower here than elsewhere in the Inland Empire region. Stirling plans to break ground on a new building of about 400,000 square feet, and expects to lease it before completion.

Hillwood Development Co. had a similar experience in 2014 when it began a 510,443-square-foot spec at its AllianceFlorida development in Jacksonville's Cecil Commerce Center. "Very early in the process, GE Oil & Gas came calling," says Hillwood SVP Dan Tatsch, and took the entire building for an advanced manufacturing plant that will provide the region with 500 high-skilled jobs. The land had been an active military base until its closure in the 1990s, and "the city's been trying to spur economic development there ever since."

"The business park is still relatively new," Tatsch says, and after the recession and its hangover, "it's taken the city and the park awhile to hit their stride." But the lease with GE could be a milestone for both. "It's a huge deal, not just for Jacksonville, but for Florida as well." GE will use the state-of-the-art plant to manufacture flow control devices for commercial industry, and probably felt the large retired military presence would supply a labor base with highly-developed skills.

"Manufacturing jobs tend to pay higher wages," Tatsch adds, especially the kind needed by GE in Jacksonville. In addition, these facilities typically have higher levels of capital investment than the shells used for distribution, pay more in property taxes and are more likely to bring in institutional investors.

Hillwood has developed four buildings for the park. Alongside GE, FedEx and Bridgestone have distribution centers, and Saft, an advanced battery manufacturer, occupies the fourth. "Our goal is to develop a world class logistics park," says Tatsch, one not necessarily focused on manufacturing. Municipal and state officials would, of course love to see every industrial building taken by a manufacturer, "but they are realistic enough to know that is not going to happen." Still, the company will soon begin another spec, this time of about 400,000 square feet, and "we're crossing our fingers that another GE type will knock on our door."

Some areas that have seen a long-term slide in manufacturing are also showing signs of revival as developers discover new uses for old production sites. In 2013, Hampshire Cos. took over an abandoned glass factory on 33 acres in Carteret, NJ, cleaned up the contaminated site, and then constructed a 459,600-square-foot light industrial building with 36' clear ceilings. The building was recently leased by Serta Mattress, which can now make and distribute its products from a facility close to its many customers in the densely populated area.

Developers have launched many similar projects in this land-scarce region as they try to meet what has become an intense demand for new space, says David Knee, JLL's senior managing director of industrial. Food manufacturing has become especially important, as consumers increasingly desire fresher specialty foods. "These may not be traditional manufacturing jobs, but many do require very high skills."

The transformation of New Jersey's economy may be best illustrated by Blue Apron. One of the many new meal companies that promise to quickly deliver fresh ingredients to their customers' homes, it recently decided to lease a 495,000-square-foot building in Linden completed by Duke Realty in 2014. "It's a repurpose of an old GM truck manufacturing plant," says Knee.

E-commerce firms are still leading the way in much of the nation, including New Jersey. Wayfair Inc., an online distributor of home furnishings and décor, earlier this year leased a 1.2-million-square-foot facility in Carteret, NJ, and Knee estimates that Amazon has taken around four or five million square feet in the northern half of the state in just the past few years.

"We are at historic lows in terms of vacancy, and I am seeing rents I've never seen," says Knee. But "at some point the e-commerce platform will be built out. New Jersey has only got so much land; we can't continue to build like Chicago." Still, "new development has been relatively restrained during this cycle," and that could stretch things out a few years. And he expects the repurposing of underused or vacant sites to continue, although that too should move at a slow and steady pace.

The state has a high barrier to entry, he explains, and not just due to the number of permits needed for new construction. Most of these old industrial sites, such as Duke's old GM plant, need a great deal of cleaning and environmental study. The cost can be prohibitive, and many owners prefer to spend a small amount each year on their brownfield sites, rather than jumping in with both feet. "It takes time and people have to be patient." ◆

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