A Means to an End

For private equity firms buying portfolio companies, a sale-leaseback can be a key component of the capital stack

By Paul Bubny

Private equity's use of sale-leasebacks dates back at least to the dawn of the leveraged buyout boom of the 1980s. That's when a team of investors led by former Treasury secretary William E. Simon acquired Gibson Greeting Cards and, to help finance the acquisition, sold three Gibson manufacturing and warehouse properties to W. P. Carey Inc. Now a publicly traded REIT, WPC has executed a great many SLBs since that pioneering deal, including about $3.4 billion worth since 2003 with PE firms and their portfolio companies.

The basic level of risk in a circa-2017 SLB isn't much different than it was in former years, says Gino Sabatini, head of investments and managing director at New York City-based WPC. "We're dealing with less-than-investment-grade companies, typically with a significant amount of leverage," he tells Real Estate Forum. "We have to spend a lot of time believing the private equity story, believing in the business of whatever the tenant does and believing they're going to pay us rent for the full period of our lease term—which is usually longer than the PE owner is expected to be involved with the company. All of those things have been true for the past 30 or 40 years."

In comparison to more volatile property types, single-tenant SLBs tend toward consistency in terms of transaction volume. Will Pike, Atlanta-based EVP and co-head of CBRE's net lease property group, says he doesn't see dramatic movement up or down

The $5.5-billion deal for outdoor sporting goods chain Cabela's will include a sale-leaseback component when the transaction closes.

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in deal velocity in 2017 compared to 2016. Yet even as Sabatini, Pike and other experts cite an overall long-term steadiness in the PE market for net lease financing vehicles, they also see the current environment as especially active. And that's not only because of a couple of recent high-profile deals that have put PE firms' use of net lease financing in the spotlight.

Gordon Whiting, founder and portfolio manager of the net lease strategy at Angelo, Gordon & Co. in New York City, sees an uptick in such transactions as PE firms become "more focused on leverage levels, revolvers and other traditional corporate finance methods. So a sale-leaseback is a good alternative since lenders aren't looking to lend at the same leverage level. It's a fairly efficient way to get this done, and you can get it done relatively quickly."

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GINO SABATINI, W. P. Carey Inc.

The alternative, he continues, "is to go get a mortgage loan, which will fund maybe 60% of the value of the building, and then that loan must be paid back in 10 or so years. If you do a sale-leaseback, you're going to get 100% of the value of the building, you're going to maintain 100% control of it and there's no balloon payment at the end. Generally, you can get as many renewal options as you want, so you maintain long-term operational control of the facility while maximizing value, taking the cash out of the bricks and mortar and using it to pay down debt, do a dividend recap, acquire new technology" or free up capital to grow the business.

"We're seeing more sale-leaseback activity of varying sizes in this first quarter than we have in a while," says Shelby Pruett, co-chairman and CEO of Capri EGM LLC, headquartered in Chicago. "The PE firms have been able to access the capital that they want in this way and the market to sell into has gotten much bigger in the past five to 10 years, so it's much easier for a PE firm to execute a sizable transaction, meaning $1 billion-plus."

Two large-scale transactions in the retail space illustrate Pruett's point. In 2014, PE firm Golden Gate Capital traded approximately 500 Red Lobster locations to what was then American Realty Capital Properties—now VEREIT—in a $1.5-billion SLB as part of Golden Gate's acquisition of the seafood chain from Darden Restaurants. Subsequently, VEREIT sold many of the locations back to Golden Gate as the net lease REIT sought to reduce its exposure to restaurant retail.

More recently, a partnership of Bass Pro Shops and Goldman Sachs' private equity arm agreed to acquire Bass Pro's rival, outdoor sporting goods chain Cabela's, for $5.5 billion in an all-cash deal that includes a proposed SLB component. The SLB is expected to close when the acquisition does, in the first half of this year.

PE firms are also turning to net lease financing in support of acquisitions well outside the retail space. In March 2015, Dallas-based PE giant Lone Star Funds acquired Forterra Building Products from German concrete manufacturer Heidelberg Cement for $1.4 billion. The deal entailed an equity investment of $432 million and third-party debt of $940 million. In connection with the Forterra acquisition, Lone Star entered into an SLB for 49 industrial properties. "They recognized that they had $200 million-plus tied up in their real estate, and pulling that money out and using it to pay down debt or for other corporate purposes made a lot more sense for them than leaving it tied up in real estate and generating a single-digit return," Sabatini says.

This past April, Sabatini arranged an SLB with Nord Anglia, a leading global premium school organization controlled primarily by a Baring Private Equity Asia fund, to three private preparatory school campuses in Florida and Texas. The purchase price for all three properties totaled $176 million, with WPC agreeing to provide up to an additional $128 million in build-to-suit financing over the next four years to fund the expansion of existing facilities.

Although prep schools aren't the usual property type for such transactions, in other respects the Nord Anglia deal followed the SLB formula. "The schools are a little bit different in terms of an asset class, but the basic financial engineering aspect of it is the same," says Sabatini. Nord Anglia, he adds, "had a desire to pull some money out of their real estate and put it to what they felt was a higher and better use. That's quite common with PE firms."

In terms of their understanding how to manage the SLB process to best advantage, "Companies are just getting smarter," says Glen Kunofsky, senior director of the net leased properties group at Marcus & Millichap. He cites PE firms' firmer grasp of property values, but also the advantage of not necessarily using an SLB as an immediate source of financing.

"Historically, all they cared about was getting the capital in," says the New York City-based Kunofsky, a 17-year veteran of SLBs. Companies with 200 or 300 locations would look for a real estate buyer immediately; if they lost $100 million or $200 million of value in exchange for surety of close in helping them finance the acquisition, they would do it. Today, companies are saying, 'is that the best route? Or should we finance the company and spin off the real estate slowly and keep that arbitrage?"

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GORDON WHITING, Angelo, Gordon & Co.

PE firms' leeway in gradual selloffs of the properties is greater when, as Kunofsky says, the buyer pool is larger and more diverse. "There's a bigger market in net lease besides REITs and institutions buying hundreds of millions of dollars of it," he says. "Companies are looking at outlets to sell properties individually to private investors, or in smaller chunks." In so doing, PE firms are often able to secure better lease terms and lower rates.

That doesn't mean the REITs have lost their appetite, though. "Many of the net lease REITs are specifically gauged to buying

only sale-leaseback: Spirit Finance, STORE Capital, Realty Income, National Retail Properties—all they do is own single-tenant net lease, so they're actively trying to solicit these opportunities," says Kunofsky. However, he points out that post-election spikes in 10-year Treasury rates, along with the Federal Reserve's recent decision to raise the federal funds rate, have hit REITs in their market capitalizations and stock prices, "which they equate to their cost of capital. So their rates are still pretty low, but they're up over the past six months especially. This creates an opportunity for other buyers in the net lease industry" to compete on a cost of capital level.

Whiting sees the rate increases as a potential spur to deal volume. "I think people are starting to do more SLBs now because they're worried about interest rates going up," he says. "Rising rates in theory lead to higher cap rates, which lead to lower purchase prices. Companies are saying, 'Rates are going up, but they're still pretty low. Let's do an SLB.'"

When it comes to structuring an SLB transaction, "every deal that we look at is unique," says Katie Barthmaier, executive director at WPC. "The way that we evaluate every deal is based on the underwriting of the credit that we're dealing with, the real estate that they own and how critical that real estate is to the company. All of that determines the appropriate transaction structure and pricing. This past November, Barthmaier arranged $145 million of SLB financing to Cerberus Capital Group in connection with the PE firm's acquisition of ABC Group Inc., which supplies molded thermoplastic components and systems to original equipment manufacturers for the automotive industry. The ABC portfolio includes 10 manufacturing facilities across three different countries—the US, Canada and Mexico. "We were able to structure a deal on a 20-year lease in a way that met both our needs and Cerberus' needs," she says. "We can also do build-to-suits. We did a large BTS for Sun Products, which manufactures detergents like All, Wisk and Snuggle and is owned by Vestar Capital Partners. In that case, we were able to meet the growth needs of a portfolio company. So you can structure transactions in different ways" to match the tenant's specific needs.

Pruett also cites "forward sale-leasebacks" in advance of the PE firm completing its purchase, "so they've got that as part of their closing capital. We see a lot of it being done by the PE shops, really as part of their equity raise, so that's the predominant factor.

"The flip side, which is interesting, is that we also see corporations doing it, as a defensive strategy at times," he continues. This strategy can come into play "when activist shareholders and others want changes in management or you have hostile takeovers, where a publicly traded or private company is entering into an SLB and creating value for shareholders by selling assets and raising capital through share buybacks and other accretive investments."

When considering whether a portfolio company would represent a good credit risk, especially when it's less than investment grade, "We look at many of the things that a senior lender would look at, from the stability of the business to the stability of the cash flow, and their ability to service debt, which in our case would be the rental obligation," says Sabatini. "What's a little bit different is that we also look at the real estate, making sure that it's critical to the operations of the company. The idea is that if the owner of the company gets into trouble and has to restructure the balance

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Sale-Leaseback Financing

$108,240,535
Headquarters
$45,895,000
Structured Parking
GOODYEAR
NYSE: GT

$76,000,000
HENSLEY BEVERAGE CO.
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$158,600,000
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CAD 54,000,000
CASCADE aerospace
A subsidiary of IMP Group Limited

$39,600,000
Fresh Express
a wholly-owned subsidiary of
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$48,210,000
DS SERVICES™
A wholly-owned subsidiary of Cott Corporation

$45,000,000
MATTEL
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$160,000,000
csm Bakery Products
A portfolio company of Rhone Group

$83,000,000
NORDIC
A portfolio company of AIM

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sheet, we then own real estate that is critical to the ongoing operations of the company. And if it emerges from a restructuring, our facility is going to be key to the ongoing operation."

In the case of portfolios of assets, the underwriting process extends to property-by-property scrutiny "on a very granular basis," Sabatini adds. "What is the 10-year history of that particular asset, and is it going to be a contributor? In addition, we often structure single master leases to reduce the chance that we could get cherry-picked in a downside scenario."

Similarly, Pruett notes that a 15- or 20-year lease is only as good as the strength of the tenant. "Whether it's KKR, Cerberus, Golden Gate or whomever, we look at their business plans pretty thoroughly from the standpoint of what they're going to do with the assets. That's a key consideration; the other is that it's wonderful to have a 15- or 20-year lease, but you need to be sure that the company is going to be there and thriving in 15 to 20 years."

Not all of the major net lease shops are enthusiastic about working with private equity. "It's an excellent vehicle for all types of industries," acknowledges Paul Domb, SVP, asset management at United Trust Fund in Coral Gables, FL. "It's a great way to increase market share and offset the cost of the acquisition. But I'm wearing a different hat, in that I'm trying to underwrite the creditworthiness of the tenant that's going to be paying the rent over a 12-, 15- or 20-year term. That's like hitting a moving target when you're dealing with private equity. At least that's been our experience."

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GLEN KUNOFSKY, Marcus & Millichap

When a PE fund is still in the acquisition stage, for instance, "you have no idea what the balance sheet is going to look like," Domb says. "So you get a pro forma. But pro formas are pro formas. They're forecasts. We don't deal in forecasts. We deal in the reality of the actual numbers, and that's what we have to underwrite, that's what we have to go on. And very often, what's said about the numbers tomorrow doesn't come to fruition."

Ultimately, for net lease firms that do work with PE, it comes back to consistency. "I don't anticipate a dramatic change from the past few years," says Sabatini. "Our volume targets are similar to what we've seen. Our opinion on European vs. domestic opportunity does change from year to year. Right now, we're seeing a little more opportunity in the US than we are in Europe, but that could very easily change in the next three to six months." ◆