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assetmonetization

Monetization of owned real estate via sale/leasebacks

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CBRE | Corporate Capital Markets

The Federal Reserve has twice in 2022 raised rates by 75 basis points as it battles inflation that has proven to not be "transitory" as initially pronounced. Raising the benchmark overnight rate and tightening financial conditions are the primary tools of the Fed to fight runaway inflation. The trick for Fed Chairman Powell will be applying these measures while avoiding a recession.

Rising costs of debt affect all businesses, especially those with speculative credit. The average extra yield investors require to hold junk bonds rose to 500 basis points by late July, well above January's premium of just above 300 basis points. Today's higher financing costs have discouraged some companies from issuing new debt, as junk-rated companies raised only about $74 billion by mid-summer, about a quarter of the $300 billion issued during the same period last year.

Disruptions in financial markets always raise new opportunities. The investment market for industrial real estate is aggressive today despite the recent rise in interest rates. Rising debt costs affect all profiles of investors, but increases in cap rates for industrial real estate investments lag rising interest rates. Industrial properties in primary, secondary, and even tertiary U.S. markets remain in high demand among private and institutional investors, with the demand/supply imbalance strongly favoring sellers. The result is that opportunities exist to realize value today in situations where companies with speculative credits own industrial real estate core to its business, such as light manufacturing or key logistics facilities.

Our Corporate Capital Markets team recently closed on two separate portfolios of properties that illustrate the potential for value today. Our CCM team advised a company on a nearly $700 million sale/leaseback composed of a portfolio of properties located in the U.S. and EU. The properties were sold subject to a 20-year leaseback at an initial cap rate of six percent. At closing the company had corporate debt in the market of similar remaining term that yielded just under 10 percent.

The second transaction was on behalf of a PE-sponsored company with B- credit per S&P. The 24-property portfolio included mostly older light manufacturing and warehouse properties located in shallow markets across the U.S. and Canada. The company had short-term debt in the market carrying a coupon of 8.5 percent that traded at a yield of over 20 percent at the time the transaction closed. Our CCM team executed a 20-year sale/leaseback at a cap rate in the lower 6 percent range.

New opportunities for raising low-cost capital exist if one knows where to look, and industrial real estate can offer extraordinary opportunities.

Now is an opportune time for businesses to consider a sale/leaseback of owned real estate. Cap rates remain near historic lows and are likely to remain low even as interest rates rise further. Ample opportunities for debt, strong real estate fundamentals, and attractive risk-adjusted returns for real estate will keep investor demand high.

Corporate Capital Markets provides capital markets advisory and execution expertise for planned or existing single-tenant assets on behalf of corporate occupiers, developers and owners.

Monetizing owned assets offers advantages to corporate owner/occupiers

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Optimize the tax code

Owning real estate no longer offers the same tax benefits for many corporate occupiers. This is especially true for businesses that exceed the 30% threshold for interest deductibility, as this cap doesn't apply to nominally non-interest expenses, like rent. Rent expense resulting from a lease will continue to be a deductible item under the current code, making leasing a better choice for many companies.

Accesses favorable long-term financing

The pricing of capital in a sale/leaseback is aggressive for quality properties or properties that are vital to operations of the business. Cap rates remain near historic lows, so locking in inexpensive capital via a sale/leaseback is a smart move. Corporate borrowing requires full principal repayment; sale/leasebacks provide positive leverage to a company, as only a portion of the capital is typically recovered by an investor during the term of leaseback. This arithmetic results in a cost of capital in a sale/leaseback that is often below corporate costs of debt once principal repayment is included in the analysis.

Improves financial performance

Sale proceeds raise cash, and the capitalization of leases typically results in a smaller balance sheet impact compared to ownership financing scenarios. Using monetization proceeds to pay down debt cuts interest expense and enhances borrowing capacity by deleveraging the company, and removal of depreciation expense resulting from the sale can increase earnings-per-share.

Unlocks capital for growth and operations

Capital locked in bricks and mortar provides no real return for a business and monetizing these illiquid assets liberates capital for more productive uses. Companies achieve a higher return on capital invested in their core business than the cap rate defining the leaseback expense.

Raises capital via non-traditional sources

Maintaining cash and preserving traditional lines of corporate borrowing are important as the global economic challenges continue. Real estate investors and their lenders are new sources of financing that do not require restrictive covenants found in most corporate debt instruments.

Transfers obsolescence and residual risks of ownership

Monetization can be achieved with relatively short terms of leaseback for quality real estate assets in healthy markets, making a sale/leaseback a strategic option for maximizing proceeds while planning for changing occupancy requirements. Selling assets subject to leases of even a few years can create higher net proceeds than selling properties once they are vacant. Additionally, a sale and partial leaseback can be a great option for companies with smaller space requirements today.

Maintains control of property for as long as needed

Lessees can maintain flexibility and asset control for extended periods through renewal options, expansion rights, and other lease clauses. Repurchase options or participation in residual upside can be achieved, depending on the accounting treatment desired for the transaction.

The timing for monetization of corporate owned and occupied real estate is very favorable today. Corporations can optimize tax positions, access new and cheap sources of capital to liquefy non-productive assets, improve balance sheet performance, facilitate right-sizing, and maintain asset control while transferring risks of ownership.

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