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Net Lease: Increasing Interest

Rise in Rates Could Boost Sale-Leaseback Business

By Neil Weilheimer, Senior Editor

FEBRUARY 16, 2003 -- Los Angeles - Sale-leaseback players will not readily admit it, but they are one of the few groups in the real estate industry wishing for interest rates to rise. Many say that if the historically low rates creep up, corporate America will be more likely to pursue sale-leasebacks as an alternative form of financing.

"A little blip in interest rates would not hurt our business," conceded Scott Tracy, a founding principal with Corporate Partners Capital Group Inc.

Why such a hankering for the Federal Reserve to bump rates, at least just a little? So corporations will ditch efforts to refinance their buildings and instead choose the sale-leaseback option, which provides instant cash andsome ownership-like benefits.

Though such financing vehicles have been widely used for some time now, they are likely to become even more in vogue as companies try to get their hands on much-needed cash. Many corporations have been cut off from corporate bond markets, and bank lenders have placed limits on how much risk they are willing to take. And selling stock into the public arena is practically impossible.

For these capital-squeezed companies, one of the best solutions may be to enter the net lease market. Such a decision, according to industry observers, would allow these corporations to lower their debt loads, reduce balance-sheet clutter and obtain tens or even hundreds of millions of dollars for reinvestment back in their core businesses. "The best place to raise capital is sitting right there on the corporate balance sheet," said Tracy.

The appetite for sale-leaseback transactions has steadily built in recent years. Three years ago, sale-leaseback specialists were often scoffed at and shown the door by a company's chief bean-counters. Back then synthetic leases were what corporations sought,

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and CFOs were drawn to bankers who promised they could easily raise equity using this method. In addition, many financial executives preferred to own their assets because it gave them a greater sense of control of the company's long-term destiny.

But the perception of sale-leasebacks has changed, and making the pitch for such deals has gotten much easier. "It's no longer such a hard sell," said Howard Sands, a founding principal at Corporate Partners Capital Group. "The corporation has a need for capital and to put the capital to better use. Typically, owning real estate is not a productive use of the corporation's capital. Wall Street supports that view. They want real estate off the books."

Likewise, more and more CFOs are becoming hooked on the benefits of sale-leasebacks. Such treatments do not carry the same refinancing risk as synthetic leases, which are typically shorter in term, prone to interest rate changes and carry large balloon payments at the end of the loan term.

"In sale-leaseback deals, however, you're matching a long-term asset with a long-term liability," said Sean Sovak, chief acquisition officer at W.P. Carey & Co.

So why was sale-leaseback volume flat in 2002 compared to prior years? For one thing, corporations were waiting to see if a pending review of special-purpose entities by the Financial Accounting Standards Board, the organization that establishes private sector accounting standards, would impact sale-leasebacks as well.

The corporate scandals that occurred over the past 15 months caused FASB to revamp its criteria for determining when companies must bring SPEs onto corporate balance sheets—something they were able to sidestep with synthetic leases. In January, FASB issued revised guidelines for dealing with SPEs (see story on page 10).

Other factors causing the slowed sale-leaseback activity last year were the low interest rates and lack of available product.

But nearly all players expect some increase in sale-leaseback activity this year.

"Corporations have to make some decisions with respect to their balance sheets," said Cushman & Wakefield Inc. senior managing director Michael Rotchford.

"The volume should start picking up toward the end of the second quarter and into the third and fourth," predicted Stephen Olsen, managing director of the global net lease partners fund at CB Richard Ellis Investors L.L.C. "It should continue to build because the pricing is so attractive to companies. As the economy starts to turn, there is a major liquidity issue for most of these companies. Sale-leasebacks are a very smart

FEBRUARY 01, 2003 -- The Downtown Chicago office market took a big hit in the fourth quarter of 2002. While the exact absorption figures differ from one research report to another, the reports share one common characteristic: extremely negative numbers.

MORE

solution to a capital-constrained company looking at an expanding economy."

In addition, public opinion and regulators are demanding that companies have clean, simple balance sheets. Investors have shown distaste for companies that use sophisticated financing structures.

On top of that, investors are willing to sink more money into real estate. "There is a large number of shareholder equity that has left the (stock) market. That money has to go somewhere," said Bruce MacDonald, president of Net Lease Capital Advisors Inc. Buyers are willing to pay higher prices today for real estate services, he continued. "That would indicate there should be more sale-leasebacks."

In the 1990s, companies wanted to invest in their businesses—or even acquire a competitor. As a result, they borrowed heavily from banks. And now that their loans are coming due—and with the economy readying for another expansion, as many believe will happen soon—companies will need to be liquid.

"Companies are under pressure to redeem debt, not issue new debt," said Olsen.

Credit Consciousness

In an environment where companies such as Arthur Andersen, Enron and WorldCom can have solid credit ratings one day and be struggling—or even bankrupt—the next, net lease players are placing greater emphasis on how they evaluate deals.

"We've always underwritten the underlying credit of the tenant and the real estate itself. We'll continue to do that," said Sands.

Some are even looking beyond corporate credit. "It's not just a balance sheet concern anymore but a perception of the industry the tenants are in," said Stan Johnson, CEO of Stan Johnson Co.

With so many afraid of getting burned, where do the net lease opportunities exist? Most players say it is a toss-up between retail and industrial stock.

"The industrial sector will be the primary focus for sale-leasebacks this year," said Randy Blankstein, president of The Boulder Group, based in Northbrook, Ill. "Investors are still scared of the office sector, with its high-teen vacancies and no imminent signs of recovery underway. Office is still viewed as a fairly risky asset (class) … (and) the ones doing sale-leasebacks there today are doing it out of a more urgent need for cash. People still think the recovery in the office sector is one year out. Therefore, it makes (net lease investors) nervous to have a non-credit tenant combined with an asset class that has extremely high vacancy rates."

On the retail front, which typically comprises 60 percent of all net lease deals, some observers say drugstores are the property to chase. According to Paul McDowell, CEO of Capital Lease Funding L.L.C., current demographics favor the long-term outlook for the property type, even though companies such as the giant Rite Aid chain are carrying wads of debt.

"The drug retailers in general, and Rite Aid in particular, are going to prosper because people are getting older and buying more medications," predicted McDowell. And while those customers wait for their prescriptions, he said, they are going to buy other personal care products, helping drive up sales.

Not everyone is convinced about the viability of drugstores. Even though such chains are for the most part maintaining their credit, buyer appetite may have waned, noted Blankstein. "The people who (normally) want to buy them already have them and are trying to diversify away," he said. "The people who buy retail are full of retail, especially drugstores."

So what about grocery-anchored centers? Despite generally good credit ratings, they will come under pressure from larger shopping trends, said McDowell. "If you're a grocery retailer and Wal-Mart plunks down a supercenter, you're dead. … Retailing outlets are changing because of where people are buying their food."

Nevertheless, nearly all observers point out that retail as a whole will have a healthy deal flow. "Retailers grow by expanding their bricks and mortar," said MacDonald. "They don't want to own it all. So it makes more sense for them to do sale-leasebacks because they can get a better return using that money for operating their business."

SIDE BAR

FASB Rules

Net Lease Experts Explain Guidelines, Discuss Their Effects on Industry

In a Jan. 17 ruling with tremendous significance for the real estate industry as a whole, and providers of synthetic lease financing in particular, the Financial Accounting Standards Board finally issued its new guidelines for dealing with special purpose entities. FASB's Interpretation No. 46, Consolidation of Variable Interest Entities, spells out when a company should include in its financial statements the assets, liabilities and activities of another entity.

Immediately after the ruling, CPN's Neil Weilheimer spoke with three net lease experts: Sam Mundel, vice president of 42 North Structured Finance Inc., which focuses on synthetic leases; W. Kyle Gore, a managing director at Legg Mason Wood Walker Inc.; and Ethan Nessen, a principal at CRIC Capital L.L.C., to get their take on how the ruling will impact the industry.

CPN: FASB's ruling is more than 40 pages long. What does it all mean?

EN: Let me start with a 50,000-foot view. The net impact of this is that synthetic leases, as a vehicle to provide off-balance-sheet financing, are no longer viable. ... It almost seems to me that some of the language was put in specifically to address a synthetic lease structure. When they talk about the definition of a variable interest entity … they are saying that if you're not as an entity receiving the value of the profits of the residuals, then in fact you violate the guidelines and therefore it's (got) to be thrown on the books.

KG: Start with page 8, paragraph 14 in the ruling, which talks about consolidation based on variable interests. The concept behind the interpretation is that an entity must consolidate on its own balance sheet the assets and liabilities of a VIE, with which Entity A has entered a transaction to the extent Entity A is deemed "the primary beneficiary of the variable interest Entity." That sentence is the entire ballgame. In a nutshell, the interpretation is about determining: Are you a variable interest entity? And if you are a variable interest entity, how does Entity A become a primary beneficiary? This final interpretation is significantly different from the July exposure draft right down to the definition of the entities that it seeks to consider. They have created a new definition for entities called VIEs, rather than SPEs.

Paragraph 14 also says that an entity shall consolidate a VIE if Entity A has a variable interest that will absorb a majority of the VIE's expected losses if they occur or receive a majority of the VIE's expected residual returns if they occur or both. For lack of a better term, the interpretation (also) has a tiebreaker concept. It says that if one entity is going to have a majority of the losses and a second guy has a majority of the gains, the guy who had the majority of the losses is the guy who has the problem. He will be deemed the primary beneficiary.

SM: What will be required will be that the entities that can remain active in the business and complete the transactions will need to be considered voting interest entities, and as far as we can tell, the clearest way to pass that test is to be an entity of size and scope and scale. Under those scenarios we think synthetic leases will continue and remain robust.

CPN: Will outside investors now have to put at least 10 percent equity into the deals, as many people anticipated FASB would require?

KG: As far as the 10 percent equity requirement goes, that's not what (the ruling) says. On page 6, paragraph 9 is one of the keys to life (regarding the equity requirement). FASB has said we want the world to get practical. FASB is trying to head toward principals-based accounting, and what they're saying is, "Tell me why did the transaction exist? And more importantly, tell me whether or not the equity that the VIE has, tell me whether the owners of that VIE have enough skin in the game."

The so-called 10 percent test is in here. It says, "That an equity investment of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient in at least one of the following three ways: The entity has demonstrated that it can finance its activities without additional subordinated financial support; the entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support; the amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence." What FASB has said is that you've got to comply with one of the three tests, otherwise we're looking for 10 percent or more.

CPN: Are there any other important sections people should be aware of?

KG: Yes: page 23, paragraph B10. That is a section that was not in the exposure draft. It pertains to leases. It says the following, "Long-term leases with a variable interest entity are not considered in determining the primary beneficiary of that variable interest entity if the lease terms are consistent with market terms at the inception of the lease and the lease does not include a residual value guarantee or similar feature. In that situation, the expected losses and expected residual returns of the lessee are equal to each other and are no greater than the aggregate expected losses and expected residual returns of the investors, lenders and other parties with interests in the lease." My read is that FASB has said that the tenant, if it has done a deal where it is not providing a residual guarantee, even if the lease is a long-term lease, need not worry about expected losses or expected gains. FASB has said that they cancel each other out.

CPN: For the most part, will people in your industry be pleased with the ruling?

EN: I think that once they understand it they are going to be very pleased.

KG: They are going to say it's fair. One thing that has gotten lost in all of this debate is that most participants in credit-tenant loan transactions are users of financial statements. … And anything that promotes greater disclosure and clarity is applauded.

EN: It's pretty clear that everyone is going to be pleased. The tougher thing to answer, and perhaps the more vital factor, is going to be how quickly does the market absorb, accept and react to this information. Is the market going to calm down as quickly as it got riled up when (FASB first announced that it was going to review accounting standards for SPEs)?

CPN: How do you respond to those that say synthetic leases are dead?

SM: It's likely that is an incorrect statement. The consolidation ruling ... is not drafted with the intent of eliminating synthetic leases. It's drafted to facilitate the consolidation of certain types of entities. Deals done using an SPE or entity an auditor feels that are not substantial in various forms of scope are not going to happen. If you use an entity that is substantive and can be viewed as a voting interest entity, per the interpretation, that transaction is fine.

CPN: So what do you think is going to happen to all the synthetic leases?

EN: A lot of people are trying to figure exactly that out. (The responses) fall into a couple of categories. The first is the corporations, banks and advisors waiting and hoping there was going to be a way out. A lot of them have probably started scrambling. I don't think they know what they're going to do yet. They were hoping for the best. I think there are some companies that started to react previous to this ruling. They just opted to put it on their books. The third group, and we don't know the percentage, may put some on their books and also try to keep some as an operating lease.

CPN: How much was the sale-leaseback business off last year as companies waited to see what FASB would rule?

KG: The bread-and-butter sale-leaseback business wasn't there. And we think that the FASB overhang effect was certainly prevalent in the second half of the year and most acutely in the fourth quarter. If you go back to when FASB started making noises in late spring and early summer, that wiped out the balance of deals in 2002. And at the same time, we had corporate earnings woes, more rating downgrades than upgrades.

If someone had told me in the fall of 2001, that one year from now, even after Sept. 11 but before Enron became apparent, that one year from now interest rates are going to be at 40-year lows and companies are going to be starving for capital, and that the sale-leaseback business will be down 50 percent or more, I would have said that that's not possible. That's how (much) the FASB stuff weighed in.

EN: It was off by more than that. I'd say it was off by 80 percent (from a deal volume in 2001 that totaled between $5 to $6 billion to a total in 2002 of about $1.5 to $2.5 billion). … After speaking directly to corporate CEOs and CFOs, the consistent comment has been that they were really not going to look at any of this stuff until FASB gave some guidance. This falls into whether they were going to look at simple sale-leasebacks, whether they were looking at how to handle their synthetic leases or even how they were going to handle financing in general.

CPN: How receptive will CFOs and CEOs be to your pitch?

SM: It's going to take a number of months for the dust to settle on the interpretation and for opinions to be reconciled. During that period, the confusion is going to intimidate various people in the trade. We plan on restructuring synthetics to comply with the new ruling.