NATIONAL REAL ESTATE Investor

Across the Pond, Corporate Real Estate Execs Break with Tradition

By Joe Gose

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European corporations, searching for ways to raise capital, are increasingly converting their bricks and mortar into cash through sale-leaseback transactions. Signifying a radical shift in the way companies view their real estate, the growing wave of sale-leaseback deals bucks a centuries-old custom of holding property for generations. Real estate experts say it also is part of bigger transformation in the way European companies finance, lease and manage property. The net effect is that CFOs and COOs are playing a greater role in the real estate-decision making process.

Commonplace in the U.S. for years, sale-leaseback deals were rare in Europe until about three years ago. That's when a recession and a trend toward outsourcing convinced companies to look upon real estate as a way to raise capital for their core businesses — to retire debt, invest in new technology or increase flexibility. The need for fresh capital, in fact, is trumping the cultural idea that owning property conveys social and financial status.

“A lot of European businesses were family-owned or controlled, and the feeling was if the business went bust, you at least had the real estate,” says Mike McNamara, a partner with Ernst & Young Real Estate Group in London, who has served as a corporate financial advisor on several European transactions. “But if you have an assembly plant or something like that in the middle of nowhere and your business goes bust, you've got (next to nothing) in terms of real estate value for that asset. So now business people see their property as an area where they can extract value,” McNamara adds.

Throughout Europe, corporations have completed about 50 sizable sale-leaseback transactions over the last three years, and the potential for more deals going forward is enormous for investors and owner-occupiers. European corporations own about 70% and lease 30% of the real estate in which they operate, roughly inverse to the proportion in the U.S., according to DTZ, a London-based global full-service real estate company.

In a report that examines the amount of potential investment property owned by occupiers, DTZ also predicts that investors will pour about $80 billion into European real estate over the next four years, chiefly through sale-leasebacks. McNamara suggests that amount could rise to as much as $163 billion. The deals typically would spin off 3% in fees, he estimates, depending on their complexity, size and the number of parties involved. The potential list of players includes real estate brokers, appraisers, engineers and investment banks, who may act as advisers and underwriters.

In addition, a growing body of research is helping to sell corporations on the idea of sale-leasebacks. According to an April 2002 study commissioned by the Royal Institution of Chartered Surveyors, U.K. firms could save $28 billion a year and boost profits 13% by using property more efficiently.

BBC Blockbuster Transaction

One of the most celebrated sale-leaseback deals involves the British Broadcasting Corp. (BBC) and its historical 500,000 sq. ft. Broadcasting House in London's West End. In July, the venerable government-subsidized corporation completed a sale-leaseback transaction that is providing more than $1 billion in capital for a two-phase redevelopment and 300,000 sq. ft. expansion of its five-building complex.

The transaction reflects the increasing sophistication of the commercial real estate market in Europe. The BBC sold a 150-year ground lease interest at Broadcasting House for $145 million to a joint venture group comprising Morgan Stanley and Land Securities, a British real estate investment firm. BBC holds a minority stake in the joint venture. Morgan Stanley loaned the joint venture $1.3 billion for the ground lease acquisition and Broadcasting House redevelopment, then securitized the loan on the European commercial mortgage-backed securities (CMBS) market.

The BBC entered into a 30-year lease with the joint venture that allows it to “step into” its lease payments. The BBC pays no rent until workers complete the first phase of construction in 2005, at which point it will pay about $28 million a year. When the entire project is complete in 2008, the rent rises to $70 million.

The transaction is part of an ambitious outsourcing strategy that the BBC is methodically implementing in its roughly 500-building, 8 million sq. ft. portfolio that is valued at about $1.1 billion today. (It will rise to about $2 billion after the Broadcasting House redevelopment.) The BBC wants to increase the quality of its physical structures, as well as their upkeep and management, without significantly increasing expenses.

“The [building] stock is historically underinvested in and is in poor shape, because for over 70 years the BBC has looked upon its buildings as just overhead,” says Andy Jameson, finance and commercial director for the BBC. “It was difficult for the BBC to look on the properties differently. It was a cultural change.”

Solving a Balance Sheet Dilemma

European telecommunications companies virtually led the cultural shift when they began looking for ways to pay down hordes of debt they took on to develop their wireless networks in the 1990s. In 2001, for example, BT Group (British Telecommunications) raised $3.7 billion to help mitigate $47 billion in debt by selling its 59 million sq. ft. portfolio of 6,700 properties to a joint venture led by Land Securities Trillium, a division of Land Securities.

But corporations in other industries started pursuing sale-leasebacks, too, including retailers, grocery stores, parking garages, warehouses, nursing homes and banks. Last year, Luton, England-based Laurel Pub Co. sold 280 pubs to London & Regional Properties, a private property investor, for a reported $509 million and is leasing them back for 60 years. Laurel Pub, which owns nine pub chains, including Hog's Head, wanted to acquire other pub companies but limit its debt exposure. As of mid-September, Laurel was among the few remaining bidders for U.K. brewer Scottish & Newcastle's pub business, valued at $3.6 billion.

Is the brisk sale-leaseback activity in the U.K. here to stay? Real estate experts can't be certain in the short term. An improving economy could take the onus off corporate executives to think strategically about their real estate. What's more, the ingrained philosophy of holding onto property hasn't completely disappeared. But property experts contend European corporations — some influenced heavily by U.S. business practices — are now too aware of outsourcing's advantages to pinch off the transformation.

“The way corporate real estate is practiced today is not the same as it was 10 years ago,” says Steven Laposa, director of global real estate research for PricewaterhouseCoopers in Denver. “We're at an early stage of the evolution, especially as more multi-national companies go into Europe and as more European firms become international.”

Role of Fledgling CMBS Market

On the demand side, new financing vehicles such as the young but growing European CMBS market — in which loans backed by leasing revenue streams are securitized — are facilitating sale-leaseback activity. Some 22 deals valued at $22 billion flowed through the CMBS market last year, compared with 13 deals valued at $8 billion in 1997, the first year for CMBS. By contrast, CMBS issuance in the U.S. last year totaled $66 billion.

“Just as two or three big companies started to do sale-leasebacks, others followed,” says Pascal Richard, associate director of European CMBS for Fitch Ratings in London, a global credit rating agency. “That's what we've been seeing the past couple of years.” If the dramatic growth in CMBS volume in the U.S. over the past decade is any indication, the European CMBS market is poised to take flight.

Demand-side drivers of sale-leasebacks also include foreign and domestic investors loaded with cash who are looking for places to park it. New York-based W.P. Carey & Co., a global investment banking firm, has spent more than $500 million on 18 sale-leaseback transactions comprising 42 properties in Europe since 1998. The lion's share of that investment has occurred since 2000 — 13 deals comprising 37 properties. Among other acquisitions, last year the company bought a 282,609 sq. ft. lab, office, production and research facility for $24.6 million from PerkinElmer Inc. in Turku, Finland. For PerkinElmer, a global high-tech company headquartered in Boston, the asset sale raised capital to fund its core businesses.

Edward LaPuma, executive director at W.P. Carey & Co., calls the PerkinElmer deal a precursor to more acquisitions involving entire multi-national portfolios. “We're looking at two or three deals where there are properties in as many as five different countries,” he says. “That's the next step of the evolution.”

Sale-leasebacks also are emerging in Asia as an outgrowth of fledgling CMBS markets. Late last year, Malaysian property developer Sunway City Berhard completed a $118.4 million sale-leaseback transaction, marking the first CMBS deal in Southeast Asia, and is using the proceeds to pay down debt. The transaction included Sunway's Kuala Lampur headquarters, hotels, a theme park and shopping center. Still, industry experts say the number of sale-leasebacks in Asia pales in comparison to the volume in Europe.

Rewriting The Rules

Cultural attitudes are hardly the only barrier to sale-leaseback transactions, especially in the U.K. Heretofore, tenants in the U.K., unlike their brethren in the U.S., have faced “upward only” rent review boards every five years. If market rents rise during the five-year period, then the rent for the tenant under review goes up accordingly. If rents have declined over that period, however, the tenant's rent remains the same. Because tenants also typically sign 20- to 30-year leases, that makes gauging real estate costs over the life of the lease all but impossible. In turn, that has made owners reluctant to execute sale-leaseback agreements.

The current crop of sale-leaseback deals are changing those rules, however. Ernst & Young's McNamara, for example, engineered a deal for Abbey National bank about three years ago that resulted in more favorable rent terms. It built incremental rent increases into the lease and gave the bank more — and cheaper — options to terminate leases early, McNamara says. The deal also saved the company some $350 million in lease liabilities.

The transaction transferred some 1,300 retail branches, office buildings and call centers — about 400 owned and the remaining leased — to Mapely Columbus for $700 million. The company is tied to international financier George Soros and British property firm Delancey Estates. After years of acquiring other banks and amassing its real estate portfolio, Abbey National pursued the sale-leaseback to give itself more flexibility, especially with Internet banking on the rise.

As of mid-September, McNamara was working with Earls Court & Olympia Group, the owner of a West London concert and conference venue of 2 million sq. ft. Of course, as someone who has had success in engineering sale-leaseback deals — he also worked on the BBC transaction — McNamara wants to see more corporations adopt the concept as standard operating procedure.

The challenge is to reverse a cultural indoctrination that for generations has equated social and financial success with property ownership. “More companies need to convince themselves — and perhaps be convinced by others — that they need to be doing things more cleverly with their real estate.” he says. “But I don't know if the culture has evolved to the point I'd like to see it. Being a beneficiary of these deals, I'd like to see it happen a lot faster.”

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