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Sale and Leasebacks

More than Contra-Cyclical?

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Executive Summary

- Sale and Leasebacks (SLBs) are not merely contra-cyclical; a recent increase in activity suggests more factors now at play besides the economy.
- Unprecedented levels of capital targeting European real estate creating increased liquidity and favourable conditions for disposals.
- We see growth opportunities in the Industrial and Logistics field in particular. New sources and forms of capital targeting this sector continue to grow and improved pricing levels are creating favourable sales conditions for occupiers.
- The need for strategic investment by both investors and occupiers operating in the European industrial and logistics sector supports the business case for transactions which can provide operating flexibility and facilitate business expansion. SLB transactions, when planned and executed correctly, can be the ideal transaction medium to facilitate these needs.

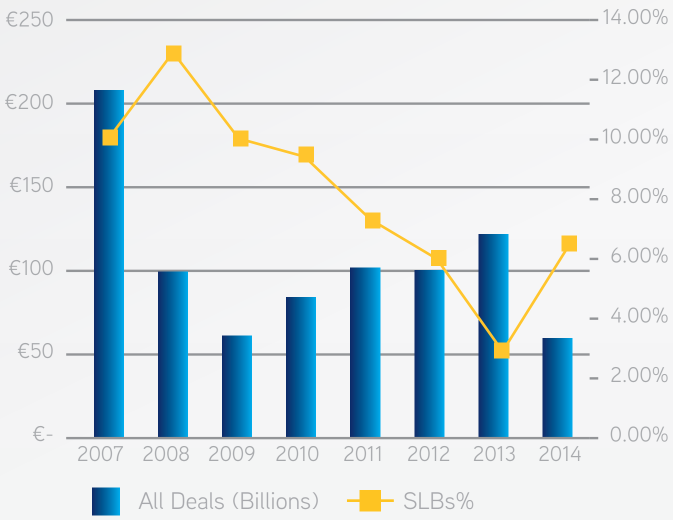
Introduction

In 2014 we witnessed a marked increase in Sale and Leaseback (SLB) transactions around the European markets; accounting for 6.4% of market transactions at a value of €3.8 billion, compared with less than 3% at the end of 2013.

In this report, we briefly investigate what has driven the sudden rise in SLB transactions in 2014. Whilst high levels of SLB activity during the peak of the financial crisis in Europe show that this type of transaction has tended to be contra-cyclical - i.e. more common in tougher economic environments - the recent increase suggests that the economy is not the sole driver, and there are other factors at play.

This report will demonstrate that SLBs need not be reserved for corporates in need of a last-ditch effort to raise cash, and instead, there can be a number of competitive advantages in using SLBs as part of a detailed ownership strategy. In particular, we look at manufacturing and industrial-derived SLBs, and explore the strengths and weaknesses these types of deals present.

Figure 1: European Investment Transactions & SLBs



A Quick Recap

In 2012, we produced a report which looked at the market for SLBs in Europe. At the time, SLBs accounted for approximately 10% of all investment transactions across Europe from 2007 to mid-2012, when including partial SLB deals, when the seller leases back only part of the sold property. If only full SLB deals are included (i.e. lease term of 1 year minimum remaining), the average drops to 7%.

The report showed that during the peak of the financial crisis in Europe, SLB transactions as a proportion of all sales had reached a lofty 13% (circa €13 billion) in 2008. Since then, as the European investment market has recovered, SLBs as a percentage of all transactions have declined to represent less than 3% of the market as of end 2013, supporting the contra-cyclical nature discussed in the original study.

A recap on the key findings from the original report to provide greater context to the discussion, starting with conditions and considerations impacting the market for SLBs:

1 SLBs can serve the need for corporate entities to raise cash whilst allowing investors to secure longer-term income streams, thus enabling better financial terms – a transaction medium that can benefit both parties.

2 As of mid-2012, freehold assets held by corporate bodies currently constitute an estimated 83% of the total commercial real estate market in Europe. With such low volumes of SLB sales since then, it is clear that the potential scope for SLB activity remains significant, especially if there is a shift in the long held view that 'real estate should remain in corporate hands as a cultural norm'.

3 From an investor perspective, a strong covenant from the vendor will enable an investor to secure more favourable capital financing terms, especially if a vendor can opt to agree to terms longer than 3-5 years. However, if the assets in question are non-prime, too specialist or have limited alternative use value, this could reduce the likelihood of securing favourable lease terms.

4 From an occupier perspective, the major benefits of selling property, relative to selling all or part of a company are that the corporate occupier maintains control over the day-to-day management and planning of the business, allowing for a capital increase in the business. This is especially the case where the occupier can retain and partially control the use of the space via the lease terms and conditions set out in the sale agreement, and rent can reduce tax liabilities.

5 Re-investing the capital back into the business is critical – historical evidence points to certain companies which did not re-invest their capital, struggling to survive. SLBs need not be, nor should be, a last-ditch effort to raise cash.

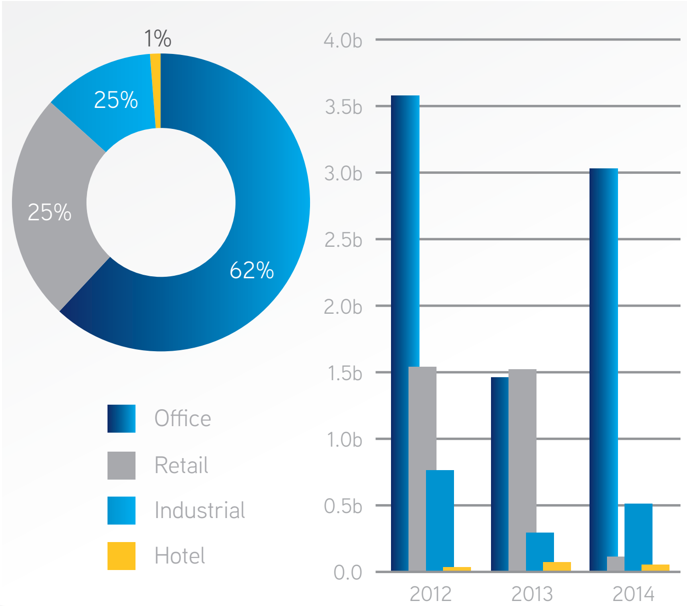
6 How assets are valued and how a sale and/or leaseback (or leases) are treated in legal, accounting and financial terms can create significant complexity. While SLBs are a worthwhile transaction medium, they require careful planning and consideration to be successful for both the vendor and purchaser over the established duration of the transaction. Professional real estate, valuation, financial, legal and taxation advice is paramount, enabling a positive transaction for all parties.

With this in mind, what trends and insights can we establish from SLB sales activity since mid-2012?

Recent Activity: Key Trends - Offices

The first obvious trend is that offices have dominated SLB transactions over the two year period, comprising 63% of all deals. Offices are followed by retail (25%), industrial (12%) and then hotels.

However, while office deals have been the most dominant sector, retail-derived SLBs surpassed offices in 2013, although offices have since bounced back in 2014.



Germany, the UK and France dominate the list of most active countries with just over 50% of office-based SLB volumes. This is not surprising, given that they have been by far the most liquid investment markets in Europe.

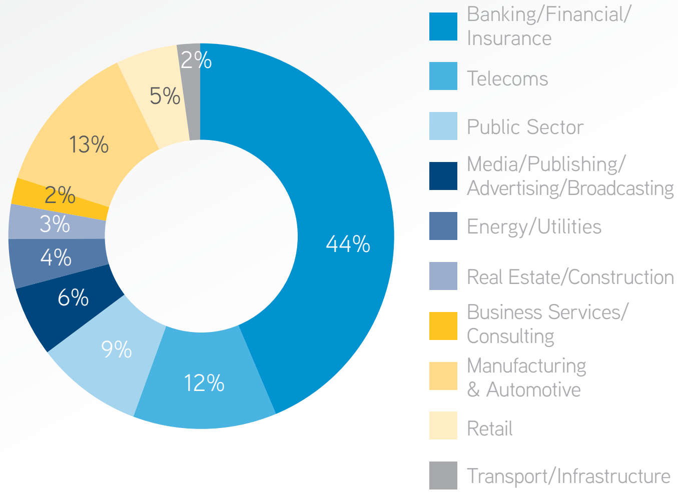
Switzerland and the Nordics also feature strongly in the geographic representation, both markets driven by banks' disposals. In fact it is the banks which have been the main source of office-based deals over this time, representing 44% of the total office deals closed between 2012 and H1 2014.

Credit Suisse, BAWAG, WestLB-Zentrale, Commerzbank, Credit Agricole and Morgan Stanley have been some of the key vendors in the banking sector, selling their office facilities - in some cases their European HQ – for sizeable sums. Credit Suisse alone has closed four deals worth a reported total of €1.5 billion.

The telecoms and public sectors have been other key 'office-based' business sectors sources of activity, particularly in Spain where public sector asset sales have been prevalent in recent years.

Outside of the primarily office-based business activities, the other key business sector source of activity has been the manufacturing and automotive sector, accounting for 13% of SLB office sales. Key transactions have included the sale of Phillips' High Tech Campus Eindhoven - where it houses its IT, intellectual property and innovation activities. The campus was sold in a SLB deal worth a reported €425 million back in 2012, coming as part of the company's €800 million cost reduction programme announced in 2011.

Office Derived – SLB Transactions, by Business Sector



In a similar cost-reducing approach, we have also seen the sale of Peugeot's HQ in Paris for a reported €245.5 million, after the company had announced plans to sell €500 million of property assets as part of a €1.5 billion asset disposals program in 2012. This has led to the recent sale of two office buildings located in Milan, in Via Gattamelata and Via Gallarate, owned by the PSA Peugeot Citroën group. The acquisition by real estate fund Pegasus was enabled by PSA Peugeot Citroën signing two long-term leasing contracts on both properties.

Key Trends Industrial & Retail

Within the industrial sector, we have seen some similar patterns emerge. Yet again the more liquid European markets of the UK (43%), France and Nordic markets (Sweden and Finland) have been the most active. There has been some activity in Europe's manufacturing and distribution core of Benelux and Germany, but only the one deal to date in Eastern Europe – with the 2014 sale by Bang and Olufsen, of its 16,400 m2 premises in Kopřivnice to Palmer Capital on a 15-year lease contract.

By sector, there has been a real mix of activity and a range of buyers have been engaging in activity – from institutional investors to logistics providers in primarily single asset deals. There have been sales by a number of packaging and logistics firms – such as Huhtamaki Oyj in Hammenlinna, Finland, acquired by NREP Nordic Strategies Fund. In Sweden, the fund further demonstrated its appetite for the logistics sector with the acquisition of a 46,000 m2 portfolio on an SLB basis with DSV.

In Germany, Fiege has acquired the product groups of Pirelli Deutschland GmbH to consolidate the existing small storage locations around Pirelli's production plant in Breuberg into a new Fiege logistics facility in Dieburg, Hesse – thus consolidating the position of Fiege as a leading tyre logistics company. Pirelli will occupy a considerable portion of the new building while the remaining space, in keeping with the multi-user concept, will be available for other customers from Fiege's eight core industries. Union Investment will be the final investor in the Dieburg project, paying a reported €50-€60 million.

Other key transactions have included the 18,000 m2 campus of Cargotec in Tampere, Finland by WP Carey for a reported €40 million on a 20-year lease. In Hasselt, Belgium, Coca-Cola Enterprises carried out a SLB of its distribution centre site in May 2014 to MC Capital, a private investor and real estate developer. The site had been under ownership for 40 years and comprises an industrial building of 20,000 m2 with 1,500 m2 of offices on a site of four hectares, and used to be the location of its bottling plant. This activity was stopped several years ago, leaving only the local distribution and events department in situ.

Retailers have also been active sources of asset sales. Morrison's, the UK supermarket chain, is selling much of its property portfolio to appease investors, who are unhappy at its loss of market share to discount retailers such as Aldi and Lidl. Five assets totalling circa £300 million have been sold at the time of reporting against a stated objective of £500 million, including the regional distribution centre in Sittingbourne. The company is under pressure to reduce costs to fund plans for £1 billion in price cuts and product improvements over the next three years

While some retailers have been forced to trade assets for cash in the face of operating difficulties, some retailers continue to expand. In 2014, Action, known as one of the most successful non-food discount retailers in the Netherlands, announced the sale of its distribution facility in Limburg to WDP on a sale-and-leaseback basis for a reported €70 million. This deal came together with plans to build a new distribution centre in Echt, south Limburg.

As for retail assets, again the UK has been the most active market (50%), followed by France and Spain. Household names such as Tesco and Sainsbury's have continued to deploy a strategy of utilising SLBs, especially Tesco having concluded SLB transactions worth up to €1.5 billion (including the sale of a JV with British Land for €78 million) - this accounts for 45% of all SLB retail assets. However, they have both been very quiet of late.

There were other portfolio sales including for Agrokor in Croatia, with the sale of Konzum retail stores to WP Carey for an estimated €100 million. Odeon Property Group LLC sold their Multiplex cinema portfolio to London Metric Property and their flagship Leicester Square Odeon cinema to Harmsworth Property Trust for a combined total of €107 million.

In France, the sale of the Vivarte retail portfolio to La Francaise Asset Management for €175 million, and the Metro 'Cash and Carry' portfolio sale to Hermes for €178 million were the most significant transactions. In Spain, the sale of Caixa Catalunya bank's retail branch portfolio netted €428 million, and accounted for a further 13% of all retail SLBs.

Aside from these sizeable portfolios a number of retail facilities also traded hands. Two El Corte Ingles department stores were sold in Spain (€92 million in Barcelona, circa €50 million in Madrid). In the UK, British Land took full control of the Surrey Quays Shopping Centre in London, buying the remaining 50% of shares for £48 million.

"...the phone company seeking to trim its debt pile of $37 billion..."

TELECOM ITALIA

"...it has agreed to sell the site for €120 million ($161.7 million) as part of a restructuring plan..."

RCS ITALIA

"...The amount positions as the most impressive one since the local authority's decision to shed a part of its property portfolio..."

MADRID MUNICIPALITY

"...sold the property to Crosstree in March to help reduce its debt ahead of its £471million buyout of Best Buy..."

CARPHONE WAREHOUSE

"...This operation is part of BBVA Group's strategy initiated six years ago to optimize its real-estate portfolio worldwide, by sales and lease back agreements..."

BBVA

"...with GE Capital Real Estate's publicised strategy to lower its ownership of commercial properties, selling in advantageous market conditions, and increase its focus on real estate debt lending..."

GE CAPITAL RE

"...Peugeot announces plans to sell €500 million of property assets as part of a €1.5 billion asset disposals program in February, and was reported by union officials to be considering a sale-leaseback of the head office building, as well as the possible €60 million sale of the Citroën brand's Epinettes site in the north of Paris..."

PEUGEOT

"...The sale is part of long-term plans to reduce the size of the BBC's property portfolio by 30%. The proceeds from the sale, together with the end of running costs for the site will contribute towards BBC's target of achieving annual savings in property expenditure of £47 million pa by 2016/17..."

BBC

"...The sale and leaseback of One Angel Square will release the value tied up in a non-trading asset, enabling the Co-operative Group to reinvest these funds in delivering its strategy of growing its core trading businesses to best serve members and customers..."

THE COOPERATIVE

"...After many years of building and investing in the High tech Campus Eindhoven, a change in ownership of its real estate will open up new opportunities for the other companies to access the site, ..."

PHILIPS

Conclusion

In the current climate, there is now a far more diverse range of corporate entities selling off assets on a SLB basis.

A brief review of the rationale from some of the biggest deals show the most popular phrases to be 'paying down debt', 'restoring finances', 'unlocking equity' alongside the need to facilitate corporate restructuring and/or more operational flexibility. Historically, the most prominent companies and sectors involved in SLB transactions appear to be those under significant duress. Perhaps unsurprisingly, the banking sector has been the main source of deals over the last couple of years driven by the evolution of European banking reform, under the guise of the European Central Bank (ECB) stress tests which led to the more current Asset Quality Review (AQR). This has seen finance conditions toughen and assets and/or debt held by banks needing to be in line with capital adequacy ratios, prompting a number of SLB deals since 2012.

Some of the other major transactions have been by companies beset by both cyclical and structural market challenges post-crisis. Household names such as Tesco, Morrisons and PGA Peugeot appear amongst these companies - albeit Tesco has always adopted a strategy of undertaking SLB transactions as part of their operating model, raising cash to help fund international expansion.

Within the industrial and logistics sector at least, there is more of a balanced story, where deals being concluded are helping certain operators to expand their footprint and operations, rather than shrink them.

So while the immediate reaction to this overview of activity is that SLB transactions are indeed contra-cyclical - i.e. they are more common in tougher economic environments - the ever-expanding industrial and logistics sector has illustrated that this does not have to be the case.

In addition to the general benefits of SLBs outlined earlier in this report, there is a combination of contingent and structural factors that, we believe, reinforce the business case for this type of transaction in the industrial sector in the current marketplace:

1 **The Unprecedented Levels of Capital Targeting European Real Estate:** Real estate transaction levels in core European markets (UK and Germany) are on track to reach new post-crisis highs this year, reflecting the growing interest in real estate as an asset class in Europe and globally. Record European fundraising in 2014 (the highest since 2007) and the arrival of new sources of capital from overseas point to this continuing in 2015, leading to an increase in demand for various forms of real estate product, across the risk spectrum.

2 **Growing Investor Interest in Industrial and Logistics Properties:** The traditionally high-income component of industrial properties relative to other property types, combined with the e-commerce growth story is attracting unrivalled interest and new pools of capital to the sector. Little surprise then that the industrial and logistics sector was in the top three most popular property types in our 2015 Global Investors Sentiment Survey. Particularly, we're seeing new capital from North America, including many Canadian pension funds, partnering with logistics property specialists to invest in industrial and logistics in Europe. Most of these will consider investments in large, good quality industrial portfolios, and in less strong properties with asset management potential.

3 **Window of Opportunity:** Industrial and Logistics property values have improved significantly since 2009 - although prices remain below their 2007-2008 peak in the majority of markets - creating favourable conditions for disposals. Capital values have the potential to increase further in the year ahead buoyed by yield compression generally, in response to growing investment demand. In some markets values could increase further via improving occupational conditions. However, economic uncertainty is back on the table in Europe, and a multi-speed economy means trading conditions will continue to be tough for some corporates in the year ahead, limiting rental growth. The prospect of rising interest rates in the UK in 2015, to be followed by Europe in 2016, signals that the current environment is also optimum to investors from a funding perspective. As values close on their peak in the current cycle, this dictates that the window of opportunity for owners to maximize property sales values and for investors to act on lower financing rates, could soon begin to close.

4 **Need for Strategic Investment in a Changing Market:** Remaining competitive in a fluid and ever-changing marketplace requires timely, strategic investment or risk losing market share and growth opportunities. The expansion of e-commerce and logistics distribution across Europe and, within the manufacturing sphere, the need to keep pace with technological change (automation, robotics or software enhancements) presents significant opportunities and challenges to all businesses operating within this sphere of activity. And all of these factors point to the need for continued investment. SLBs can be instrumental in raising the (extra) capital needed to invest in strategic areas of the business, allowing companies to expand their business and/or geographical footprint.

But most of all let's remember that SLBs need not be, nor should be, a last-ditch effort to raise cash. Recent evidence continues to point to the fact they require careful planning and consideration to be successful for both the vendor and purchaser over the established duration of the transaction. Professional real estate, valuation, financial, legal and taxation advice continues to be paramount, enabling a positive transaction for all parties.

485 offices in 63 countries on 6 continents

United States: **146**
Canada: **44**
Latin America: **25**
Asia Pacific: **186**
EMEA: **84**

$2.1
billion in annual revenue

1.46
billion square feet under management

15,800
professionals and staff

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