Dearth of credit slows leasebacks

Looking down every available avenue and alley for capital, more companies are considering sale-leaseback deals. Too bad lenders are in hiding.

By Beth Braverman

THE CREDIT CRUNCH IS KILLING the trend of using sale-leasebacks to raise capital, because frozen conditions have made it nearly impossible to get deals done.

Through Nov. 1, sale-leasebacks totaled $6.2 billion, less than half of the $14.2 billion in such transactions seen during 2007, according to Real Capital Analytics. Most of the deals that do close are one-off, single-tenant transactions amounting to less than $100 million each, experts say, a change from the large portfolio deals that dominated the market in years past.

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Sale-leasebacks through Nov. 1, vs. the $14.2 billion transacted in 2007.

In sale-leasebacks, owners of commercial buildings sell them to private investment groups, pension funds or institutional investors, then sign long-term leases, often in excess of 10 years, to continue occupying the properties. Though sellers frequently must still pay the real estate taxes, insurance and maintenance costs of the buildings, they enjoy the benefits of ownership without having capital tied up,

Still, the transactions have some drawbacks. In a sale-leaseback, the seller effectively gives up any profit from the building if its value appreciates. The transactions often lock in long-term lease rates, so the tenant could end up paying higher-than-market rent. And by removing assets from their balance sheets, companies could put their credit ratings at risk.

"You're giving up any control over that real estate," said Joseph Pagliari, a professor of real estate at the University of Chicago Booth School of Business. "[The tenant] may make different decisions than the owner would make."

Entering into sale-leaseback arrangements right now could force companies to take a haircut as commercial property prices continue to fall.

"Many companies would have been much better off entering into these agreements 12 or 24 months ago," Mr. Pagliari said. "They're going to get lower prices now."

From 2002 through 2007, sale-leasebacks gained popularity with private equity firms, which sold real estate assets from acquisitions to pay off the loans used to bankroll their leveraged buyouts. Having less invested capital increased PE firms' net returns on

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Sale-leasebacks slow

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assets and equity.

But few other corporations saw the need for them because the liberal lending atmosphere made capital promptly and cheaply obtainable. As that lending has dried up, sale-leasebacks, like most other forms of financing, have become both more desirable and less available.

Sale-leasebacks have slowed dramatically," said Dan Fasulo, managing director of Real Capital Analytics. "It's counterintuitive, because you'd think that they would be thriving in this type of environment. But it doesn't matter how good the tenants are, the lenders just are not there."

One reason is that lenders can no longer package loans for sale-leasebacks into securities as they did during the real estate boom.

"If the debt is available, it's available in smaller denominations, because you are working directly with a lender, not from a securitization anymore," said Mindy Berman, the managing director of corporate capital markets at Jones Lang LaSalle.

Still, some deals are managing to make it through the pipeline.

Ruth's Hospitality Group, owner of Ruth's Chris Steakhouse and several other restaurant chains, has benefited over the past few years from sale-leasebacks of its restaurants. Last month, the company took the strategy a step further with a $12 million sale-leaseback deal for its Heathrow, Fla., corporate headquarters.

Since September, Valley National Bancorp of Wayne, N.J., has been looking to "monetize some of the appreciated fair value of specific branch and office properties we own, and provide cash for future company growth through a sale-leaseback transaction," chief executive Gerald Lipkin said during the company's third-quarter conference call. Valley National may announce a deal this quarter, he said.

In addition to providing another source of capital, sale-leasebacks offer a way to reap gains on property that has been on the balance sheet. Companies have been depreciating their real estate assets for years, so the book value of those assets is low and companies should realize hefty profits on sales. But commercial real estate prices have come down considerably from their 2007 highs, and some executives harbor unrealistic expectations regarding the value of their properties, experts said.

"There is still a real spread between sellers' expectations and what buyers are willing to pay," said Arthur Greenberg, an executive vice president in the Washington office of real estate broker Studley. "There is a lot of money sitting on the sidelines, but it is primarily private equity money, and [private equity] has higher yield expectations than the current market is offering."

Potential investors will only consider deals for top-notch properties whose tenants have stellar credit, and they're looking for long-term leases that stretch to 15 years instead of 10. Medical office building sale-leasebacks represent a bright spot in the industry, while deals have dried up in sectors that have suffered more from the financial slowdown, such as retail or automotive.

"Underwriting has changed significantly in the sale-leaseback realm," said Ms. Berman of Jones Lang LaSalle. "We're back to basics. You need to underwrite the credit of the tenant and the property fundamentals."

Still, Ms. Berman said her office fields calls every day from companies interested in determining the value of their property and the feasibility of a sale-leaseback.

"In today's market, everyone is desperate," said Bill Pollert, president of CapLease, a real estate investment trust that specializes in single-tenant properties. "They're looking for every possible way to generate capital. It's hard for companies that are not in real estate to justify owning property."

Experts expect the sector to lead the rebound in commercial real estate once credit conditions relax.

"Fundamentally, the economics that justify sale-leasebacks are strong and viable," Mr. Pollert said. "It's a segment that will come back and will be strong once the debt markets come back. There is a lot of pent-up demand out there." FW