

# CORPORATE SALE AND LEASEBACKS

CB RICHARD ELLIS | EMEA RESEARCH



## AN OPPORTUNITY IN TODAY'S MORE CHALLENGING MARKET



**CBRE**  
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## INTRODUCTION

In this period of economic uncertainty, rising inflation, tighter credit and increasing costs, corporates are looking more closely at the ways in which they finance their business and manage cashflow.

In this paper we examine an increasingly popular solution to cash flow management – the practice of monetisation, or what can loosely be termed "sale and leasebacks".

We explore the growth of recent sale and leaseback activity and the details and drivers of that growth, and assess the possible future scale of this segment of the investment market.

## EXECUTIVE SUMMARY

Our research shows that the sale and leaseback market in Europe has experienced very rapid growth in recent years - from €6.7 billion in 2004 to €46 billion (or 20% of the overall European investment market) in 2007<sup>1</sup>.

Sale and leasebacks grew further as a proportion of the whole market in the first half of 2008, reaching 21.3% of the total European investment activity.

Sale and leaseback activity is becoming more widespread across Europe. 2007 and 2008 have seen significant activity in most western European countries, although the UK and Germany continue to account for the lion's share (50%). Germany alone accounted for 33% of total activity in 2007 and H1 2008, up from 18% in 2005.

Office properties continue to dominate activity, with office disposals accounting for almost half of all sale and leaseback transactions in 2007, a significant increase on the previous two years. However, the distribution of transaction activity by property type varies significantly across Europe. Moreover, there has been increasing activity in the retail sector, which has accounted for 29% of sale and leasebacks in H1 2008.

Today, the outlook for sale and leaseback activity is positive. The ever increasing corporate focus on raising capital to invest in core business - coupled with cultural shifts that increasingly favour this method and a substantial increase in the cost of corporate debt - will almost certainly lead more corporates to go down this route.

In addition, many corporates - particularly manufacturers - are being forced to absorb rapidly increasing raw material and energy costs - pushing a significant number to turn to the sale and leaseback market as a source of capital.

The improving covenant strength of companies undertaking sale and leasebacks, together with the longer leases that are typically involved, are also leading to more stable investments and more operational flexibility for occupiers - making sale and leasebacks increasingly attractive for corporates and investors alike.

Despite the rapid growth of the European sale and leaseback market in recent years, owner occupation still remains dominant in most parts of mainland Europe. On conservative assumptions, we believe the total value of corporate owner-occupied property exceeds €2.25 trillion, which is over 12 times the average annual turnover in the entire European property investment market. The potential for future growth in sale and leaseback activity - and in the European real estate investment markets as a result - is therefore great.

<sup>1</sup> Transactions where the vendor is a corporate, occupier or public sector

## RECENT HISTORY - MARKET ANALYSIS

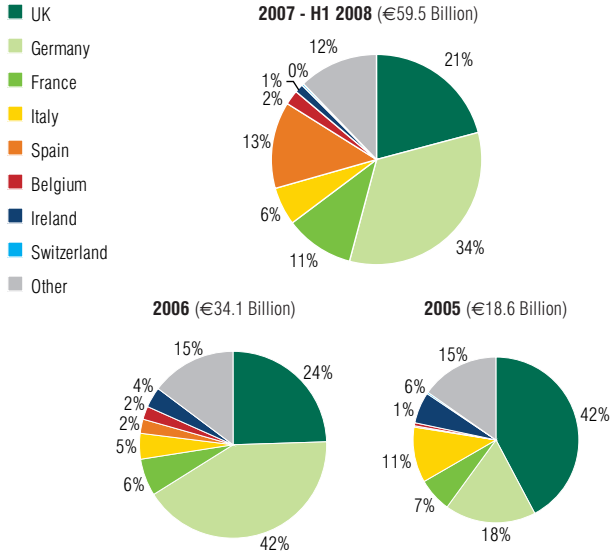
Corporate sale and leaseback activity has been growing across Europe over a number of years. The last three years have seen a 585% increase in corporate disposals overall, from around €6.7 billion in 2004 to more than €46 billion in 2007 - or from 6% of the European investment market in 2004 to 20% in 2007 and 21% in H1 2008.



Source: CB Richard Ellis

Large deals - such as the sale of KarstadtQuelle's €4.5 billion department store portfolio across Germany, or HSBC's sale of its headquarters in London for €1.6 billion - put sale and leaseback activity in the headlines. But more and more corporates are following the big players' lead and using sale and leaseback strategies as a proactive means of raising capital. 2007 saw more than 670 of these transactions take place, with an average value of €67 million. This has continued in 2008 with a wide range of deals, both big and small.

Distribution of Sale and Leasebacks across Europe by Geography



Source: CB Richard Ellis

Sale and leaseback activity has grown increasingly popular across a wider area of Europe in recent years. While the UK and Germany continue to account for the lion's share of that activity in Europe - over 50% in the past year and a half - France, Germany, Italy, Spain, Sweden and the UK each saw more than €2 billion transacted in 2007.

These shifts reflect changes in corporate culture around Europe. Companies no longer see selling their real estate as a sign of failure, but as an indication that they are actively managing their assets.

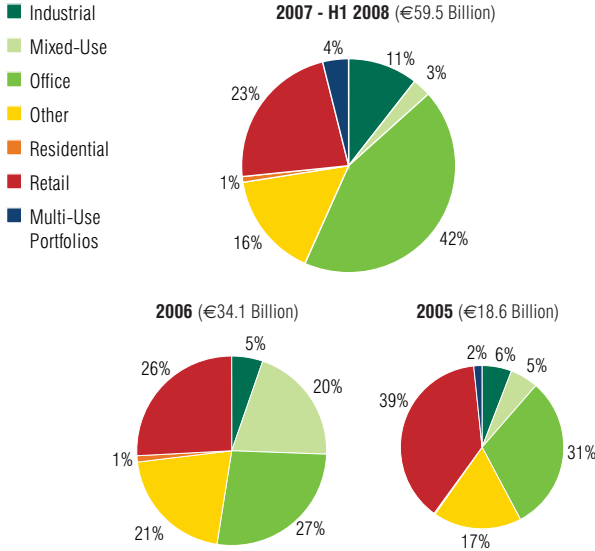
Germany in particular has seen the most marked increase in activity - accounting for 34% of total activity in 2007 and H1 2008 compared with 18% in 2005. The last six months have been particularly active, with the Deutsche Post deal one of the largest in Germany this year.

Spain and Italy have also been growing in significance in recent years, accounting for nearly 20% of the European sale and leaseback market in 2007 and H2 2008, compared with only 7% in 2006.

France has also seen substantial growth. Sales by occupiers grew from €2.1 billion in 2006 (9% of total French commercial investment transactions) to €5.1 billion (19%) in 2007.

As a result, the UK market - where this trend first took hold and continues to grow - forms a smaller proportion of European activity - from more than 40% of all vendor activity in 2005, to under 25% in each of the last two years.

**Distribution of Sale and Leasebacks in Europe by Sector**



Source: CB Richard Ellis

Office properties continue to dominate sale and leaseback activity. Office disposals accounted for almost half of these transactions in 2007 and H1 2008 - a significant increase on 2005-06, as corporates with strong service sector covenants have taken advantage of the opportunity to "monetise" high-profile city centre property assets at a level competitive with interbank borrowing.

Germany, the UK, France and Spain, in particular, have seen activity heavily weighted in the office sector - with over €2 billion transacted in that sector in each country during 2007.

However, other sectors are increasingly being seen to offer good sale and leaseback opportunities by vendors and purchasers alike and the sector split of transaction activity across Europe varies significantly with geography.

For example, in Spain and Italy, retail disposals made up a high proportion of vendor activity in 2007, with Italy also seeing the disposal of a number of mixed-use assets. Most recently it has been size of deals, rather than volume, that has driven sale and leaseback transactions in the retail sector. The trend towards the retail sector continued in H1 2008, when the sector's contribution to sale and leasebacks (€4.2 billion) was almost equal to that of the office sector (€4.7 billion).

## THE FUTURE - THE IMPACT OF ECONOMIC UNCERTAINTY

It would be easy to dismiss the substantial growth of the past three years as a product of the past bull market. Clearly, the historically high prices have been an incentive for companies to sell real estate, and have enabled them to realise substantial profits over the book value of their assets. However, for the reasons set out below, we believe that today's more challenging market may not deter corporates or investors from sale and leaseback activity.

### CHANGING DRIVERS AND BARRIERS

The criteria that most heavily affect a corporate's decision to proceed with a sale and leaseback transaction are:

- Yield of the proposed transaction versus internal cost of cash rate/return on equity
- Operational clarity and/or stability over at least 15 years
- Requirement to raise capital for restructure or other working capital requirements
- Meets the interest of the shareholders
- Doesn't break banking covenants
- Ability to accept, absorb or shelter profit gain
- Accounting treatment of leases, on or off balance sheet
- Structuring and assignment subject to future ownership/sale
- Lease structure allowing occupational flexibility
- Corporate acceptance of "selling the family silver".

Many of these hurdles have been shifting in recent years. For example, the view that real estate should remain in corporate hands as a "cultural norm" appears to be diminishing. This is one of several factors that have raised the acceptability of sale and leasebacks as a means of capital injection over the past three years - changing their relative attractiveness as a way of accessing capital.

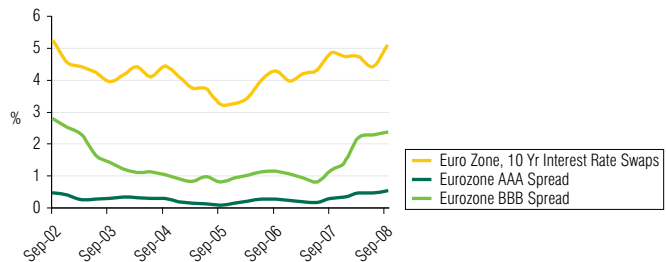
### RAISING CAPITAL

Corporates that are looking to raise capital to invest in their business will consider the opportunity and/or actual cost of the different sources of capital. And - from the perspective of most companies looking at possible sources of capital (or refinancing) - the challenging market has substantially increased the potential cost of debt.

As the chart below shows, Eurozone ten-year swap rates are over 100 basis points above their end-2006 level, and have been very volatile in recent months. Although interest rates fell in 2007, lending margins increased significantly for all but the very highest rated companies, and banks have become much more selective in their lending. Meanwhile, corporate bond spreads have been drifting upwards for AAA-rated paper and have risen much more sharply for more risky BBB-rated bonds.

#### Key Eurozone Finance Rates

10 Year Swaps and Yield Spread Over Benchmark Government Bonds (%)



Source: Ecwin

As a result, corporates can now use sale and leasebacks to raise capital at levels competitive with interbank borrowing, and, of course, without having to repay the loan. Also, many companies do not undertake annual revaluations of their real estate and it may still be possible to realise substantial book gains on disposal of properties that are being undervalued on corporate balance sheets.

### THE MANUFACTURING SECTOR

The rising cost of commodities and energy - coupled with greater price-sensitivity among consumers - is putting additional pressure on corporate balance sheets. This is particularly true for the manufacturing sector.

For many manufacturers in Europe, driving the core business has been their predominant - if not sole - focus, and competitive finance has traditionally been accessed through normal banking channels. But increasingly, manufacturers are reassessing their real estate for potential efficiency improvements and as a relatively productive source of capital.

While there is considerable scope for sale and leaseback activity to continue in the European office market, the cost pressures on manufacturers could shift the focus of the sale and leaseback market firmly in this direction.

### BUYER AVAILABILITY

Despite strong pricing, corporate sale and leasebacks have historically been seen as attractive investment propositions and it is likely that will continue. Leases are typically longer than in the wider investment market, giving the investment a more stable, bond-like performance. And, although in the majority of cases the investor will be exposed to a single undiversified credit risk, the lease obligations in sale and leaseback transactions are often backed by strong covenants. This differentiates the current period from the earlier part of this decade when the market was dominated by corporates seeking capital via this route as a "last resort".

Such investment characteristics are attractive to long-term equity-based investors - the type that are most likely to remain active in current financial conditions.

### OPERATIONAL FLEXIBILITY

The improved covenant strength of those undertaking sale and leasebacks has led to a greater degree of operational flexibility for corporate occupiers, particularly manufacturers. Investors are willing to accept more operator-friendly lease structures and are also more likely to take a very "hands off" approach with regard to operational restructuring, as long as investment value is not affected.

This, in turn, is making sale and leasebacks more attractive to corporates. The stronger the covenant and the longer the term, within any set of accounting constraints, the greater the benefit to the corporate in terms of capital-raising and flexibility.

## MARKET OPPORTUNITY

So how large could this market become in future? On deliberately conservative assumptions, the combined total of freehold property assets held by listed and unlisted European companies - and multinationals with major activities in Europe - probably exceeds €2.25 trillion<sup>2</sup>.

Of course, a significant proportion of this may not be suitable for transaction as mainstream investment product. Nevertheless, even on a conservative estimate the total represents over 12 times the average level of European investment turnover over the past five years. The scope for further sale and leaseback activity to boost investment turnover is therefore substantial.

How fast that activity grows will depend on the way investors and corporates assess this opportunity. What would you do as an investor: take out a corporate bond or take on a sale and leaseback with an underpinning asset at a level of return only marginally lower? What would you do as a corporate: issue a bond that you have to pay back at a rate of interest that is less cash flow efficient, or perform a sale and leaseback?

## CONCLUSION

In considering sale and leaseback as a possible source of capital, the challenge to both corporates and consultants is twofold. The commercial justification for the transaction needs to be established against internal benchmarks such as the cost of cash, return on equity, bond rates and banking covenants. It is also important to gauge the right time to make firm long-term commitments to properties without restricting future commercial operations.

We believe that the growing trend of sale and leasebacks will continue upwards. Despite the pricing corrections which have come about as part of changing market conditions in the past year, sale and leasebacks still make good economic and commercial sense in many scenarios. Regardless of the more challenging market, the corporate drivers for sale and leasebacks remain valid; such transactions are no longer seen as a measure of last resort and they offer a viable source of capital to invest back in to the core business. And there is sizeable scope for growth.

This, in turn, will have a compounding impact on the investment market. As well as boosting the level of turnover in the short term, sale and leaseback activity also has a longer-term, structural impact on the size of the investable market, as the total amount of real estate in professional investors' hands is increased.

In our view, corporate sale and leaseback activity will continue to be a key growth market in Europe - in both the short and long term - and a key driver of real estate investment market growth.

## METHODOLOGY

In order to assess the value of property assets held by quoted companies, we analysed the published totals for companies in the main stock indices<sup>3</sup> for the UK, France, Germany, Spain, The Netherlands, Belgium, Italy and the Nordic markets<sup>4</sup>. The combined total from this analysis is around €900 billion.

Since these indices constitute varying proportions of the total capitalisation of the quoted sector in each country, it was necessary to gross these figures up to allow for the contribution of companies that are not included in the main national indices. On the basis of the proportions for the larger markets (UK, France, Germany and Spain), the total value of freehold assets held by quoted companies rises towards €1.5 trillion.

Since these economies make up around 80% of EU-27 GDP, it is necessary to gross this figure up further, on which basis the real estate assets of quoted companies for the EU-27 as a whole are probably worth in excess of €2 trillion.

This is likely to be a conservative figure for two reasons: firstly the data for the eight economies analysed is only a representative sample, and secondly the ratio between the value of corporately-owned real estate and GDP is likely to be higher in the remaining economies, many of which are smaller and relatively immature.

Measuring the value of real estate assets held by unquoted companies, and international companies with assets in Europe, is more difficult because of the lack of systematic published data. For private companies, the measure used here was the "Europe 500" ranking (excluding quoted companies to avoid double-counting) taken from a survey by MCI for Entrepreneurs for Growth, and which ranks companies on the basis of employee growth. It is necessary to estimate the value of freehold property assets using total turnover figures (using a ratio derived from quoted companies where both measures are available) and to apply the same approach to major US companies with activities in Europe. Using this approach on a sample of company-specific data, a total of at least €100-150 billion is produced.

<sup>3</sup> Excluding property companies, whose real estate assets are already part of the investment market

<sup>4</sup> Specifically, FT-SE 100, CAC-40, DAX-30, IBEX 35, AEX, BEL-20, S&P MIB and OMX Nordic 40

### CONTACTS

CB Richard Ellis' Global Corporate Services team partner with corporate occupiers who are seeking to outsource or out-task their commercial real estate function and optimise the value of property expenditure.

At the heart of our approach is a thorough understanding of our clients' strategies and ambitions. It's this understanding that enables us to develop tailored real estate strategies and deliver solutions that support wider business objectives.

Our specialist Corporate Strategies team is dedicated to optimising the value of occupier owners' property assets on the balance sheet. We understand how business strategy, accounting, tax and property interface and are able to translate the language of each discipline back to our clients.

Our services include:

- Process management consultancy – Realignment of the corporate real estate strategy to match the corporate business strategy in relation to the balance sheet, profit and loss and working capital
- Partnering arrangements (joint ventures) - Development of partnering arrangements to share risks, benefits, profits and to offset liabilities
- Investment / sale and leasebacks – Development of compliant finance structures to suit corporate needs whilst aligning investors understanding to expedite transactions

We work across all sectors and have a depth of experience in all classes of real estate.

Our intense focus on our clients' business strategies and our deep knowledge across a broad range of asset classes and industry sectors has enabled us to deliver measurable results as the partner to more than 300 corporate clients worldwide.

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