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The Beginnings of a RE Rebound

As institutional capital creeps back into real estate, opportunity abounds

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The commercial real estate market today is essentially a tale of two cities. Large investors with ample cash have been chasing properties in the top coastal markets like New York, Washington D.C. and San Francisco, pushing capitalization rates down to, and in some cases below, the 5 percent level.

This effectively prices trophy assets at pre-recession levels, which is evidence of a near total reversal of the risk aversion seen across the industry over the past few years. Lenders and investors that moved money out of the alternative investment class altogether are now back in the game in a big way, demanding core properties in major markets—and they're willing to write big checks for quality. Banks, pension funds, life companies, subordinated lenders and private equity firms are sitting on a lot of capital that is eager to find a home in real estate. As long as interest rates continue to be kept artificially low by the US government, capital will continue to chase yield in Class-A assets because there is less operational and financial risk.

At the other end of the spectrum, Class-B and lesser quality assets in secondary and tertiary markets are a bit of a different story. Stabilized assets with strong cash flows have long been the darling of middle-market players who operate in the shadows of Wall Street heavy hitters and the Blackstones of the world, as lower credit tenants and older facilities require management that is more involved at the asset level. However, smaller players without access to capital markets are hurt the most when loan-to-value and debt service coverage ratios move in the wrong direction. Lenders are placing debt, but less of it, necessitating more equity or subordinated debt.

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So now that institutional debt and equity is getting back into real estate, what does that mean for middle-market private equity real estate firms and investment banks that have sector expertise? A mix of opportunity and new competition for the former, and a potentially lucrative revenue stream for the latter.

For private equity real estate firms, fundraising should get easier for core-targeted vehicles in the near term and core-plus and value-added in the medium to long term. However, the wrinkle here is that while pension funds and other institutional capital sources are eager to balance often underweighted exposure to commercial real estate, some are choosing to do so through separate accounts where they can exercise more control over the outcome of the investment. Additionally, given the reality that asset price appreciation from a rock bottom going- in cap rate will probably only occur over a period of time much longer than the life of a traditional private equity fund, some institutions are looking at real estate through the eyes of old fashioned real estate investors: recurring and stable cash flow, with inflation pushing capital appreciation over the long haul as icing on the cake.

Real estate as a distinct practice within middle-market investment banks is certainly not as common as at bulge brackets. However, those with the capacity to do deals are probably a little busier today. In the good old days (read: just a few years ago), an owner/operator or developer of multifamily or office properties could expect to easily obtain 85-90 percent of the capital they needed through traditional bank or life company debt, with the rest coming from a combination of country club fundraising and retained earnings. However, the confluence of lower loan to value percentages, less willing and able friends and family, and cash reserves depleted by

covering shortfalls have real estate operators making new friends with investment banks. Even traditional mortgage brokers fall short in their ability to complete the capital stack.

What many operators are discovering as they learn the ropes of institutional limited partner capital is that they are not only hungry for one-off deals, but are increasingly looking to form larger joint ventures with experienced real estate firms that weathered the recession and can demonstrate relatively positive performance through the cycle. Middle-market investment banks stand to reap the benefits of more newcomers to the equity market seeking institutional capital for the first time. Moreover, as that capital chases yield further down the risk spectrum and into the secondary and tertiary markets ignored by large REITs, opportunities abound for investment banks with solid connections to smaller real estate clients.

Perhaps an even larger opportunity for middle-market investment banks lies in the role that real estate plays in unlocking value in traditional corporate M&A transactions.

Asset-based borrowing has long been a prevalent form of financing for private equity firms and management groups looking to acquire companies with significant corporate real estate holdings.

Although until recently the volume of new acquisitions had dropped precipitously due to the limited availability of capital sources in the prevailing credit environment, asset-based financing is again emerging as a viable source of funding for companies with strong management and solid business strategies.

The long term sale-leaseback is a form of asset based financing that allows companies to access the value embedded in corporate real estate and convert it to a liquid source of capital that can be used to fund new acquisitions, retire existing debt, fund operating costs, support expansion strategies or some combination of all four. The basic premise of the sale-leaseback is that a corporation sells its real estate to an investor who then leases the property back to the company on a long term basis. The transaction allows the company to access the value of the real estate asset while retaining control of the property.

One way that value can be unlocked in the context of middle-market M&A transactions is through the sale-leaseback of real estate assets of the acquiring or target company or both. Sale-leaseback investors who have proven to be a "constant source" of capital in good times and bad are those who evaluate new investments in terms of their ability to generate consistent income over the longer term. Traditionally these investors look for critical assets owned by companies that are well positioned in their industry and have a long term business and growth strategy that will enable them to "pay the rent" well into the future. The best investors in this sector are those who are credit oriented and have the ability to look at a company and its pro forma financials in the framework of its post merger structure.

Although the sale-leaseback may seem like a simple concept, a company that "sells" a key operating facility to an investor needs to know that the investor is capable of closing the transaction on a timely basis. In addition the company needs to assess the investor's ability to structure a transaction within sale-leaseback contractual parameters while addressing the specific operating and financial requirements of the company. The investor must also have the financial expertise to determine independently that the company's operations will support the rental obligations to the investor owner and also generate a profit for the company.

A critical question from the company's standpoint is "What is the source of investor capital that is funding current sale-leaseback transactions?"

The answer: Some is provided institutionally through private sale-leaseback funds and some is provided by individual retail investors who invest in REITs committed to a sale-leaseback investment strategy.

Whereas the institutional funds tend to be less focused on generating current income for their investors, retail investors are primarily seeking a steady current income stream and preservation of capital over the longer term. The ideal sale-leaseback partner is one who manages funds on behalf of retail investors but brings institutional expertise to the investing process.

The purchasing fund or REIT should have secure long term capital commitments. It should also be structured so that a failure or default with respect to any individual portfolio property does not impair the overall financial strength of the investor. Consequently the size and diversity of the investor's portfolio as well as the financial structure of individual investments held by the investor should be understood. Portfolio diversity should include diversity with respect to geography, industry and tenant. Given that the purchasing entity in a sale-leaseback transaction is in essence becoming a long term financial partner of the company as well as its landlord, the purchaser's investment history, reputation and depth of asset management need to be understood as well.

The middle market is critical to the health of the U.S. economy and a consistent trend is that its ownership structure is shifting. It is estimated that private equity owns 48% of midmarket businesses, by valuation compared to just 23% in 1997.

While the availability of financing has certainly improved from its low point of a few years ago, many traditional lenders remain cautious and lending criteria and conditions for acquisitions involving lesser credits remain stringent.

When it comes to developing a capital structure for a proposed middle-market M&A transaction, purchasers of companies with substantial real estate assets may well find that sale-leaseback financing is able to fill the financing gap in lieu of more traditional sources.

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