SLAUGHTER AND MAY

Slaughter and May Podcast

Raising capital through sale and leasebacks: In conversation with JLL

Jane Edwarde	Hello and welcome to our podcast. Today we're talking about sale and leaseback transactions. I am Jane Edwarde, a Real Estate Partner at Slaughter and May, and I'm delighted to be joined by Nick Compton and Mike Evans from JLL. Nick and Mike, would you like to briefly introduce yourselves please.
Nick Compton	Thank you Jane, it's Nick here. I'm Nick Compton. I lead JLL's corporate capital markets business across the EMEA region. It's a team of people that specialise in raising capital for corporates from their assets, so we spend a lot of our time preparing assets for sale and leasebacks.
Jane Edwarde	Great thank you, and Mike.
Mike Evans	Yes, I'm Mike Evans. I'm a director in the corporate capital markets team. I've been with JLL for 13 years, I'm a chartered accountant by profession, so I get involved in the financial and accounting side of property transactions and IFRS16 is a bit of a specialist subject for me.
Jane Edwarde	Great, well we'll come on to that shortly. Thank you very much both of you for joining me today. I might start please by asking you Nick about what the numbers look like last year 2019, and then of course this year's struggle with COVID-19. What do the numbers look like in terms of transaction levels in this sector?
Nick Compton	We've been tracking the subset of the market for the last decade of all corporate asset sales across Europe, Middle East and Africa and there has been a steady increase in activity during that decade and last year there was a particularly notable uptick and ultimately leading to a total of around €23 billion, which was a record year over the data set that we have, reflecting a whole range of things that have become more established over time.
Jane Edwarde	And what do you think explains that increase in the numbers and that steady increase over the last decade?
Nick Compton	I think there are a number of notable characteristics in the data set that we can see, and I'll perhaps pull out some of the ones that are most significant. The big change for us is that you can see that assets are being sold more in portfolios rather than individually, and to some degree these factors overlap in that one of the other big characteristics that we can see is the presence of investors that are willing to invest in multiple countries at the same time. So you can see that those investors are enabling transactions to take place that would otherwise perhaps have had to take place just in one country because they're willing to invest across a whole region.

	Companies that own portfolios of assets are able to do one large transaction rather than a series of smaller ones. I think that's a big factor. Also, those investors, and particularly a subset of those investors are particularly interested in specialist assets. So assets that perhaps previously might have been out of scope, like manufacturing sites or research campuses, are increasingly becoming translatable because there are investors who are hunting for those type of critical assets. So that's also been a factor, and I guess the sheer weight of capital pursuing industrial and logistics property has, to some degree, driven corporates to exploit that and put those assets into the market.
Jane Edwarde	Yep, and to what extent has IFRS16 affected those numbers?
Mike Evans	Well it's interesting really because I think we would have expected that, you know, in the first year of IFRS16 being implemented, we would have expected the numbers to fall with the idea was that companies would probably prefer to own than to lease, but as Nick just described the numbers that increased, and I think there's a couple of things around that. I think companies still look at sale and leasebacks, and corporate disposals as an alternative source of capital raising, you know traditional sources of debt and equity. A number of the transactions are also with private equity owned firms, and typically those organisations are less driven by accounting and much more driven by cash and so you know perhaps they are doing sale and leasebacks to pay down debt or to take money out of the business, and then I think a third area is a feature of the corporate disposals this year, or in 2020, has been that a number of them are non-core assets, so headquarters that companies are putting two year sale back on and exiting, and in those cases the accounting rules really make for very little difference. So, it's really interesting that actually the numbers have risen in spite of IFRS16.
Jane Edwarde	Yer, and certainly, we're seeing in practice a mix of different types of transactions which would qualify as a sale and leaseback, so in different lengths of leases, different terms of leases and as you say, some very short term leases intended effectively as an exit strategy and some much longer institutional investment type products that are created for that market. Are you similarly seeing a range of interest from investors in different types of products?
Mike Evans	Yes and I think that that's perhaps one of most notable changes between the activity last year and this year, is last year there was a great deal more driven by the level of M&A activity in the corporate market place, with private equity investors particularly being very busy, and that drove quite a lot of transactions that were driven purely by capital raising to refinance post-acquisition. In this year, the market's been characterised by two quite different strategies. One is a strategy primarily focused on capital raising and the second is a strategy driven by the crisis' impact on corporates footprint needs, and as

	corporates are trying to figure out what they need for the future, where they need it, and what form they need it, in particular in terms of offices, that's having a corresponding impact on office assets and whether they choose to continue to hold those. So the sales in those circumstances are likely to be short term, but the vast bulk of the transactional activity we've seen this year, certainly earlier in the crisis, was driven by challenging equity and debt markets, where capital that could be released from property was seen to be quite a good alternative to those other sources of capital.
Jane Edwarde	Yes, challenging markets to borrow sort of otherwise and also a real need for capital coming in to the business in the absence of revenue in various sectors, such was the distress of course of COVID-19. Yes we've seen the same, and what about say ground rent transactions, something that we've seen is ground rent transactions sitting alongside a debt package on an acquisition, so effectively providing additional equity alongside traditional debt as acquisition finance, at the same as maybe completing an M&A deal. Do you see those sort of follow up portfolio transactions and, if so, do you think they'll continue post-COVID?
Nick Compton	Yes I think they will, I think it's a solution that's quite specific to circumstances, so they won't necessarily be applicable in every case but for certain types of transactions, perhaps where you have a large number of quite similar assets, so potentially perhaps distribution network for example, or a care home portfolio, some portfolio that has similar characteristics, where also a client has a desire to attain a high degree of control over what happens to those assets in the future, then I think ground rents might appeal, but obviously the other side of the ground rent equation is they don't raise as much capital as the more traditional form of sale and leaseback. So for clients that are primarily driven by capital, ground rents might not be the right solution for them, but certainly its part of the portfolio of options that we see clients considering.
Jane Edwarde	Yep, and back to COVID inevitably if we may for a while, what have you seen in terms of the impact of the various government support packages which have been offered, what impact have they had on the market and on demand and supply?
Nick Compton	Well I think we see things quite often depending on who we're working with on a global basis, so quite a few of our clients are supported by initiatives that are not just UK governments but governments in other countries where they operate, and it's clear that to some agree in certain cases there are government interventions that have been so supportive that an intention to raise capital from a sale or leaseback has become less necessary because the level of state support has essentially supplanted that and become more important, so we have seen situations this year where packages have been readied for market on a sale and leaseback basis but those have been put on hold whilst they use the state support that they have available in different countries as a preference. So that's one example, and Mike maybe you have other examples.

Mike Evans	Well I think as Jane was saying earlier, you know activity for companies has fallen and I think companies are generally following defensive strategies. I was looking at a CFO study issued recently where the top three priorities for CFO's in the UK is reducing costs, increasing cash flow and reducing leverage, and you know I think when companies are looking at their property portfolio, they're probably looking at, given the impact of COVID, they can actually reduce their overall demand and there's probably some properties they can dispose of if they own them perhaps on short term sale and leaseback and then for their core properties maybe there is an opportunity to monetise them and raise capital from them. As Nick was saying, we've seen a variety of companies, we've done a number of feasibility studies where companies are looking at the range of options across their portfolio in terms of raising capital from property, whilst also at the same time pursuing other potential capital raising avenues, such as the issuance of debt and you know they're going to choose whatever is the best option for them at that point in time, and so you know we've seen some potential transactions put on hold, and others given the green light.
Nick Compton	And just to add, I think it's reasonably likely that some transactions will perhaps wait until Q1, Q2 next year. Both because there's a perception that the market perhaps might be a bit more stable at that point, but that also that the level of state intervention, state support, might start being reduced at that point, so it's possible that corporates will think, actually well it's better to hold those sale and leaseback options for a point when we might need them to replace support that's being removed by the state at the time. So I think there's a sense in some cases that 2021 might be also quite a busy year for asset transactions. I think that numbers show for this year so far in H1 2020, we're looking at about €7.6 billion across the region which, compares quite similarly to other years where typically the first half of the year is quieter part of the year compared to the second half, particularly the last quarter, which is traditionally the busiest. So, so far this year, and it's partly because of a lag from 2019, the numbers look quite similar to an average year.
Jane Edwarde	Which is good, and I was interested earlier in your comment that there are more sort of perhaps niche sectors, niche asset types coming through as potential candidates for sale and leaseback transactions, and increasingly specialised landlords looking at these more complex different assets and seeing the value there. So you mentioned, as an example, manufacturing. Perhaps you could talk about that Nick and the challenges of valuing those more, those different types of assets.

Nick Compton	Manufacturing is an asset category that is still quite often held as a freehold or is owned by corporate, so where corporates have often already sold their more generic assets, so the assets that they have to consider for a sale and leaseback are often left to just specialist ones, so if there's a potential solution for those that gives them a new angle for capital raising. But you do raise an interesting point that obviously manufacturing sites are specialised so that they don't have a great deal of market evidence to back up rental levels, but they also do quite well suit other forms of sale and leaseback such as credit tenant leases, so where we have clients with strong credits, it's possible to do transactions where the rent doesn't have to be quite so linked to the market, and the value of the transaction is more driven by the length of the lease and the quality of the credit of the tenant. So I think that's certainly something we're looking at for manufacturing assets. Obviously the underlying value of the property is obviously supporting that and because the strength of the logistics and distribution market, the underlying land value of manufacturing assets is quite often supported by that level of demand. So in the event of default, the recourse is back to logistics and distribution as a redevelopment opportunity. So that's also helping. I think one of the other limiting factors of manufacturing assets being sold has been a concern of loss of operational flexibility. So obviously manufacturing needs frequent changes of processes and investment in new buildings and new structures, new process equipment, but the specialist investors are very willing to grant the operation or flexibility that tenants need so that's been eliminated really as a cause for concern.
Jane Edwarde	Yep and I guess, as you say tenant covenant is key there but also the importance of that asset strategically to the wider business because clearly if a group depends on its key manufacturing facility to supply perhaps a number of product or product lines, then the impact of that going under is huge beyond the relevant tenant on that lease so that gives the investors some comfort the rent is likely to be paid.
Nick Compton	I agree. There's definitely a subset of the investment community that uses the level of criticality as a means to underwrite the assets in their approach to pricing. So examples would be automotive car plants, car assembly plants, that kind of property where the cost of replacement and the visibility of those large companies to where they manufacture and their supply chain, it is relatively easy to see the degree to which a particular asset is critical to that company's ongoing success. So that's certainly something that is scrutinised. I think also the same is true for R&D property and that's a sector that has shown huge amounts of demand from investors which is also very costly and time consuming to replace and commission, so again it's relatively easy to see levels of criticality of those asset categories for investors.

Jane Edwarde	Yes, and what about the much lambasted retail sector. I mean we have seen a lot of activity haven't we, particularly in relation to supermarkets.
Nick Compton	The retail sector has been a real, almost like a polarised world, in that the growth of the supermarket sector has obviously almost thrived during the crisis, it's been seen to almost be a critical level of infrastructure to the health of the country, so they've done pretty well to continue to supply everyone with food during the crisis, and the businesses have economically gone through the crisis with significant strength and, at the same time, you've seen an increase in sale and leaseback activity, not just in the UK but across Europe, of supermarkets selling both their stores but also their supply chain and distribution buildings and I think that's partly because whilst they've got through the crisis reasonably unscathed, long term consumer habits have changed and there is a need to invest significant capital in modernising store networks. So one of the reasons supermarkets have been unlocking capital from property is to release cash to invest in modernising their stores, repositioning them, repurposing them, bringing in third party occupiers that kind of thing. But the other end of the retail spectrum, the high street retail area has also been quite active with sale and leaseback but that's partly been driven by just a need to raise capital to invest back in the business. We've seen a few examples of those.
Mike Evans	I think on the other side of the retail market, I think there's interesting developments there really. I think actually given the change in pricing of high street retail post-COVID, I think we could see some occupiers who are perhaps financially stronger, looking at buying in some of their assets because they are cheaper and because they're on balance sheet anyway, perhaps they may as well buy them so I think that's something we could see in the future. I think the other area that is going to be interesting to see how it develops is whether turnover leases take off. We're seeing some landlords beginning to create turnover funds and I think that a lot of retailers may want to pursue that route because it's a way of sharing some of the risk with their landlords, but also from an IFRS16 stamp point, its significantly beneficial because really it's only the base level of the rental that comes on balance sheet not the turnover element so there's some potentially accounting benefits of turnover leases as well.
Jane Edwarde	Interesting, because we are definitely seeing those in the market, and it's just a question I guest of how it can be accommodated into a sale and leaseback type planning and continue. I think just concluding then Mike and Nick, what are your hottest predictions for the next 6-12 months? Hopefully, post-COVID, we'll all keep our fingers crossed. Where do you see this particular market going?

Nick Compton	I think we'll see more specialist assets coming to the market on a sale and leaseback basis. I think the logistic supply chain properties will continue to be strong, and our specialist in those sectors are reporting values that are now higher than going into the crisis in some cases, so that market I think will continue to thrive. I think the office market is perhaps the one which will take time to really figure out because corporates are only partly a way along their journey of figuring out what footprint requirements they have for the future, where they should be and in what form. So I think it is going to be a really interesting time to be in the market, seeing how corporates react to the post-COVID world.
Mike Evans	Yer, and I think perhaps in that office market, I think you could see a larger number of non-core properties coming to market as office occupiers downsize their portfolios. I think we could see that happening. But also where they have core properties, actually using the strength of the market to raise capital to improve liquidity.
Jane Edwarde	Thank you. Let's hope some interesting and very active and busy times ahead. Thank you so much for joining me today, Nick and Mike. Thank you very much. For more information on this topic or to hear our other podcasts, please visit www.slaughterandmay.com. You can also subscribe to the Slaughter and May podcast on iTunes or Google Play.