

Privcap / Briefing: Creative Deal Finance

Context for Private Capital Investment

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Consider the Alternative

Investors drive returns through operational improvements. That's private equity 101. But in today's PE climate, where the heat is on to deliver results, firms that want to survive and thrive must do much more than the basics. They must innovate.

Creative deal finance—including such non-mainstream financing options as sale-leasebacks and seller notes—loom large today as one of the most effective ways GPs can further optimize the performance of their investments. It can bridge the gap between an investor's bid and a company's asking price. It can make undoable deals not only possible but profitable.

Creative financing can work any number of ways. The only limits are the investor's imagination and dedication to success. "There's always something creative that can be done," noted Christian Oberbeck, managing partner at Saratoga Partners. "You just have to find it."

Among the most productive creative financing options is the sale-leaseback, which can unlock maximum capital from assets. Typically, the asset is real estate, but as Oberbeck discovered, it can be almost anything. He once used a sale-leaseback to turn a cache of platinum at a German glassmaking factory into a large chunk of capital.

More frequently, of course, investors use sale-leasebacks to pull full value from real estate. "With real estate lenders being much more conservative, you won't get anything close to the 100 percent fair market value we typically pay," said Jason Fox, managing director at sale-leaseback specialist W. P. Carey.

This report takes an in-depth look at the many facets of creative financing and features insights from Oberbeck, Fox and two other experts in the field of alternative financing: Gino Sabatini, managing director at W. P. Carey, and Kenneth Clay, senior managing director at Corinthian Capital Group.

Enjoy the Briefing,

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Creative Deal Finance

Key Findings

An executive summary of the Privcap series featuring four experts in the area of creative deal structures

- 1 Creative financing expands the deal pipeline
- 2 Sale-leasebacks deliver full value on real estate assets
- 3 Nontraditional financing isn't limited to a deal's front end
- 4 Creative alternatives can monetize valuable background assets
- 5 Where there's imagination, there's a solution



Left to Right: Christian Oberbeck, a managing partner with Saratoga Partners, Kenneth Clay, a senior managing director at Corinthian Capital Group; Jason Fox, co-head of Global Investments, W. P. Carey; and David Snow, Privcap.

To stay competitive in today's market, private equity firms must drive returns through an array of strategies. The starting point, as always, is operational improvements. But sophisticated investors increasingly employ creative solutions to finance deals and maximize their investments as they mature. Below are five key takeaways from the Privcap expert-discussion series "Creative Deal Finance," featuring Christian Oberbeck, managing partner at Saratoga Partners, Kenneth Clay, senior managing director at Corinthian Capital Group, and Jason Fox and Gino Sabatini, the co-heads of Global Investments at W. P. Carey.

1 Creative financing expands the deal pipeline

While today's market is receptive—liquidity is available and the lending community is open to a variety of credits—there are still some "speed limits" imposed by senior lenders, Oberbeck said. When a prospective company exceeds those limits, creative solutions can enable

financing beyond what's accessible via equity and make a deal work.

"Go through all your assets, all your financing capabilities," Oberbeck said. "Senior lenders, asset-based lenders, mezzanine lenders, unitranche lenders, equity, preferred stock, real estate-oriented lenders, equipment finance people—go through all those and fit them together to optimize your cost of capital."



Christian Oberbeck

Kenneth Clay of Corinthian noted that the market always adjusts to the financing community. “When there’s more readily available traditional financing, the prices tend to drift upward because you’ve got other funds looking to take advantage of traditional financing.” And in this competitive atmosphere, creativity can squeeze value out of more investments. “If you’re going to get any kind of a significant return, you have to figure out what you’re going to do differently,” he said. “If you can do something a bit more interesting on the financing side that others aren’t thinking about, that differentiates your firm and, hopefully, drives returns.”

2 Sale-leasebacks deliver full value on real estate assets

A lot of firms employ traditional financing alternatives like asset-based lenders to leverage a company’s inventory and receivables or use cash-flow lenders to pull credit from the quality of a business’ cash flow. But firms sometimes overlook the value they can unlock by working with a sale-leaseback investor.

That value can be significant, because sale-leaseback investors typically extend far more credit on real estate than other sources. “Asset-based lenders, in terms of real estate, are giving much less credit than what we’re typically giving,” Fox said. “You may look at 30 percent or 40 percent from your typical asset-based

Building Bridges with New Tools

When a deal is in negotiation, gaps can appear. A firm bidding for a company puts together a package it thinks is workable—and the seller wants more. How can a firm bridge the divide? Get creative. “Go back and relook at everything,” said Saratoga Partners managing partner Christian Oberbeck. “Sometimes there are unusual assets there. You might say, ‘OK, well, there’s a sale-leaseback, a \$30 million sale-leaseback. Maybe that \$30 million is the difference on a billion-dollar deal.’”

Firms that think creatively can see value in out-of-the-way places. Maybe a company has an old manufacturing plant in the middle of nowhere. It might think the plant isn’t worth much. But if it has infrastructure that’s hard to duplicate, the plant may be worth more than the company realizes.

Similarly, a firm with the ingenuity to construct a creative deal can distinguish itself from the competition when a company has multiple bidders. “If all the buyers are at X and you can find a way to get creative to get at X plus Y, that can be the difference between winning the deal or not winning the deal,” Oberbeck said.

lender. If you go out to the mortgage markets, you might get a little bit higher LTV, maybe in the 50-to-55-percent range. But in this day and age, with real estate lenders being much more conservative, you won’t get anything close to the 100 percent fair market value we typically pay.”

Sale-leaseback companies don’t look at real estate strictly as an investment on their part. They usually put in place 15-year or 20-year leases and don’t obsess over future value. “Really, we’re in the credit busi-

Thinking Small and Creatively

Creative financing is not only a tool to use in a large-scale deal. Alternative solutions also help unlock value in lower-market and middle-market investments. Gino Sabatini, co-head of global investments at W. P. Carey, recalled a deal his company did several years ago. Private equity firm Sorenson Capital was buying a company called LifePort, which refurbishes aircraft.

“They called us and said, ‘The seller has two facilities he owns and we’d like to buy the facilities from him at closing and use the proceeds to help buy the company,’” Sabatini said. The size of the deal was fairly small for W. P. Carey—under \$10 million for both buildings—but the firm was ready to help make the investment happen.

Eighteen months later, Sorenson called Sabatini back to ask about capital to expand LifePort. “They said, ‘We’d like to put another \$2 million into this facility. Is that something you’d like to do?’ The company was doing very well and we said sure. So we expanded the building for them. It’s a good example of how we partner up with private equity firms.”

ness,” Fox said. “If this tenant is capable of staying in business and paying our rent, then we’re not really in the real estate business, we’re a cash-flow collector for rent. The residual value 15 or 20 years out doesn’t have a big impact on what we’re doing.”

3 Nontraditional financing isn’t limited to a deal’s front end

Creative financing is useful not only at the outset of a deal. There are various stages in the life of an investment at which nontraditional tools like sale-leaseback can extract value. “I would say 25 percent of our business is what we call build-to-suit financing,” Sabatini



Gino Sabatini

said, “where a company has a need for a new facility and they’ll come to us and say, ‘We really don’t want to come out of pocket for the entire cost of this facility. Could you build it for us and we’ll lease it from you?’ That’s a big piece of the business.”

Sale-leasebacks can also give a private equity firm elbow room in investments that are at their conventional limits. “That’s where something like a sale-leaseback can be very useful, particularly if it’s expansion-driven,” Clay said. “You can take an asset that’s on the books and do a sale-leaseback and free up some additional capital. Proceeds can be used to pay down existing indebtedness, allowing you to run the revolver back up as a company grows and needs additional working capital.”

4 Creative alternatives can monetize valuable background assets

Nontraditional financing can unlock value in corners of companies that private equity firms have overlooked. Oberbeck recalled a time when his firm mined a company’s stockpile of precious metals to raise needed capital. “Sometimes when you’re in a business, you find assets you weren’t aware of that are financeable,” he said. “We had one instance where we had some precious metals, largely platinum, that were involved in a glassmaking furnace for one of our facilities in Germany. It turned out that we could do a sale-leaseback of the platinum.”



Kenneth Clay

He had to approach a number of lenders to find one willing to do the deal and it then took over a year for market conditions to turn favorable, but the transaction ultimately freed up a significant amount of capital that his firm was able to redeploy in the business. “Something like platinum—it went up a lot, it went down a lot but at a certain point in time we were able to get that type of financing. It comes and goes, so you have to be aware of what your assets are and then how the markets for financing them evolve.”

5 Where there’s imagination, there’s a solution

When it comes to creative financing, necessity is often the mother of invention, especially later in the lifetime of an investment. At the beginning of an acquisition, it can be risky to assemble a deal with too many moving parts. But as an investment matures, unconventional capital opportunities will come along and firms should keep an open mind and be ready to jump.

“You need to be appropriately conservative about what’s going to win the deal on the front end,” Oberbeck said. “You want to be careful not to take little flights of fancy as to what can happen to make things great and really be more ‘middle of the fairway’ in getting hold of a deal if it’s competitive.”

Firms Take Notes

Another way to creatively maximize the value of a deal is the seller note. This is financing provided by sellers who are willing to step in and bridge a financing gap that the market won’t. Usually the financing is priced a little above senior financing but below traditional third-party mezzanine financing.

Seller financing was a popular tool during the credit crisis because there was meager bank financing and almost zero cash-flow financing. In a more positive market, it’s a way for sellers and investors to come together, especially on companies that show potential. “The seller is going to be unwilling to sell the company, in effect, on the cheap if some good things happen,” said Kenneth Clay, senior managing director at Corinthian Capital Group. But the seller’s price is contingent on positive developments and traditional lending markets won’t advance against promises.

In that case, seller financing “allows a seller who has conviction around these events in question to put their money where their mouth is,” added Jason Fox, managing director at W. P. Carey. “If the company delivers and hits those benchmarks, then the business is worth more but you can still get the returns because you have the leverage. And if not, then you haven’t overpaid.”

But once a deal is done and the investment is evolving—during a restructuring, for example—private equity firms should be aggressive, imaginative and explore all options. “There’s always something there,” Oberbeck said. “There’s always an asset. There’s always something creative that can be done. You just have to find it.” ♦

Expert Q&A

with Jason Fox, co-head
of Domestic Investments,
Managing Director
W. P. Carey



From a private equity perspective, how does a sale-leaseback work?

> A sale-leaseback is a relatively straightforward transaction. A corporate owner-user who has a long-term need for a real estate asset but wants to unlock the value and the equity tied up in that asset will choose to sell their real estate to an investor like us, W. P. Carey. In turn, they will receive 100% of the market value of the real estate. We, in turn, will execute a lease with that company that generates the type of long-term income stream that our investors are looking for. Sale-leasebacks can happen at any point in time with a company. When we work with private equity firms, there are really a number of reasons why they would do these.

What is 'cap-rate arbitrage'?

> When a private equity firm does a sale-leaseback, there is this cap-rate or multiple arbitrage that occurs, especially when they're buying industrial companies that tend to trade at lower multiples. For instance, in the case of an industrial company that they may be buying for six times cash flow that owns its manufacturing plants, its corporate headquarters, maybe some distribution plants, we can do a sale-leaseback on those assets at current pricing in the sale-leaseback market, based on cap-rates that are typically in the 7% to 10% range, which is effectively equal to a 10 to 14 times multiple for those cash flows. So the simple math is, if they're buying companies for six times cash flows and selling a portion of those cash flows in the form of rent to us at 10 to 14 times, it's immediately accretive to their equity.

Where in the world does W. P. Carey operate?

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For more information, please contact Jason Fox at jfox@wpcarey.com • www.wpcarey.com/

The Sale-Leaseback Industry Goes Global



by Tom Stein

Europe is now the largest market for sale-leasebacks, but Asia is the next big opportunity

America and Europe have different attitudes when it comes to property ownership. In America, real estate has never been the sole measure of wealth. That's not the case in Europe, where one's position in society was often dictated by how much land one owned. That's probably why approximately 70 percent of European businesses are owner-occupiers, compared with just 30 percent of U.S. firms, according to real estate advisory firm DTZ.

"In Europe, there is a deep tradition of real estate being the true measurement of wealth," says Jeffrey Lefleur, managing director of European investments at W. P. Carey & Co. "It's a concept that dates back thousands of years."

With property owners reluctant to part with their land, Europe was once a tough nut to crack for the sale-leaseback industry. But, with the rise of globalization, European companies and their private equity backers have come to embrace sale-leasebacks as an important financing option. In fact, Europe is now the largest market for sale-leaseback transactions, ahead of the U.S.

Here, Lefleur talks about the challenges and opportunities in the global market.

Privcap: How is the European market different from the U.S. market when it comes to sale-leaseback transactions?

Lefleur: U.S. private equity firms are more engaged in sale-leaseback transactions. European firms will close a private equity transaction and then a few weeks later a real estate advisor will contact us about doing a sale-

leaseback. I find that the European private equity firms are less engaged in the actual sale-leaseback transaction. Instead, they look for their advisors and the market to provide them with the best terms. U.S. firms, however, are much more involved in the closing of a sale-leaseback transaction. They are more involved in the negotiations and the details of the deal, and they

Asia has incredible potential for the sale-leaseback market

are less reliant on advisors to do a transaction. Our real advantage is the relationships we have with private equity funds in the U.S. We are trying hard to develop those kinds of relationships in Europe. It is coming along but it is still not at the level it could be.

Privcap: Have you done any interesting deals with private equity firms in Europe?

Lefleur: We worked with private equity firm Eurazeo for one of their portfolio companies called Fraikin Group, a large European truck leasing company. Soon after Eurazeo acquired Fraikin, we got a call from their real

sale-leaseback investor, you are targeting industries that are asset heavy and have the need to grow through assets. So there is a big opportunity to work with retailers.

Privcap: Are there other areas of opportunity in Europe?

Lefleur: Overall the biggest opportunities in Europe right now are municipal sale-leasebacks and state-sponsored sale-leasebacks. This is because of the credit crisis. But there is still some fear around selling real estate because it can be perceived as a sign of weakness. Political organizations are worried about the optic effect of selling state-owned assets, but there is huge value in some of those assets.

Privcap: How has the global recession impacted the sale-leaseback industry in Europe?

Lefleur: Economic uncertainty is a real detriment for all forms of corporate finance, including sale-leasebacks. [Sale-leaseback volume in the EMEA region plummeted from \$35.6 billion in 2007 to \$10.6 billion in 2011, according to research firm Real Capital Analytics.] It is hard to make decisions in this market because of uncertainty. And while the U.S. is showing improved signs of stability, in Europe you still have the euro-zone debt crisis, and the market has certainly slowed down because of this. The market is a small percentage of what it was in 2007, but our market share has increased.

Privcap: Is Asia the next big market for sale-leasebacks?

Lefleur: Asia has incredible potential for the sale-leaseback market. There is still a very high degree of owner-occupancy in Asia, which for us presents a very real target. There are massive amounts of volume to be unlocked over the next several years. In truth, though, we have not seen a lot of activity to date. That's because there is a flood of capital competing with sale-leaseback money, and it is very opportunistic and short-term capital. Also, a lot of Asian corporates have not really tied themselves to the idea of sale-leasebacks yet, but there will definitely be a demand for alternative forms of financing in the future. It's just a matter of time. ♦

European private equity firms are less engaged in the actual sale-leaseback transaction

estate advisor offering us the assets. I think that private equity shops in Europe have embraced sale-leasebacks as a form of financing. But that direct relationship with private equity is not really there. The private equity firms mostly work with a big real estate advisor rather than doing an off-market deal. In the U.S., more private equity deals with a sale-leaseback component are done off-market.

Privcap: It seems that the sale-leaseback of retail assets—like supermarket chains—is a growing trend in Europe. Is that where all the action is?

Lefleur: Yes, retailers took the lead in large portfolio sale-leasebacks. Over the last ten years, we've seen retailers step up with €100 million, €200 million, €300 million sale-leaseback transactions. We never really saw that before. There has been lots of growth and consolidation in the retail industry. You have massive retailers like supermarket giant Tesco that have built up massive banks of retail assets. The idea of working with their retail property portfolio as a financing source is a modern concept that retailers have to embrace. As a

Series/ Creative Deal Finance



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