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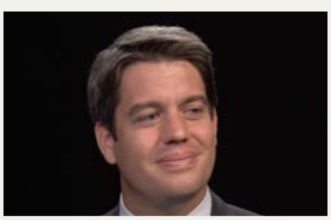
Q3 2015

VIDEO SERIES

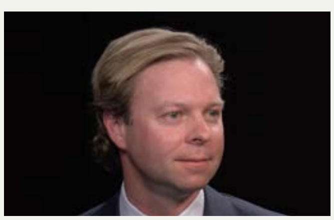
Briefing

Unlocking Real Estate Value

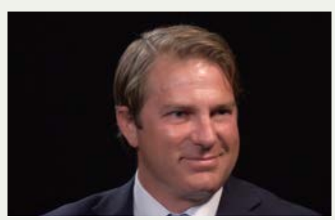
Three experts discuss getting the best value for real estate amid rising prices and competition



Billy Butcher
KKR



Jason Fox
W. P. Carey



Peter Westmeyer
MB Real Estate Healthcare Group

Unlocking Value From Real Estate Portfolios

Key Findings

1. Is now the time to sell?
2. The asset-light trend
3. Criticality is key to underwriting
4. Control is the biggest hurdle
5. What makes a successful deal?

The Panelists

Billy Butcher
Director,
Real Estate,
KKR

Jason Fox
Head of Global Investments
and Managing Director,
W. P. Carey

Peter Westmeyer
President and Managing Director,
MB Real Estate Healthcare Group

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1 IS NOW THE TIME TO SELL?

Whether through the use of sale leasebacks, REIT conversions, or net-lease sales of their property holdings, corporations are under increasing pressure to monetize property assets, thanks to a combination of low interest rates and rising real estate valuations.

"For the opportunistic capital allocator CEO, it is a great time to pursue sale leasebacks of real estate," says Billy Butcher, director of real estate at KKR. "We have historically low cap rates, and unlike a debt financing, this is a permanent sale."

However, there still needs to be a place to put those proceeds to work. Peter Westmeyer, managing director of MB Real Estate, which focuses on the healthcare sector, says companies unlocking the value within their real estate holdings need to have a plan for investing proceeds. "Healthcare's a very expensive industry," he says. "Physician retention and recruitment technology is very expensive, and sometimes the best access to capital is selling their real estate."

W. P. Carey head of global investments Jason Fox adds that in the current cycle, many activist investors are putting pressure on companies to shed ancillary businesses that may not be core assets—and for many, that means real estate.

"We are seeing a bit of a shift right now where companies, whether they want to or not, are being forced to look at the real estate," he says. "And it's the right move. The investors in a manufacturing company are not looking for real estate type returns. They want to have yields commensurate with the operating business, as opposed to the real estate."

He agrees, however, that the current environment of low interest rates and rising prices is spurring companies to look creatively at unlocking value hidden within their real estate holdings. "We're seeing activity in sale-leaseback transactions, whether it's public companies going through management buyouts and then they're [using] sale-leaseback [financing] as a component of that [take-private], or seeing companies utilize build-to-suits, which is really a form of sale-leaseback financing where they can use a developer and a capital partner like W. P. Carey to finance the expansion or new development of new real estate facilities," says Fox.

You Need to Be Creative in Acquisitions Today

Jason Fox,
W. P. Carey

Investors and managers are starting to get creative with figuring out the best ways to source deals and create value.

"You have to, and we're doing it in different ways," says Jason Fox of W. P. Carey. With the U.S. seeing a lot of capital inflows, Fox says it's difficult to find good opportunities that are off-market, and now is a good time to take advantage of the firm's global footprint.

"Over the past 18 months, Europe has been a big place for us," he says. "Because of the distress and uncertainty that's been going on, there's less capital than there is here in the U.S., and we've been taking the opportunity to over-allocate to Europe. We did a deal with the State of Andalucía, and government real estate is something you don't see trade often."

2 THE ASSET-LIGHT TREND

Many industries are following in the footsteps of the hospitality and retail sectors in becoming increasingly asset-light, leading to a rise in sale-leaseback and net-lease transactions.

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Taking a PE and RE Perspective to Deal Flow

Billy Butcher,
KKR

In closing on a take-private of Sunrise Senior Living in 2013, KKR took a traditional op-co/prop-co transaction and first viewed it through the lens of real estate investing.

"We first got involved, recognizing there probably was more real estate value [in Sunrise] than the public markets appreciated," says KKR's Billy Butcher. Ultimately, however, the firm decided to be "the op-co buyer, because that was what was available at a price that we thought was interesting for our capital."

Partnering with Healthcare REIT, which acquired the real estate components of Sunrise while KKR bought the operator as well as some of the development properties and operation, Butcher says KKR could have played either the private equity or real estate side of the deal. "We recognized the strategic value of that operator as an op-co, and that's a case where we would play, frankly, on either side."

There are many reasons driving this trend, says Fox. "Rents have increased, occupancies are very strong, and cap rates are near or at record lows at this point in time. So from an absolute valuation or a proceeds standpoint, this is a pretty optimal time to be considering sale leasebacks and unlocking real estate value."

One sector currently taking advantage of unlocking value from its real estate assets is healthcare. Though it was traditionally against the practice, Westmeyer says the sector and the CEOs within it see the sale of real estate assets as becoming necessary as the industry continues to evolve.

"I see it as a reluctant trend," he says. "I think that health systems are going to [sell real estate] because there's access to capital. You can go to the debt markets or tax-exempt bonds and get a very, very attractive rate, certainly less than the cap rates that we're looking to buy at. [But] there's a lot of need for capital, so they will have to do this to stay competitive, grow market share, and continue to recruit the best physicians [who], at the end of the day, are the drivers of their revenue."

3 CRITICALITY IS KEY TO UNDERWRITING

Understanding just where a property fits in a tenant's organization goes a long way in helping to ascertain whether or not a tenant is likely to renew their lease, says Fox.

"When you're talking to the CFO or the CEO of the company, they know what you're looking for from an underwriting perspective," he says. "But when you're touring with the plant manager, they're proud of their facility. They want you to really understand how much money they have invested in it and how difficult it is to move the machines that they have in the manufacturing plant. You can glean a lot of things from the tours on the likelihood of renewal." Criticality is oftentimes hard to determine before making an investment in a real estate asset but is something that can be discovered in the due-diligence process.

"I think that one interesting thing about this sector in real estate is a lot of the deals look the same on the surface—and yet criticality, because it's such a subjective measure, oftentimes doesn't drive the difference in pricing," says Butcher. "But it is absolutely critical to the underwriting. And as a result, oftentimes it becomes very hard to look at someone's deal from the outside and assess whether it was a good or bad investment, because you need to have done that underwriting, really walk the space, to understand what elements are in it."

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4 CONTROL IS THE BIGGEST HURDLE

Loss of control is the biggest fear facing corporations wanting to unlock the value of their real estate holdings, even though it might make the most financial sense.

In healthcare, not least hospital systems, control is ingrained in the culture. “There’s certainly a cultural fear,” says Westmeyer. “They think that if they’re losing their real estate, they’re losing a piece of themselves and their brand. They don’t want anyone else to come to their campus, so they’ll combat that with ground lease covenants or deed restrictions to effectively remain in control while not owning the real estate.”

Butcher says there are always pros and cons to giving up control. From a corporate perspective, selling real estate is good capital allocation. The question, for him, is : What is the landlord-tenant relationship going to look like down the line?

“There are plenty of examples that are well documented that you can point to where that landlord-tenant relationship has not gone well at critical points,” he says. “And so part of it is getting the tenant comfortable with who the landlord is and their general approach to problem-solving. What happens if that tenant wants to create an addition in a building and they have to go to a landlord to get approval? What happens if there are change-in-control provisions vis-à-vis the tenant in the lease? That can create some friction.”

5 WHAT MAKES A SUCCESSFUL DEAL?

It all depends whom you ask, but the general consensus is that a successful deal is one that closes. “You have to have a meeting of minds,” says Fox. “You need to meet the requirements and goals of each side to have a successful transaction.”

That starts with the right price, he adds, but more important are the terms of the lease. “What kind of flexibility does it provide the landlord or the tenant?”

Butcher says the old cliché of a successful deal is when both parties are pushed to the brink. However, he disagrees with that sentiment. “I think in the sale leaseback of real estate, the opposite can be true, where both parties feel like they really got something meaningful,” he says. “And that is driven by this arbitrage between how an asset is valued when the two parts are combined versus how investors look at the individual parts.”

Westmeyer agrees with all of the above. “It’s both parties walking away feeling like it’s a win-win situation.” ■

Targeting Healthcare as a Real Estate Play

Peter Westmeyer, MB Real Estate

Investing in the U.S. healthcare sector has grown exponentially since the introduction of the Affordable Care Act, or Obamacare as it is known, and there seems to be no end in sight to that appetite, not least among real estate investors eyeing deals in medical office, outpatient facilities, and hospital system properties.

“There’s a huge capital infusion in the healthcare space,” says Peter Westmeyer of MB Real Estate. “It’s a huge part of our economy. A lot of people like the fundamentals and what we’ve got in front of us in the sector. Institutional investors are getting more outside the box on what they will buy.”

Just a few years ago, real estate investors were only interested in medical office buildings and were reluctant to buy long-term, acute-care (LTAC) facilities. “Now people are more apt to go after the LTACs, the hospitals, etc.,” he says. “They’re broadening the scope of actual properties within the sector.”

Case Study

Hornbach Baumarkt Net Lease

Bad Fischau, Austria

With Jeffrey Lefleur,
Managing Director,
W. P. Carey

Describe your net-lease deal with the European home-improvement retailer Hornbach. Why is it important?

The transaction was our first investment in Austria. It was a $31M net-lease investment in a DIY or a home-improvement store—a big-box freestanding home-improvement store just outside of Vienna. It's important to W. P. Carey, because it was our first deal in Austria, and any time we get to enter a new market, we're really expanding the capacity that we can offer new clients. We're following corporate clients around the world, and if we're not in countries where they're active, then we're not really adding any value for them. Also, from the business side, it's good for us to have new markets where we're seeing new investments and we can prove ourselves as being a capable investor.

How do you underwrite the criticality of retail properties over a 15-year lease term?

When you're talking about retail—in particular, free-standing big-box retail—whether it's 15 years or five years or one year, the question of criticality is very hard to answer. If you look at a single stand-alone property, you might say, "How important is this one property to a large multinational retailer?" Whether it's Hornbach or Walmart or Carrefour, the reality is that there's no single property that really controls their business. And that's the nature of buying retail assets. So when we look at these retail deals, we look at the 15 years as the time that we have to earn our equity back. Also, this was a 15-year lease renewal. International retailers are very savvy about properties, and they wouldn't have renewed this lease for 15 years had it not been of importance to them.

How are you underwriting risks today within the retail property sector?

It's a very simple brick-and-mortar approach. You have to see the property. You have to understand what visibility it has from the streets, what footfall it has, how busy it is during the day. A property that's not well located, it doesn't matter who's operating it. A property that's well located, near a large population center with good access from the road, there will always be a demand for good retail space. The risk is getting caught believing a retail story that doesn't really pan out.

Where's the growth in Europe for W. P. Carey?

At our core, we're a sale-leaseback investor. But the reality is that the sale-leaseback market is not an enormous market, and so our transition to the net-lease market is a very smooth transition, because our core competency in sale-leasebacks translates very well to net-lease investments. Net-lease investments provide us with an order of magnitude [in European transaction volume] that we could never have done in terms of pure sale-leasebacks. That shift is evident from last year alone, when we did about $1B of total investment in Europe, the bulk of which was net-lease investments. ■

Case Study

Intuit Inc. Net Lease

Plano, Texas

With Kathleen Barthmaier,
Executive Director,
W. P. Carey

Describe your net-lease acquisition of the Intuit office property in Dallas.

The Intuit transaction was a little bit unique for W. P. Carey, because we typically focus on long-term, single-tenant opportunities, preferably 15 to 20 years. In this case, CPA 18—our public non-traded REIT fund—acquired this office building that's leased to Intuit in the Dallas submarket for 11 years with an earlier termination right. We acquired the facility from a company called Piedmont Realty Trust, which we have worked with before, so we have a great relationship with them, and they chose us because of our ability to execute in a timely fashion. The reason we were able to get comfortable with the shorter-term lease is that we have a very strong asset in a thriving market that's leased to Intuit, and the property is very attractive.

This was a build-to-suit facility for Intuit developed in 2001. How did Intuit's capital improvements to the property since that time play into your underwriting?

It is a core regional office for Intuit. They really made it their own. They have a basketball court, volleyball court, even a community garden. And what most impressed me in touring with the manager is how proud he was of the facility and some of the projects that they've done recently. Over the past three years, Intuit has invested about $9M of capital into upgrades in the facility. And even during our due diligence, they requested some work to put solar panels on the roof and on the roof of the parking structure. So all of that demonstrated their commitment to the property.

How do you view the office's location in Legacy Business Park in Plano, Texas?

Legacy is a thriving market. The location was critical to our analysis, particularly for the residual analysis. Dallas, in general, is the fourth-largest MSA [metropolitan statistical area] in the country and has been growing rapidly. Legacy was developed by Ross Perot in the early 1980s, when he moved the EDS [Electronic Data Systems] headquarters there. And since then, it's really grown into a mixed-used town center. There are a lot of corporate headquarters and regional headquarters, including J.C. Penney and Frito Lay. And there's some recent news that Toyota is actually moving its headquarters from California to Legacy. That is very big news for the market. It's 1.5M square feet, with more than 4,000 employees, and they'll bring with them a lot of the suppliers. So there's a lot of activity and demand in the market.

What about new development concerns?

We see it as a very strong market. Now Dallas, interestingly, has a history of overdevelopment. So that's something that we had to take into consideration as well. What's to keep Intuit or someone else from building a new facility? It comes back to the math, where we feel very confident and comfortable with our basis in the property. It would be difficult to re-create this building with the parking structure for the same price that we bought it for. ■