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Will Corporate Owners Be the Next To Cash Out?

Top Pricing Paid for Office Assets May Lead Corporate Owners to Put Up More For-Sale Signs on Their Properties

Despite ferocious trading in back-to-back, record-breaking years, the property sales market shows little sign of abating any time soon. Indeed, with investors' seemingly insatiable appetite for real estate and plentiful capital to invest, a potential new wellspring of deals is seen coming from corporate sellers who may opt to cash out their holdings at today's peak valuations.

Changing operational needs, coupled with the real estate market's heady blend of excessive capital and aggressive lending are coming together to push the traditional owner/occupier into the sales market, according to market observers.

"We are at the very front end of a major shift of transference of corporate-owned real estate into the hands of investors, in the form of sale and leaseback," stated Kenneth Rudy, an international director with Jones Lang LaSalle's Capital Markets group.

Rudy's team has a particular focus on corporate sellers, and has consulted some of the nation's top corporate users on real estate strategies. According to Rudy, corporate owners are increasingly eyeing their real estate-owned holdings as a potential windfall to their balance sheets.

Right now, U.S. corporations own as much as 40% to 45% of their facilities, with the balance being leased, according to Jones Lang LaSalle. That represents a little more than $1 trillion in real estate that is embedded on corporate balance sheets, Rudy asserts -- and a helluva lot of real estate that could hit the market.

"It's an opportunistic marketplace where tenants, companies that owned real estate for their own purposes, maybe it's time they cash in like others," said Ken Ruderman, an executive managing director with Studley Inc. in Manhattan. "Personally, I wouldn't be surprised if we saw that now."

A corporate seller represents a different animal compared with a typical real estate operating company, Rudy explains. In addition to looking to optimize the financial outcome, the corporate seller is also looking to maximize the operational outcome and is simultaneously selling a lease and structuring a major operating agreement at the same time it is negotiating a sale of the property, which can get pretty complicated in today's marketplace.

Today's business environment requires that companies be nimble and flexible, rules that the real estate game doesn't always adhere to. With all of the mergers and acquisitions, changes in the labor force, technological changes, etc., business needs for flexibility are driving some corporations to consider the role of tenant as opposed to owner/occupier.

"Business cycles have begun to dictate that real estate doesn't give them the flexibility they need to operate in today's environment," Rudy claimed. As a result, sale-leaseback decisions are increasingly becoming operating decisions, and not just financial maneuvers.

Underscoring all of that, of course, is the obvious appeal held by the astounding values being commanded by top assets in the real estate investment sales. The market continues to break records with an onslaught of capital chasing real estate and aggressive underwriting.

Add to that the fact that corporations are showing a growing appetite to use the capital in more core operations, such as paying down debt and core investing. So, as companies are looking at ways to monetize their capital they are selling real estate -- capital that can be cheaper than traditional lines of credit.

Buyers and Sellers

Of course, companies have pursued sale-leasebacks all along. Financial institutions have been riding the sale-leaseback wave for quite some time. Just look at American Financial Realty Trust's growing portfolio of bank branches and office space.

But more recently, even longtime owner-occupiers are starting to test the waters. Merrill Lynch is in the market now with its 1.2 million-square-foot property at 800 Scudders Mill Rd. near Princeton, NJ. Cushman & Wakefield is handling the marketing of the building and an adjacent development parcel. Merrill Lynch plans to lease back the entire building until early 2008.

One industry Rudy said may become a major source of sale-leasebacks are pharmaceutical companies that he said have lagged behind the curve. They tend to own a lot of real estate versus leasing, and are good candidates for this movement, he said.

Industrial companies with core manufacturing facilities are also jumping on the bandwagon. Warehouses and regional distribution centers have always been interesting to investors, Rudy said. These sale-leaseback deals tend to be shorter-term leases, giving the tenants the ability to adjust to the markets.

As for buyers, in general, sale-leasebacks appeal to a wide spectrum of investors, from pension funds to private equity players. If a high-credit corporate seller is looking to pull capital out to do a stock repurchase and is willing to do a long-term lease, that type of deal would appeal to a broad set of core investors. But an oddball asset in a secondary market may be snapped up by a local real estate developer who can easily re-entitle the property, Rudy said.

As is the case in most areas of commercial real estate investment these days, the private equity guys are becoming bigger players in the sale-leaseback arena. In many cases, they are the ones willing to take the bigger risks, take on some value-add properties or a unique asset, he said.

Sale-leasebacks don't make sense for all corporate users. Obviously, highly specialized facilities, buildings with unusual designs or shapes that won't be candidates for an alternative use, may not attract outside investors.

Plus, while tenants who own real estate may want to capitalize on the value of their real estate, they still have space needs, said Studley's Ruderman.

That's why some companies are considering partial sale-leasebacks and short-term deals. For example, Verizon Communications Inc. sold the 1.4 million-square-foot office tower in Manhattan two years ago to Equity Office Properties Trust for $505 million. But Verizon retained ownership of the 200,000 square feet of space that house its switching equipment.

These deals are happening all over the place, from the top markets, down to tertiary markets. Silicon Valley, in particular, is an area worth watching. The technology companies bought up and retrofitted a lot of their real estate in the high-flying days of the late '90s when they had enormous amounts of cash.

Sun Microsystems, for example, sold one of three large office complexes in the Bay Area last year to BioMed Realty Trust Inc. for $215 million. As part of the deal, Sun Microsystems signed 10 short-term leases for the 10 buildings at its Newark, CA, campus with plans to exit the property in phases over an 18-month period. BioMed Realty plans to reposition the property for use by life science tenants.

Given the intense competition and rabid consolidation occurring across most industries today, watch for those companies with large real estate holdings to increasingly consider property sales.

Pfizer just announced that it plans to slash its manufacturing operations worldwide virtually in half. And Whirlpool's acquisition of Maytag is already resulting in the disposition of manufacturing facilities. Then there's AT&T's pending acquisition of BellSouth, which will surely see office properties hit the market in Atlanta where BellSouth owns about 10 properties totaling more than 3 million square feet of space, according to CoStar Group information.

Some of the drivers of those decisions include duration and the vibrancy of a given market. In markets that are highly vibrant, users tend to gravitate toward leasing, because those that want to own in those cities will face some steep competition and pay a lot of money for their space. On the flipside, renting space in a rural or tertiary market could become quite expensive.

And size matters, too. A company that is looking for 200,000 square feet of space generally won't want to own a 1 million-square-foot megaplex and deal with the complications of multiple tenants.