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Raising Capital from Corporate Real Estate: Opportunities from a Changing Environment

CBRE

Summary

IFRS 16, has stimulated increasing sector and press speculation regarding the future of S&LB activity. With almost all leases now destined for the balance sheet, a S&LB will usually no longer be considered a form of off-balance sheet financing. Several commentators have considered this sufficient to pronounce the early death of the S&LB.

Yet we've seen major commitments to S&LB transactions by the likes of KPMG, Lloyds Banking Group and DHL. The reasons behind these organisations committing to leasebacks are diverse and not simply a final 'push' before the introduction of the regulations in 2019.

The benefit of a S&LB as a means of off balance sheet financing is, after all, only one of a range of considerations. Whether a S&LB is the right strategy for a given scenario or corporate occupier will depend upon a balance of considerations which we classify as; operational, financial, property and market.

We also predict the impact on balance sheet gearing and loan covenants to be less than many expect and primarily sensitive to a company's specific circumstances. For some, the changes to lease accounting under IFRS 16 could provide new opportunities by boosting shareholder value and capital structure efficiency in the short term.

We contend that S&LB can continue to offer major benefits to many companies. We see that the largest impact of IFRS 16, will be the requirement to pay greater attention to the structuring of any S&LB, to ensure the positive opportunities are captured and any negative effects mitigated.

INTRODUCTION

At the announcement of IFRS 16, many were quick to predict the death of the S&LB for companies reporting under IFRS. With all leases now destined for the balance sheet, what would be the incentive for a company to commit to a S&LB?

Fast-forward 18 months and we've seen major commitments to S&LB transactions by the likes of KPMG, Lloyds Banking Group and DHL. The reasons behind these companies committing to leasebacks are diverse, but we do not believe this is simply an opportunistic move to take advantage of the 'window of opportunity' to recognise the full P&L profit of a leaseback, before 2019. At CBRE we continue to witness considerable interest in monetisation of real estate for a variety of reasons and stronger buyer demand than ever before.

In this paper, we cut through the technicalities of IFRS 16 and focus on the fundamental drivers for monetisation activity. Is there still a place for S&LB as a strategic option for corporate occupier's post 2019? This paper looks at companies reporting under IFRS and whilst companies reporting under US GAAP will also have to record leases on balance sheet post 2019, there are notable differences in accounting treatment which will impact some of the financial drivers for a leaseback. Nevertheless, many of the drivers for a S&LB will be the same regardless of accounting treatment.

THE RATIONALE FOR CORPORATE REAL ESTATE MONETISATION

Whilst the 'off balance sheet' nature of a S&LB was historically an advantage, it was not the only benefit from a S&LB. Other factors included

- Optimising capital structure and shareholder value by finding lower cost of capital finance
- Release capital tied up in illiquid real estate on the balance sheet, to reinvest in the core business
- Leaseback lengths can be matched to a specific occupational requirement
- Allowing the transfer third party management obligations or vacancy (in the situation of a sale & partial leaseback)
- Reducing exposure to real estate markets and transferring residual ownership risks, a major benefit outside of prime real estate markets
- Avoid potential book value write-offs in instance of vacant assets.
- Flexibility and ease with which to re-locate at lease expiry, without having to sell a vacant asset

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We also see high demand globally for income producing 'real assets'. Long sustainable income profiles currently represent a great alternative to bank debt and bond markets. Therefore, for many companies the current market cycle provides an opportunity to secure low cost financing and boost returns from core business activities.

Many companies have a high exposure to real estate with 70%+ of their operational portfolios owned. These companies expose themselves and their shareholders to real estate risk and dilute the returns from their core business activities, especially when sites are sold at the end of their life-span. Such sites can take a long time to sell and often yield low sale proceeds, which are below book values which reflect the depreciated investments of the asset. Often undertaking a S&LB at an earlier stage can provide an opportunity to exit at attractive terms.

EFFECT OF IFRS 16

Balance sheet: Increased Indebtedness

The major impact of IFRS 16 is the removal of operational lease treatment which enables lessees to hold lease liabilities off balance sheet. Companies that report under IFRS, will have the vast majority of their leases classified as finance leases and appear on balance sheet. The inclusion of leased assets on balance sheet will result in an increase in both the lessee's reported assets (ROUA: Right of Use Assets) and liabilities (the Present Value (PV) of the lease commitment will appear on balance sheet).

Historically, one attraction of a S&LB was that operating leases were not capitalised on balance sheet, providing a potential financing source without increasing overall indebtedness of the company.

IFRS16 will have a particular impact on companies that are sensitive to gearing ratios including those with banking covenants that are linked to balance sheet indebtedness. However, in our view this will be a relatively limited impact. Many banking covenants have 'carve outs' protecting against changes in accounting regulations and more recent deals have often explicitly excluded the impact of IFRS 16 entirely.

The Loan Market Association has since June 2016 provided optional wording to mitigate the impact of any new leases on financial covenants as at before the introduction of the new standard in 2019.

References to finance or capital leases in the templates can be replaced with a reference to:

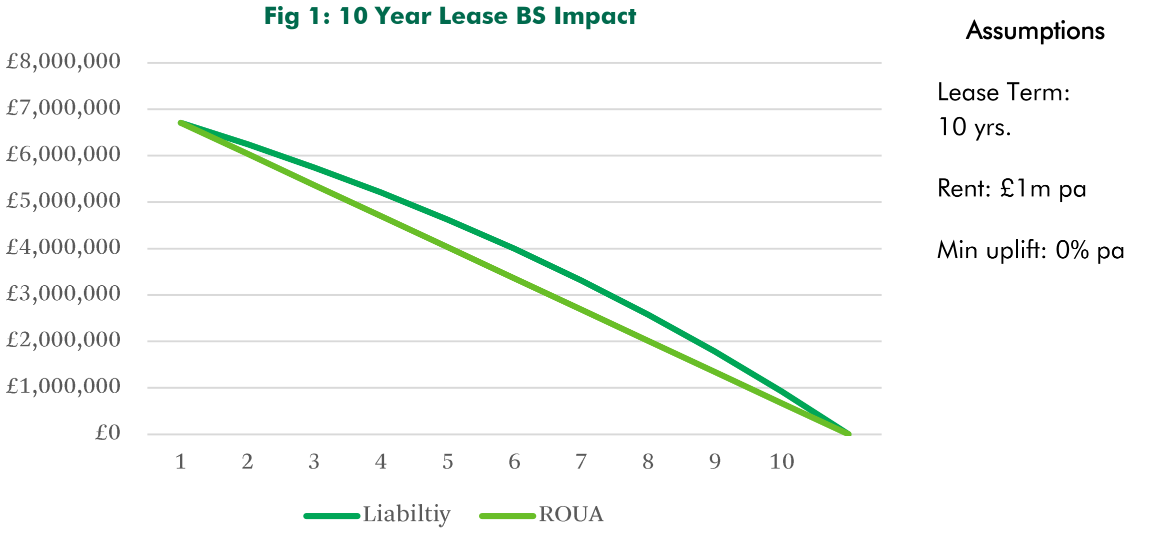
"…any lease, which would, in accordance with applicable GAAP, be treated as a balance sheet liability [(other than any liability in respect of a lease or hire purchase contract which would, in accordance with GAAP in force [prior to 1 January 2019]/[prior to [ ]]/[ ], have been treated as an operating lease)]…"

If adopted, this effectively freezes the financial impact of IFRS 16 on debt covenants. Add the fact that the entire market including bondholders, lenders, analysts and credit rating agencies will now have to adjust to increased indebtedness due to capitalisation of lease commitments means that, in our view, the practical financial impact on many companies will be limited.

Indeed, SLBs will, in effect, continue to offer a partial off balance sheet solution as only the PV of the rent will be capitalised on the balance sheet. This still compares favourably with bank or bond finance, which require the entire principal amount to be recorded. Often the rent will also be discounted by the company's weighted average cost of capital which will usually be higher than the yield on the SLB, further reducing the balance sheet impact and still providing a significant balance sheet advantage over other forms of debt.

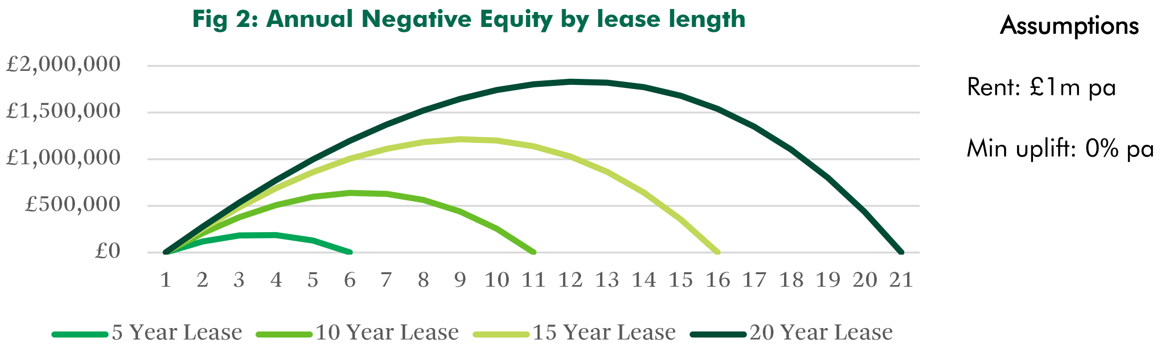
But careful structuring will be important to minimise the overall impact of IFRS 16. Long leases may increase the balance sheet impact. However, it is worth noting that many flexible leases structures, such as 'buy back' options or make whole provisions, which were previously overlooked because they would trigger finance lease treatment are now very much back on the table again and we see scope for more structured lease solutions to provide occupiers with their required flexibility.

Additionally, the new regulations could cause a 'negative equity' impact on a company's balance sheet by capitalising a liability that is larger than the equivalent asset (ROUA). Specifically, the asset depreciates at a quicker rate than the liability. Ref figure 1.



Source: CBRE 2017

The impact of this 'negative equity' is exacerbated by lease length as shown by Fig 2, as the liability takes a longer period to unwind:



Source: CBRE 2017

We note that companies reporting under US GAAP will still have the option to obtain operational lease treatment. Whilst this will not stop the lease commitment appearing on balance sheet, it will mean that issues associated with the divergence between the ROUA and the liability will not exist, as the liability and asset's depreciation will be matched throughout the lease term.

Effect on Shareholder Value

Monetising corporate real estate can be a highly effect way to optimise the value of a business ahead of an exit, equity raise or refinance. Structured well, it can both reduce the cost of finance and enhance the value of shareholders' equity. This takes advantage of market inefficiencies and arbitrages different pricing approaches in the real estate and corporate markets. This was historically the rationale for many of the 'Opco/Propco' deals seen that were undertaken pre-crisis and many of the more recent REIT spinoff deals in Europe and the US.

Whilst many of the pre-crisis leasebacks were under-collateralised and did not prove resilient to market weakness, it remains a valuable tool to enhance shareholder value particularly for the private equity community. The adoption of IFRS 16 may actually have surprising benefits for those looking for a short-term boost in equity returns from such structures.

The reason for this lies in the Enterprise Value/ EBITDA multiple valuation methodology that is now widely adopted, together with the impact on EBITDA caused by the new accounting standards.

IFRS 16 will shift most lease payments from an operating cost that would be deducted in an EBITDA calculation to a combination of interest and depreciation that is not accounted for in EBITDA.

Therefore, under IFRS 16 most companies with operating lease liabilities will actually see EBITDA rise, albeit any equity valuation will now need to take account of the additional indebtedness created by the future rental liability as a deduction from the Enterprise Value. However, as the rise in indebtedness will not usually fully offset the rise in Enterprise value allowing for value creation.

The impact of this on equity valuation is not straightforward and depends on a range of factors including the arbitrage caused by the relative differential pricing between property yields and interest cost as well as the lease length.

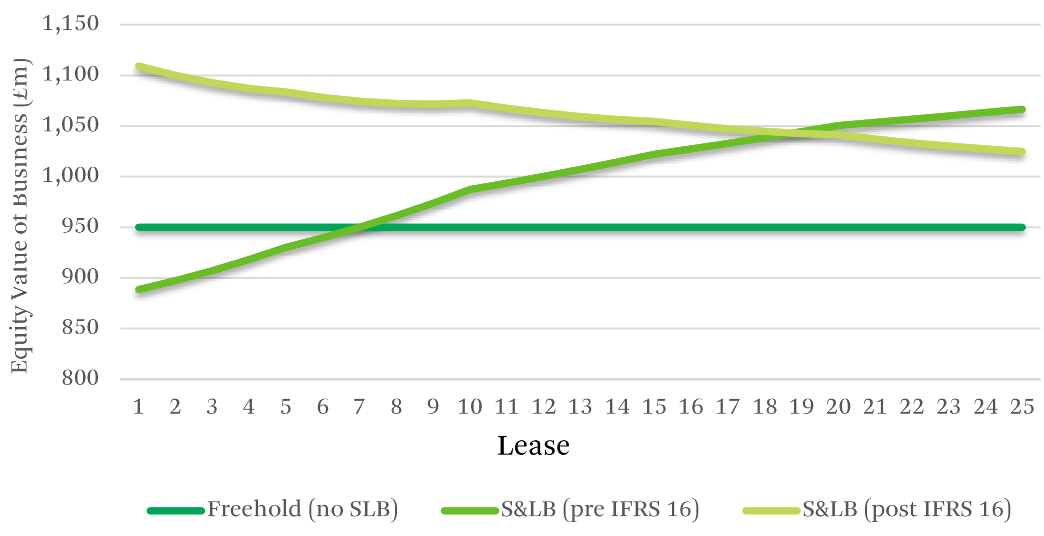
Fig 3 and Fig 4 demonstrates an example of a hypothetical equity valuation based on an showing the theoretical impact on equity valuation of a sale and leaseback (pre, and post IFRS 16) at a constant EBITDA Multiplier.

Assumptions

EBITDA: £100M
Debt: £250M
EBITDA MULTIPLE: 12x
Rent (S&LB): £20M

Property yield: dependent on lease term e.g. 10 yrs. = 6.75%

Fig 3: COMPANY EQUITY VALUE PRE AND POST IFRS 16



Source: CBRE 2017

Under the Pre IFRS 16, the value of the equity is improved when the property yield is lower than the cost of capital implied by the EBITDA Multiple. In this case the 'breakeven' lease term is about 7 years. In the post IFRS 16 world, this arbitrage is still present but the effect is complicated by the deduction of the lease liability from the Enterprise value, which makes shorter leases even more attractive. The valuation analysis for a 7-year lease is summarised below:

Fig 4: COMPANY EQUITY VALUE PRE AND POST IFRS 16

£M		Freehold (no SLB)	S&LB (pre IFRS 16)	S&LB (post IFRS 16)
EBITDA		100	80	100
Enterprise Value	12X	1,200	960	1,200
Debt		-250	-250	-250
Net S&LB Receipt		0	240	240
Rent NPV		0	0	-116
Net Liabilities		-250	-10	-126
Equity Value		950	950	1,074

Source: CBRE 2017

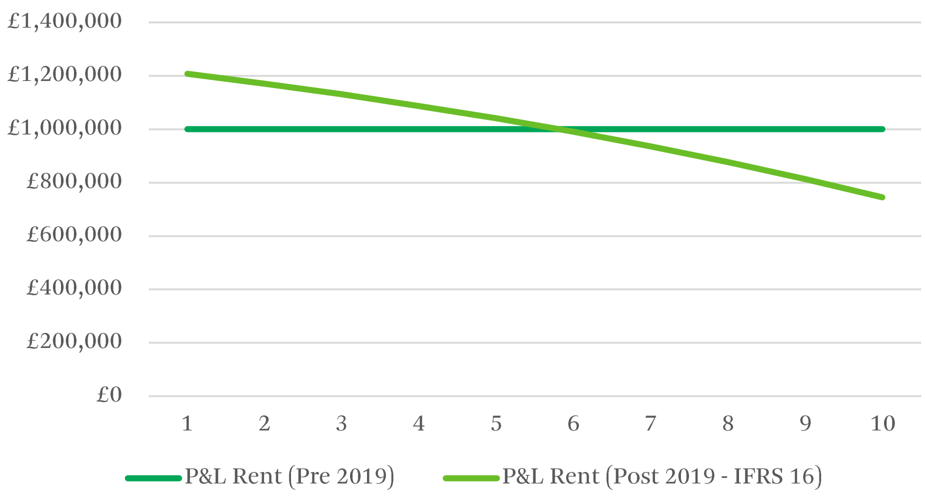
Whilst actual figures will vary significantly depending on both the structure of the leaseback itself and the underlying market dynamics of the company, it does illustrate that the potential positive financing impact of S&LBs will continue post 2019, and they can may be enhanced if the deal is structured appropriately.
The key question is whether the corporate valuation market will adjust efficiently to mitigate against these effects for example by reporting additional 'normalised' EBITDA measures after rental deductions. Whilst we think it might, we believe this will take time and inefficiencies will remain. The specific circumstances of each company will create its own opportunities for shareholders and Directors looking to make more of their real estate. In any event as the whole market will be shifting in the same way, so there will continue to be relative value opportunities for companies and their shareholders.

Impact on Profit & Loss

One of the key impacts of the changing accounting regime will be the effect on P&L. At one level the reclassification of lease expense into both interest and amortisation creates a variable P&L deduction that will usually decease initial profits and boost profits towards that later part of the lease. This effect on P&L rental charges post IFRS 16 is compared to current treatment in Fig 5:

Typically, therefore there will be a greater initial profit impact than the cashflow impact. On the face of it this may make shorter leases more attractive. However, with the current strength of investor demand for long income products, we also see scope for tenants to occupiers to negotiate long term leases on core assets in exchange for significantly reduced rents to raise the same amount of capital, thereby reducing both the cash and P&L impact. Without any concerns surrounding potential finance vs operating lease treatment we now believe tenants will be more inclined to take long leases in exchange for lower rents and agree buy-back options (prior to IFRS 16, this could have triggered an unwanted finance lease treatment).

Fig 5. P&L Rental Charge pre/post IFRS 16



Assumptions

Lease Term: 10 yrs.

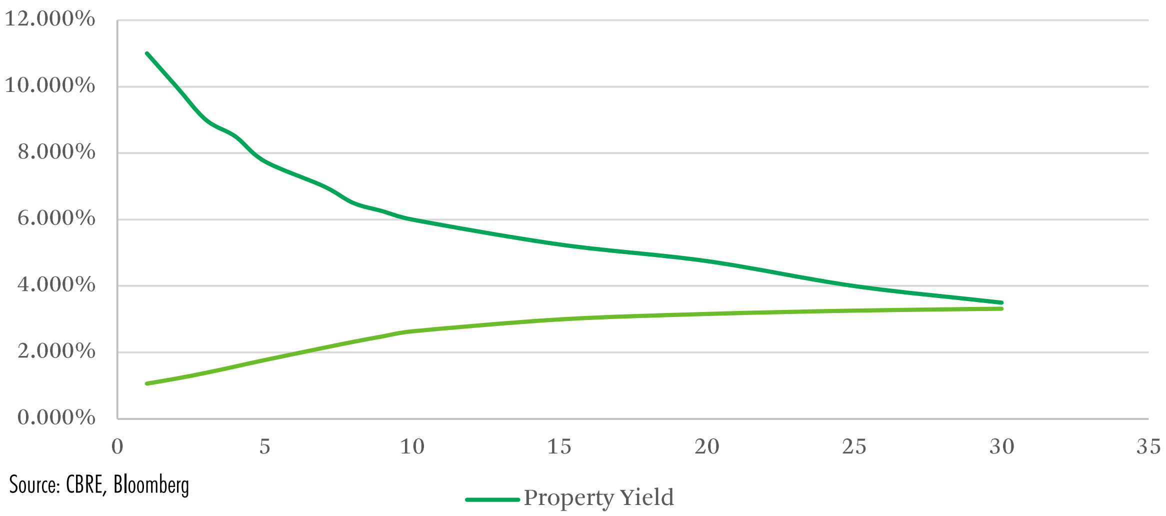
Rent: £1m pa

Min uplift: 0% pa

Source: CBRE 2017

Additionally, unlike with the corporate bond market, the total cost of financing typically reduces with longer lease terms, as shown in Figure 6 below:

Fig 6: Indicative Property Yield v BBB GBP Bond YTM



Source: CBRE, Bloomberg

When comparing total cost of finance, it is also important to remember, that unlike with bond financing, there is usually no requirement to pay back the principle at the end of the term.

The effect on P&L is much more time sensitive when considered in circumstances where the sale and leaseback itself creates a realised profit on book value. Under current regulations, this profit will be accounted for in the year of the transaction, whilst sale and leasebacks undertaken post March 2019 will force a large element of this profit to be spread over the lease term. Ref Fig 6 below:

Fig 7 – P&L recognition of a S&LB pre and post 2019

Assumptions

Book Value: £6m

S&LB Proceed: £14m

S&LB Term: 10 yrs

S&LB Rent: £1m pa

S&LB Min uplift: 0% pa

	Pre 2019	Post 2019
Sale Proceeds	£14,000,000	£14,000,000
Book Value	£6,000,000	£6,000,000
Profit on Book Value	£8,000,000	£8,000,000
Rent NPV	n/a	£6,710,081
Price apportioned to real estate	n/a	£7,289,919
As a %	n/a	52.07%
Day 1 P&L Profit	£8,000,000	£4,165,668
Spread Recognition	n/a	£3,834,332
Annual Recognition	n/a	£383,433

Source: CBRE 2017

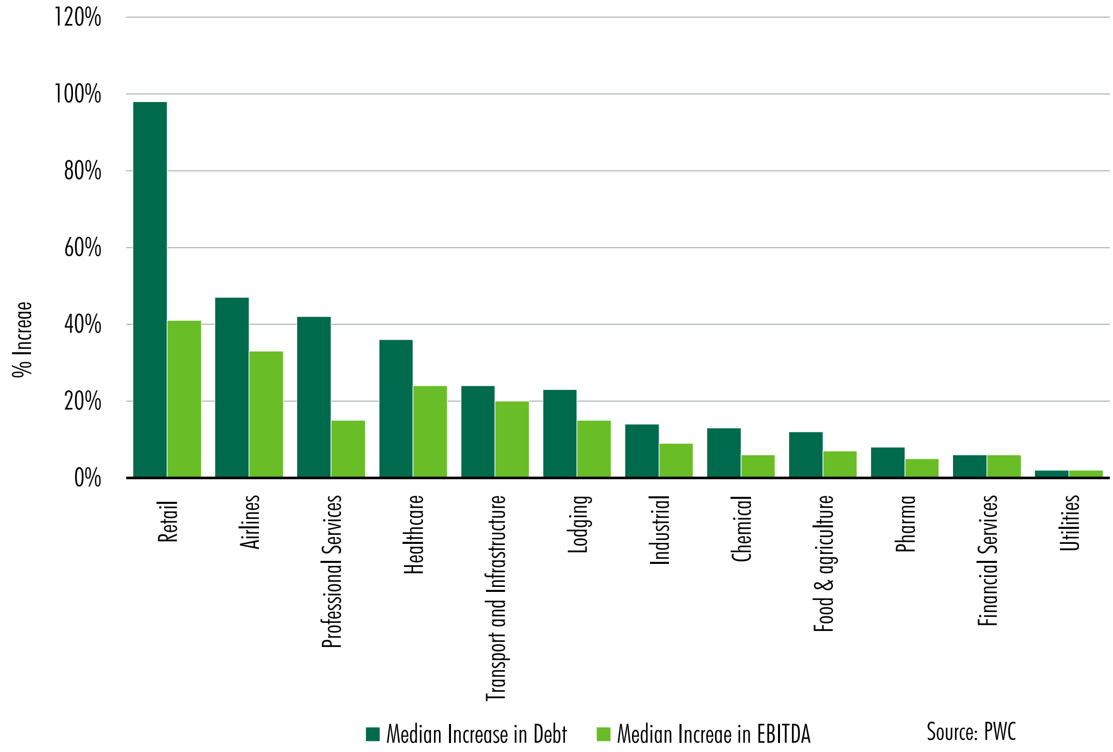
In some circumstances, this creates an incentive for companies to act now and structure sale and leaseback transactions well ahead of the January 2019 deadline. Early action is key to understanding the potential benefits and structures available to find the best solution for each company.

Sectoral Differences

In our view the potential benefits from real estate monetisation will vary from sector to sector. For example, we see manufacturing companies as particular beneficiaries with often relatively low levels of gearing, high freehold ownership and low EV/EBITDA multiples. Online retailers with a high logistics component may also benefit from an alternative low cost finance. By contrast, we see many in the banking sector more inclined towards freehold ownership due to the need to maintain capital ratios coupled with lower cost debt finance. Some retailers will also be much more negatively affected with a large increase in gearing levels forecast due to often long lease lengths, low levels of freehold ownership and high debt levels. The impact depends on a range of factors such as lease lengths, average gearing ratios and the differential between EBITDA multiples and yields achievable from the underlying real estate.

Figure 8 illustrates the very wide range of impact to both EBITDA and gearing on different business sectors under IFRS16 adoption. The variance in impact across different companies within each sector will be even greater.

Fig 8: Sectoral Impact on Company EBITDA and Debt levels



Source: PWC

Beyond Sale and Leaseback

S&LB is one of the most well-known real estate monetisation strategy for owner occupiers. However, it is not the only route available for corporates to monetise assets, especially today as investor demand increases for long-secured income, and buyers become more open to alternative structures.

Examples of these options include:

Long term credit tenant financing. These can often provide a lower cost of financing for long term occupiers with a strong credit profile.

Income strips and finance leases, which provide a low cost of financing for long term occupiers an often include buy-back provisions to enhance tenant flexibility.

Synthetic leases. Structured to maximise flexibility and control whilst significantly lowering the balance sheet gearing effect over equivalent debt or leaseback alternatives.

The right approach depends on the occupier's requirements, credit profile and quality of underlying real estate. We expect interest in some of these alternative strategies to grow as owner occupiers, now unconcerned with avoiding finance lease treatment, find ways to enhance their balance sheet and the market develops new solutions to facilitate allocation of capital to the sector.

CONCLUSION

Whilst the benefit of a S&LB being a means of pure 'off balance sheet' financing will mostly disappear with the introduction of IFRS 16, the wider benefits of a S&LB will not.

The most tangible benefits of a S&LB will remain unaffected and the balance sheet impact will still be less than many alternative funding sources. We see the impact of S&LBs on balance sheet gearing and loan covenants to be far less than many expect and highly dependent on company specific circumstances. The changing treatment of lease liabilities will also throw up opportunities to enhance capital structure, shareholder value and minimise tax, particularly for opportunistic companies and their shareholders. Careful structuring will be required to help minimise the impacts.

The suitability of a S&LB will depend upon a range of factors and considerations which will need to be weighed up by the corporate occupier prior to committing to a S&LB.

In summary S&LB will continue to be an integral part of a corporate's capital raising tool-kit, albeit we see scope for more structured deals that address specific needs and the impact of changing legislation.

About CBRE Corporate Capital Markets

CBRE Corporate Capital Markets are an integral part of CBRE Capital Advisors Ltd, a market leading advisory team. We provide capital Solutions to the corporate real sector ensuring our clients drives the maximum value of out of their real estate, whilst providing optimum flexibility to the client's business needs
We advise on a range of structures bringing in both real estate sector specialisms with corporate finance and expertise to ensure we provide the right solution including:

- Sale and leaseback structures
- Finance leases, CTL financing and Income Strips
- Synthetic lease structures
- Debt funding
- JV/Investment vehicle structuring
- Build to suit financing and forward funding
- Site optimisation and development advice
- Advice in relation IFRS 16 adoption

We work closely with sector and regional specialists across the globe to deliver the best results fulfilling our clients financial and real estate objectives.

Should you wish to discuss any aspect of this report or would like to discuss options for your own needs, please do get in touch.

For more information regarding this Viewpoint, please contact

Paul Lewis
Head of CCM EMEA
CBRE
+44 7970 987 950
paul.lewis@cbre.com

Chad Brown
Director
CBRE
+44 2071822976
chad.brown@cbre.com

Douglas Smith
Executive Director
CBRE
+44 7770 653 105
douglas.smith@cbre.com

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