Colliers

Leveraging corporate finance to unlock real estate capital

Value creation opportunities in volatile times

Corporte Capital Solutions
White Paper
11.2022

Accelerating success.

Organisations that act with conviction, take steps to broaden the range of tools in their financial portfolio and forge new alliances will often be those best positioned to thrive.

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Executive Summary

Economies and markets have grappled with a succession of enormous challenges in the wake of the pandemic. Healthcare and geopolitical crises have cascaded into the fiscal, financial, supply chain and monetary realms, with inflation rearing its head and interest rates rising in its wake.

Complicating matters, the turbulence has both global and distinctly regional characteristics. The energy effects of Russia's invasion of Ukraine have dealt more of an inflationary shock in Europe than to the United States, where rising prices are more the result of endogenous overheating. In China, a zero-COVID approach has combined with credit liquidity challenges to dampen the country's normally vibrant growth rates.

Rising interest rates will, in our view, cause commercial real estate values to correct significantly over a two-year timeframe. Some investors are taking to the side-lines in this period, subduing overall activity. Others are seeking opportunities. Many of these opportunities will emerge among corporates seeking to monetise their property assets in order to release capital. This will be for both defensive purposes (for instance, to service or pay down debt), or to explore new growth opportunities of their own.

For this reason, Colliers expects to see a surge of interest in alternative financing structures such as property sale and leaseback arrangements. These transaction structures enable corporates to partner with investors in order to unlock capital from the real assets they own, while continuing to enjoy the control of and access to these assets needed to sustain business activities. Sale and leaseback transactions boast a number of advantages over traditional financial structures, which we will explore in this report.

Once the macroeconomic picture has stabilised, we expect significant quantities of capital to re-engage with real estate markets, given the sizeable amounts of capital focused towards the property sector and the attractive characteristics of the asset class. Rather than a full-scale retreat, the current period should be viewed as a time for both corporates and investors to take stock of their goals and identify areas of potential that innovative financing arrangements and partnerships may help unleash.

As we've witnessed so many times in past, the organisations that act with conviction, take steps to broaden the range of tools in their financial portfolio and forge new alliances, will often be those best positioned to thrive. They will be best placed to take advantage of new value creation opportunities when the inevitable stabilisation and recovery takes hold.

Colliers Corporate Capital Solutions

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I

Macro outlook: the global pricing reset

The key forces contributing to financial market volatility, and how they will impact real estate assets.

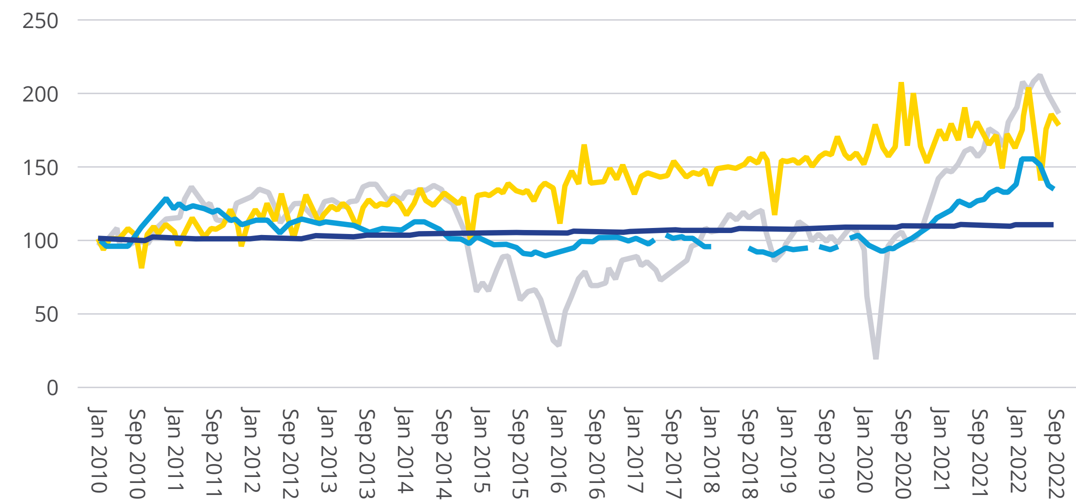
A succession of shocks

The last three years have been unprecedented across global and European markets. The COVID-19 pandemic brought an abrupt end to the previous economic cycle, triggering huge changes to the way we function and interact with the real estate environment. The state intervention that followed resulted in even further quantitative easing and record low interest rates, helping the economy recover.

The real estate investment market recovered with it. Following a slump in volumes during Q2 and Q3 2020, activity picked up significantly in Q4 and fed through to a record year for global and European investment in 2021. This coincided with record low yields, so an anticipated correction in asset pricing required at the end of 2019 went in the other direction - up. By Q3 2021 it was evident that inflation was building across global economies, reflected in higher energy prices, construction costs and pressure for interest rates to rise. Interestingly, even in our [Global Investor Outlook report for 2022] (based on surveyed opinions in November 2021), the consensus outlook on inflation remained relatively benign.

Few people expected a war to break out in Ukraine in early 2022, or the subsequent supply-side shocks that saw huge hikes to the price of basic commodities – fertilisers, food, oil, and gas – and the subsequent shift to 70-year record high inflation.

Global community indices



Source: Colliers/Factset

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Thankfully, key commodity prices have started to drop from their mid-2022 peaks. Demand for energy is diminishing as economic growth slows, particularly from China which is set for a 25-year low growth rate. Government intervention is also playing its part in alleviating supply chain pressures, but the recent narrative around the continuing war in Ukraine means there will not be an even path to the recovery in commodity supply chains and pricing.

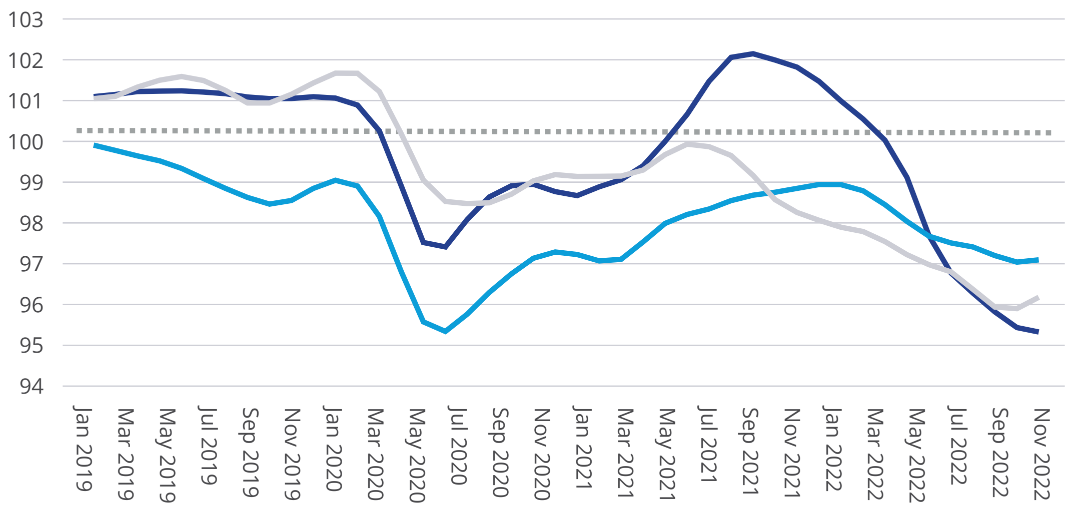
Consumer confidence indicator: OECD

EA

JPN

USA

Source:
Colliers, OECD



Energy price caps such as those recently announced by the UK and Germany seem to be having a positive impact, with negative consumer sentiment bottoming out across the globe and inflation levels finally looking like they will be pared back in Q4 2022.

While the outlook is improving, inflation levels are set to remain much higher than their long-term average throughout 2023, with sustainable levels not expected until 2024. Energy and commodity prices will gradually be managed down, as recent falls in wholesale gas supplies demonstrate, but core inflation pressure has been growing with wage rises, and mid-term shifts in the prices of goods and services.

CPI: long-term average, YTD & 2yr forecast

LT Avg (06-21)

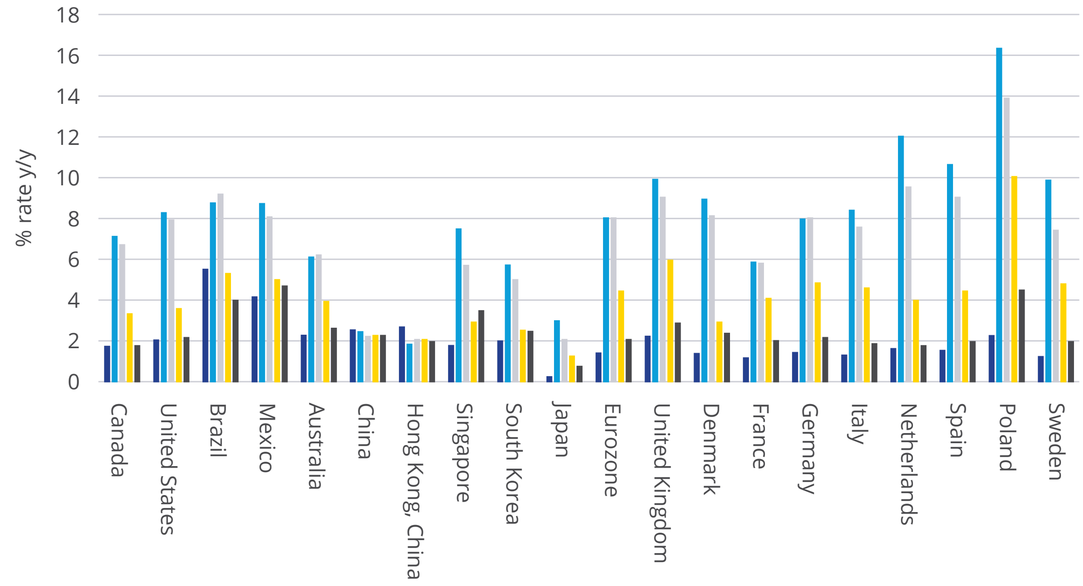
2022 YTD

Forecast '22

Forecast '23

Forecast '24

Source:
Colliers, OECD, OxfordEconomics, Factset



Quantitative tightening & asset pricing impact

All this inevitably means policymakers worldwide have begun the quantitative tightening process. The rate and speed of tightening picked up markedly during the summer of 2022, with significant rate hikes intended not only to manage inflation, but also to dampen volatility in currency markets as the safe-haven US dollar appreciated against other currencies globally.

Short-term interest rates (STIR): long-term average, YTD & 2yr forecast

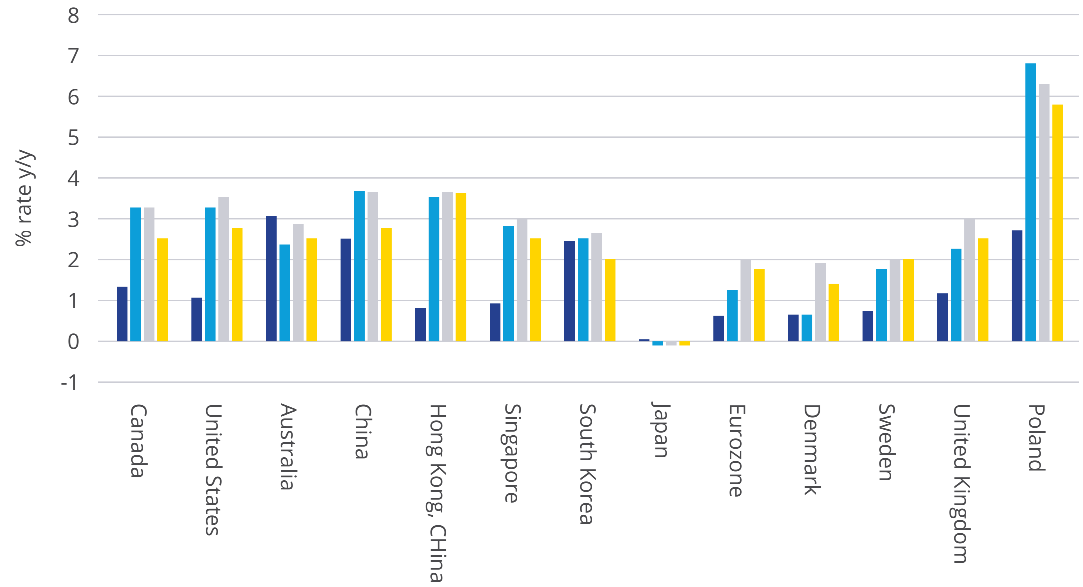
LT Avg (06-21)

2022 YTD

Forecast '23

Forecast '24

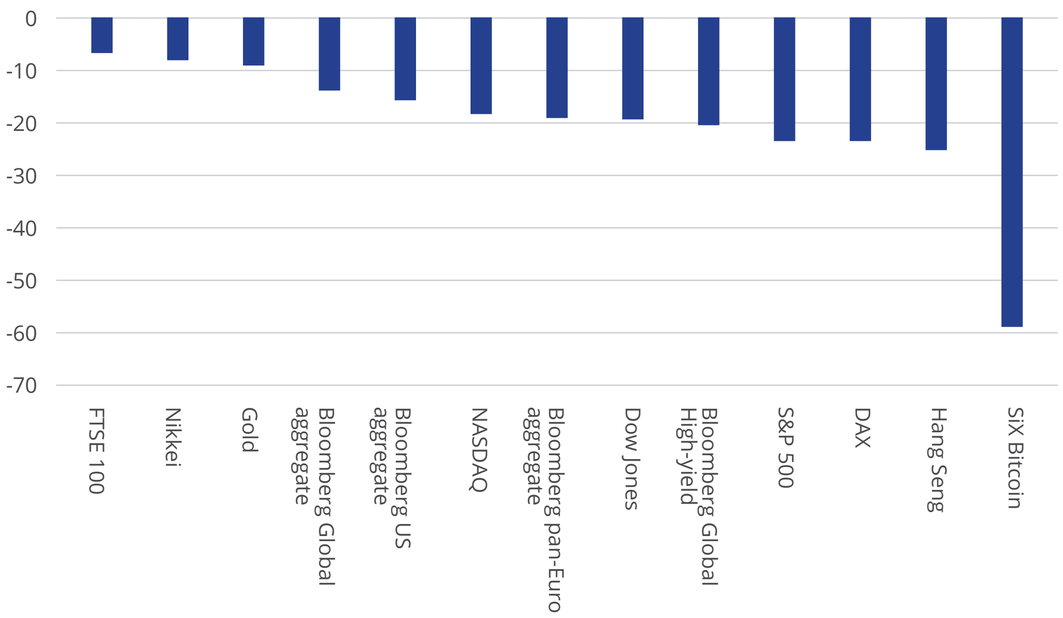
Source:
Colliers, OECD, OxfordEconomics, Factset



This has pitched financial markets into a vortex of volatility. Corporate bond rates, and short and long-term interest rates have reached 10-year highs in some locations. The expectation of further rate rises is playing havoc with asset pricing and swap rates. Global equity and fixed-income markets have plunged by up to 30% as of end September. There has been a recovery in equity markets during October, but swap rates continue to trade over 100 basis points above forecast short-term interest rate movements at the time of writing.

Global asset pricing: equities, fixed-income, bitcoin and gold - Q3 2022

Source:
Colliers, Factset

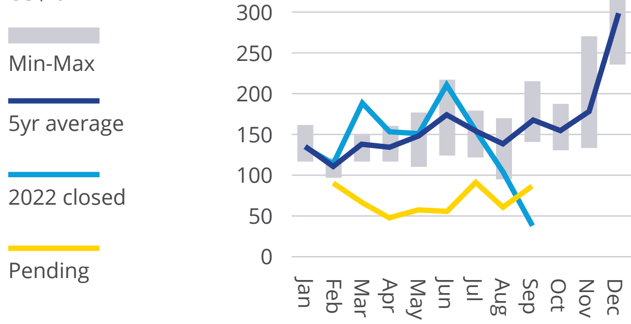


Real estate markets are clearly spooked, with global investment volumes dropping to new monthly lows, below even those of the peak pandemic year of 2020. This picture differs by global region, with European volumes to end-September faring best of all.

> *We have all had the benefit of negative or low interest rates for over a decade, and a vast amount of capital was invested in real estate during this time," comments Alice Vacani, Vice President, Blackbrook Capital, the European real estate investment firm. "With rates rising, other asset classes start to become interesting on a risk-adjusted basis."*
> ***Alice Vacani – Blackbrook Capital***

Global

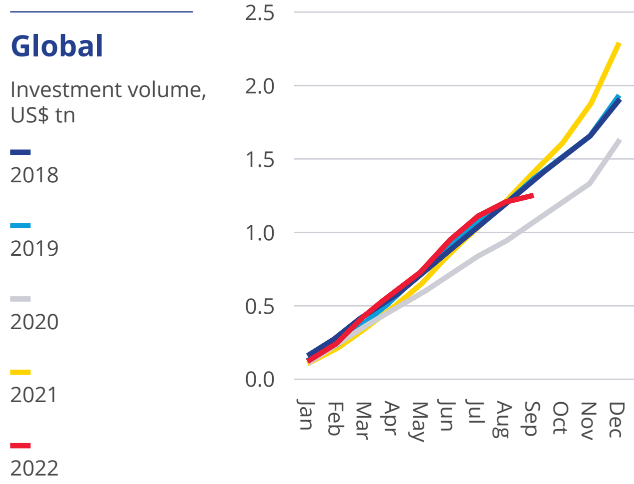
Investment volume, US$ bn



Source:
Colliers, MSCI Real Capital Analytics

Global

Investment volume, US$ tn



The journey to new, sustainable pricing

Although real estate yields have started to move out across Europe and the world, we expect that commercial real estate markets will witness a significant correction in the face of continued rate hikes over the next 24 months.

> *In the next six to 12 months we expect to see a broad correction in pricing, and not just in real estate," predicts Ward Stocker, Managing Director, Investment Management, LCN Capital. "We anticipate continued caution among investors as they adapt to a rise in interest rates. Companies with high leverage and interest expenses may find it difficult to refinance."*
> ***Ward Stocker – LCN Capital Partners***

The journey to more sustainable pricing will differ markedly across locations due to the speed and extent at which rates are changing, in combination with varying local fundamentals. Markets have already moved substantially in the last two quarters. Interestingly, UK retail yields have moved in as they had already over-corrected by end-2021.

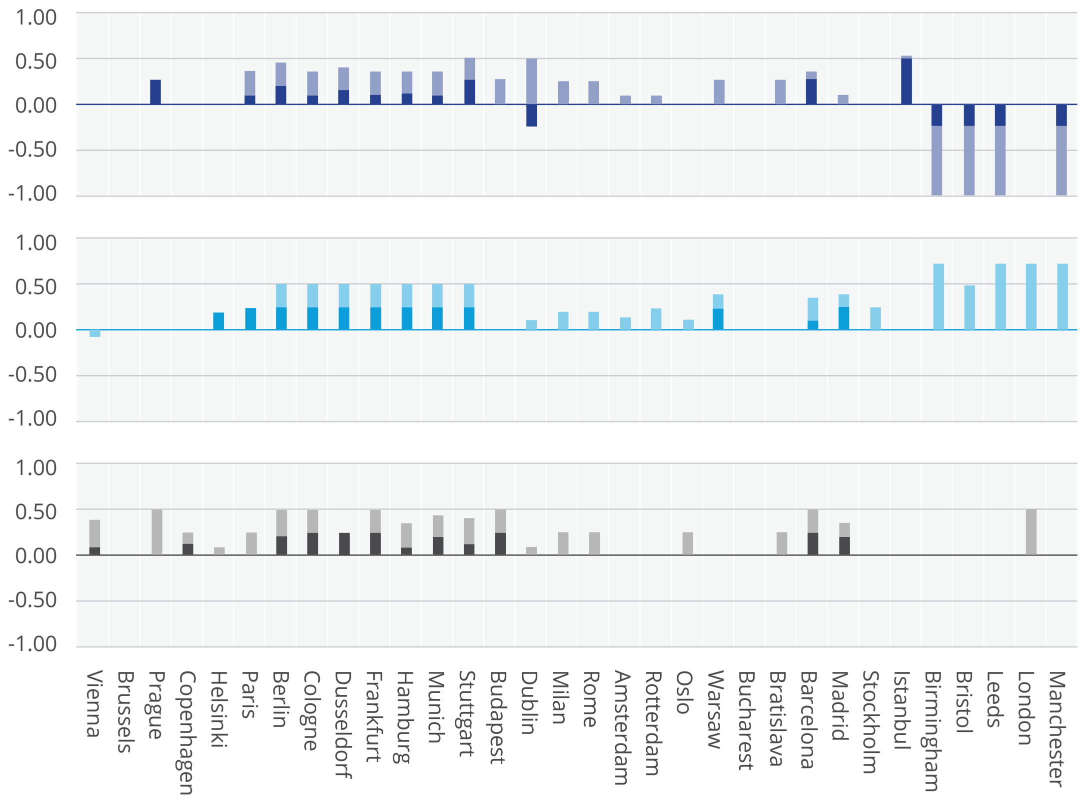
Prime yield change (%): since Q1 2022

Retail Q2/32

I&L Q2/Q3

Office Q2/Q3

Source:
Colliers



Despite these developments, yields will need to move out by a further 75 basis points, on average, which converts to a 15% correction in capital values. This could be higher, reflected in the scale of capital value change expected, ranging from 0%-30%. Key determinants of this re-pricing will reflect how much yield pricing has already moved in-line with interest rates, anticipated long and short-term interest rates and cost of debt, plus the size of any net reversionary yield gap brought about by the movement in rents. The timing at which these changes unfold will vary from 6 to 24 months. By end-2023 we should see investment activity bottom out and start to recover.

Global market indices

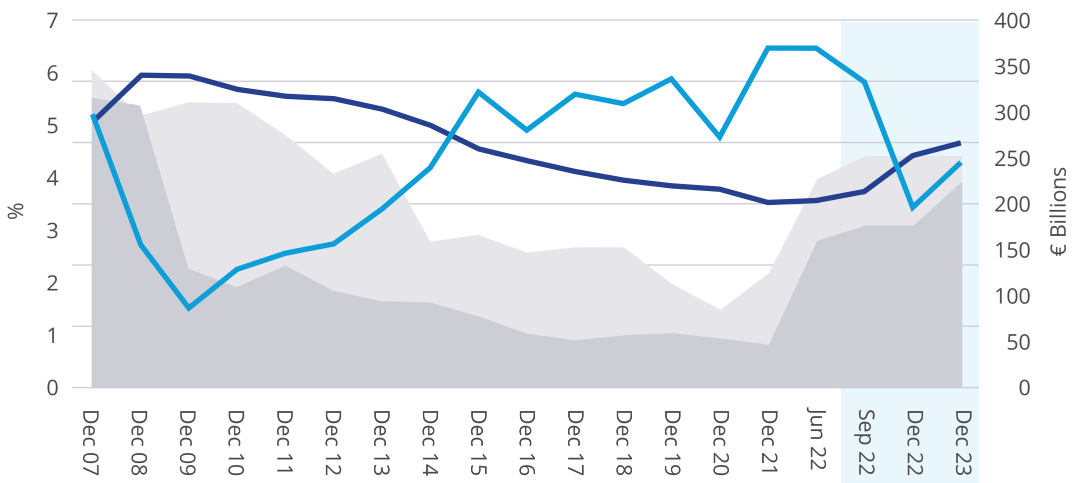
LTIR-blend + margin

STIR-blend + margin

All sector yield

Total investment volumes

Source:
Colliers, OECD, OxfordEconomics, Factset, MSCI Real Capital Analytics



What to expect during the reset?

Market activity will in our view be driven by a combination of the following factors. The scale of each will vary according to local market composition/ fundamentals, depth of liquidity and speed of adjustment.

Market inertia as pricing recalibrates. Until there is a value correction and bid-ask spreads shorten, markets will see lower levels of investment activity. Valuations will catch up – at the time of writing anecdotal information is suggesting some book value write-downs are imminent. But it will take six months for consensus to be reached on where pricing should be. Refinancing requirements will kick in on an ongoing basis, driving valuations, which will ultimately support further activity and opportunities for debt placement.

An equity to debt switch. The annual requirement to refinance creates an opportunity for the creation and deployment of debt funds. This is reinforced by the availability of higher returns generated by rising interest rates and debt margins. Equally, the need for debt varies across the capital stack – from senior debt on large lot sizes, to junior and mezzanine debt requirements to support project finance, for example.

A lack of loan covenant breaches. At least not in Europe, with loan to value ratios (LTV's) significantly lower than during the global financial crisis. On average, LTVs are around 30%. Yields would need to move by well over 200 basis points for this to become problematic.

Cash is king. Equity-driven investors, notably private buyers, are often less hindered by market forces and will remain active. The opportunity to bid for assets in an environment with limited buy-side competition will see sustained activity from such investors. Locations offering long-term safe-haven and 'trophy asset' status will be most active, including affluent markets such as London, Munich and Copenhagen.

Contracyclical investment – primarily sale and leasebacks. Many opportunities will arise to buy assets from companies which need a cash injection or see an opportunity to upgrade existing assets in partnership with investors, e.g., energy efficiency upgrades to reduce occupancy costs and support environmental, social and governance (ESG) strategies.

Closed-end fund terminations seeing assets come back to market at fund expiry. There will undoubtedly be some extensions to original deadlines, but assets will need to be sold, driving some activity.

Defensive assets in favour – industrial & logistics (I&L) and residential retaining the strongest capacity for rental stability and growth, alongside core offices. Incoming rental caps for residential in Europe warrant a degree of wariness. For I&L, low vacancy, digitalisation and just-in-case demand growth will support stable rents short-term, and a quick turnaround in rents when economies respond. It is evident from European investment volumes during Q3 2022 that these are the most favoured sectors. Over the course of 2022 residential volumes have expanded to account for ca. 34% of activity; in September this was up to 46%. I&L volumes have accounted for ca. 28% of activity during 2022, rising to 38% in September.

Beyond the initial recalibration, expect the significant weight of capital looking at real estate, and real assets, to re-engage with markets. We also expect a continued, long-term push into assets tied to new, energy-efficient infrastructure.

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Global relativity

Tokyo remains the stand-out global market in terms of relative pricing, and with the yen at historic lows it looks even more attractive.

Given current funding rates and margins are closer to 250 bps, and the broader shifts in 10-year bonds, attracting global capital into Europe means yields there are under the most pressure to shift, alongside the major markets of Australia, South Korea and Singapore.

Global offices - current NIY vs 3yr SWAP & LITR

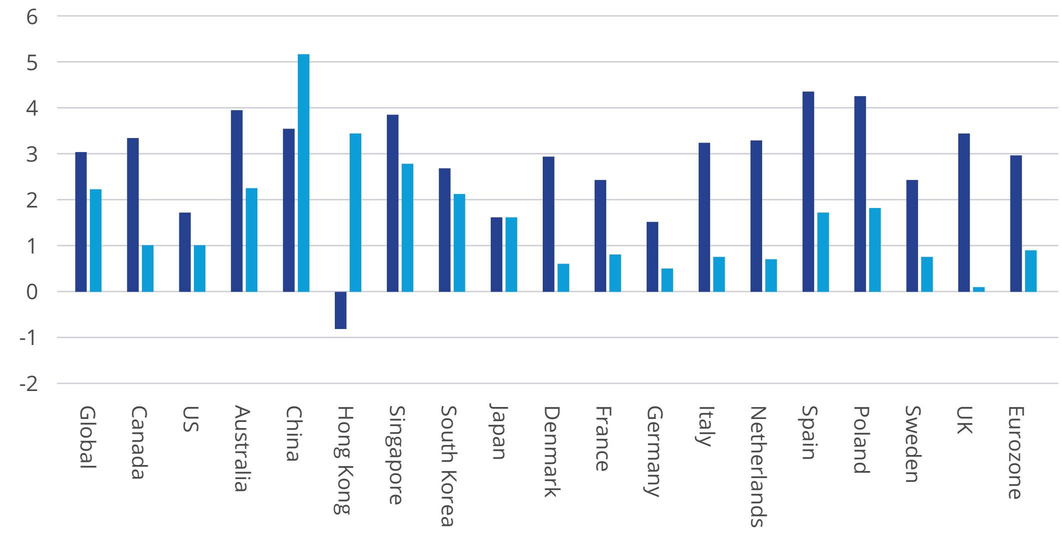
Source: Colliers, Factset

Equally, while our office yield matrix places US markets in a much more attractive position, investors need to recognise the impact real estate fundamentals and changing occupier demand will continue to have on real estate markets.

Major US metro CBD offices are going through a significant repositioning, with vacancies up to around 15%, sub-leasing and incentives levels high, and the impact of hybrid working yet to really work through the market. Attracting workers and employees back to cities is a bigger quantum challenge, and rents will need to reset. Equally, higher prices and finance rates are impacting corporate and household budgets, reducing spending for the year ahead. The economic outlook is weakening, all of which renders decision-making more complex. Investors are having to sharpen their pencils to pick markets, sectors and strategies best suited to benefit from these new dynamics.

2023 GDP outlook

Source: Colliers, Oxford Economics, OECD, Factset



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Picking the tipping point

Pricing, or the required re-pricing of assets, is foremost in investors' minds given the significant interest rate rises that kicked in during the summer relative to what were record low yields at the start of 2022. While yields have adjusted since May, the question is have they adjusted enough, given rate rises are not over yet.

In our view, probably not. A number of markets sit below the 1% spread threshold to interest rate swaps and long-term bonds. These are under the most pressure to decompress.

The bulk of markets sit within the 1%-2.5% spread threshold. For many buyers this spread seems sufficient, especially cash/private equity buyers looking to pick up opportunities while bidding pressure is limited. But exit yields are clearly on the minds of investors, so the case for investment is going to be driven by either one-off deals or compelling stories. Given inflation will not be fully pushed through to tenants over the next 12 months, the case for yields to decompress further dominates.

Will Q3 2022 be the beginning of just a short-term reset or a marked slowdown? The answer is essentially down to the following:

1. When interest rates peak and where across different markets. Subsequently, if and when they drop back, and to what level
2. How this shift in interest rates impacts FX/hedging and combined with subsequent pricing movements, regional and international capital flows
3. Whether economic output leads to cost-cutting in occupier markets, reducing leasing activity or simply driving higher utilisation or deployment of hybrid working approaches by corporate occupiers
4. Whether the wall of uninvested capital currently waiting to be deployed into real estate sees investors return to transactions earlier than expected to help avoid negative real returns to their capital sponsors. Private investment managers are holding an estimated US$88.3 billion of dry powder for European real estate alone, yet fund-raising has ground to a halt

Energy and commodity price rises globally are the key structural factors impacting inflation, and thus where and when rates will change, especially in Europe. Recent events are sure to encourage the expansion of renewable energy sources and infrastructure. This has grown significantly in the last five years, but much more is needed in the next 5-10 years to de-risk energy supply and reduce emissions.

Overall, we're seeing an adjustment that has been long overdue, driven by external forces. The next 12 months will be tough, but capital for real assets remains strong.

> *Energy and commodity price rises globally are the key structural factors impacting inflation, and thus where and when rates will change*

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II

Corporate capital markets: Overview and opportunities

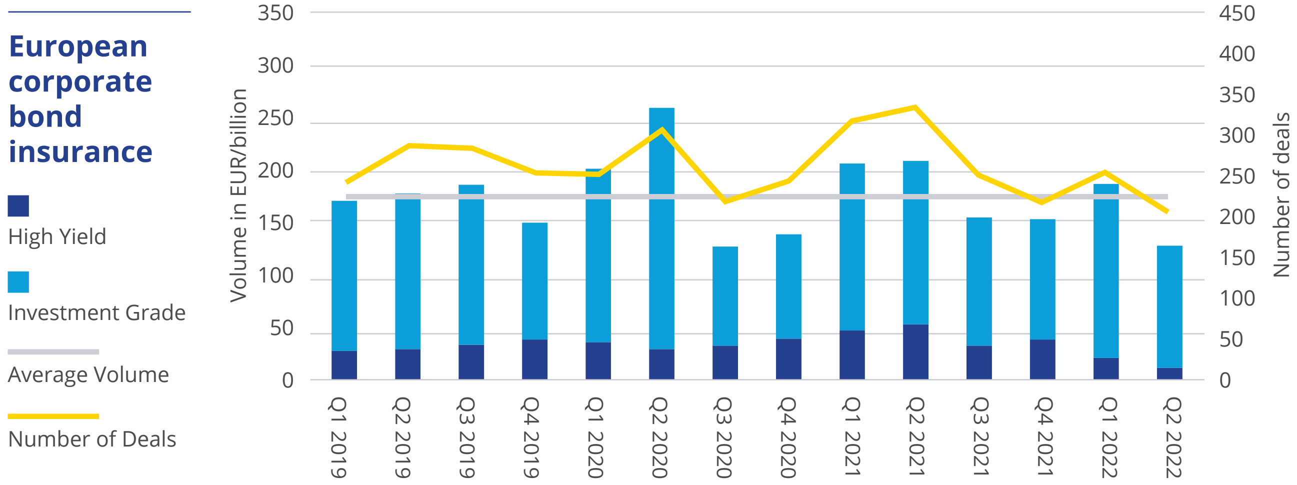
Tighter capital market conditions are creating pressure on corporates, and will also see more businesses move to monetise their property portfolios – often in partnership with investors.

Corporate borrowing levels

The growing risk of an economic downturn remains the fundamental threat across Europe, fundamentally impacting corporate credit quality.

While bookrunners are hesitant to place bonds, borrowers are on high alert about rising finance costs. As a result, corporate bond issuance dropped almost 38% in Q2 2022 compared to the same quarter the previous year. Volumes fell significantly below the European average to a total of €151 billion (US$147.2 billion).

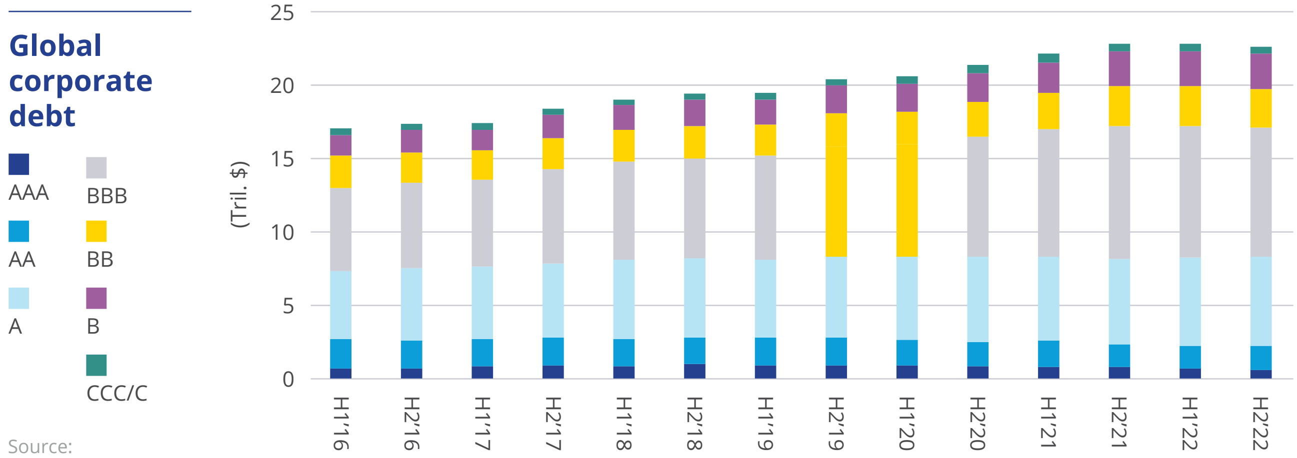
European corporate bond insurance



Source:
PwC

According to Fitch, bond and loan maturities will generally be relatively light throughout 2022 before increasing in 2023 and 2024. S&P Global meanwhile notes well-capitalised corporates have even been repaying maturing debt in order to avoid higher financing costs. As a result, global outstanding corporate debt declined by circa 1% over Q2 2022.

Global corporate debt

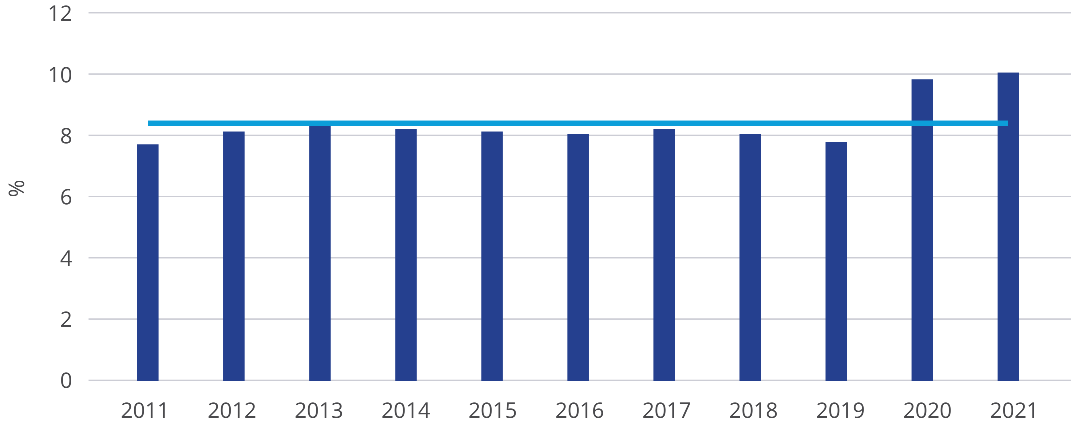


Source:
S&P Global Ratings Research

Corporate liquidity bolster

In line with lower credit issuance activity, European corporates increased holdings of cash and equivalents as a percentage of total assets in FY20 and FY21.

Average cash-to-asset by European non-financial corporates



Source: FactSet

On average, corporates increased their cash and equivalent holdings to 10% of their total assets. This exceeds the one-year average of 8.4% across all industries in Europe and demonstrates the need for liquidity as a preferred risk mitigation measure when the economy is expected to turn south.

Sustainability-linked and green bonds

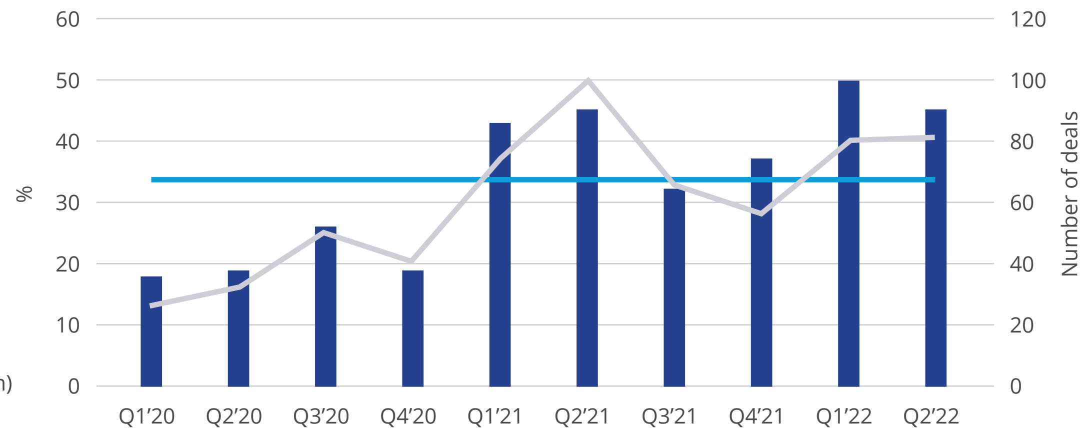
After a record quarter of around €50 billion raised in Q1 2022 via corporate bonds with a sustainability-linked or green element, issuance declined in Q2. However, while European corporate bond issuance dropped by 38% in Q2 2022, sustainability-linked and green bond issuance fell by only 12.5% compared to the same quarter of the previous year.

Corporate sustainable linked and green bond insurance in Europe

Volume (€bn)

Average Volume (€bn)

Number of deals



Source: PwC

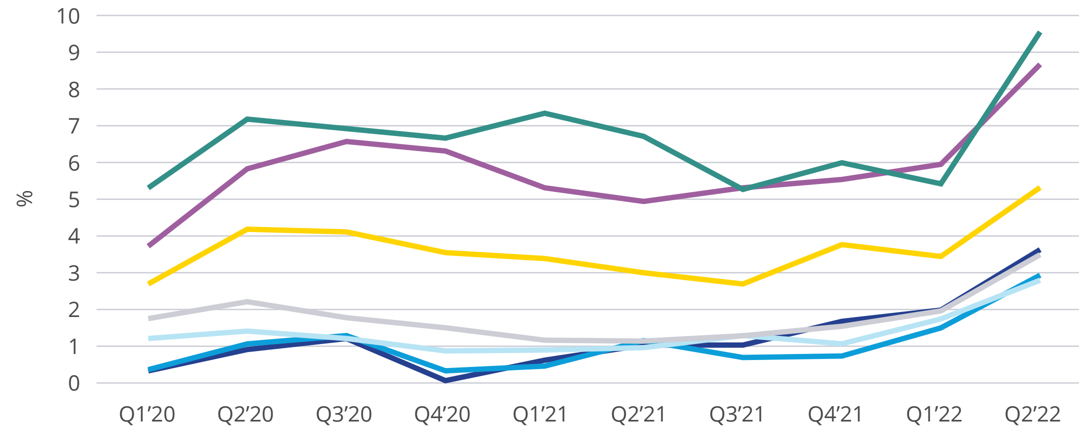
The number of deals stayed constant across the first half of 2022 even as volumes fell, evidence that the average ticket size per deal dropped in light of the economic uncertainty. The volume of European sustainability-linked and green bonds issued in Q2 2022 was still 35% above the two-year average of €33.4 billion per quarter. In May 2022, Netherlands-based utilities company TenneT issued the largest ever corporate green instrument, a four-tranche bond raising some €3.85 billion.

Rising bond yields across all ratings

Bond trading accelerated at the beginning of 2022, seeing sharp price appreciation across investment-grade and high-yield bonds. The average yield-to-maturity (YTM) increased by 230bps across all covenant levels.

European corporate bond yields

AAA
BBB
AA
BB
A
B
CCC



Source: FactSet

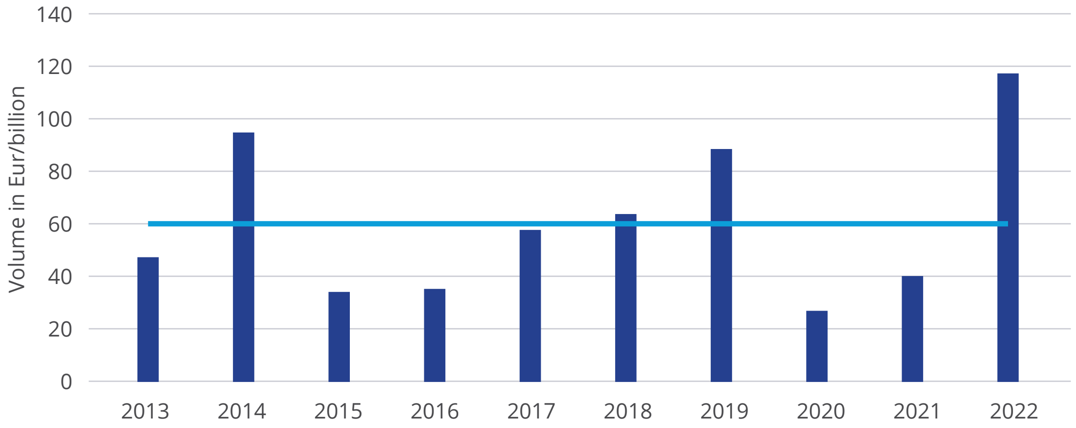
This increased cost of raising capital had been anticipated, and issuers have had to pay a premium to raise corporate debt in a rising interest rate environment and due to uncertainty in the market. Notably, the average YTM for AA-rated bonds nearly doubled from 1.46% in Q1 to 2.90% in Q2 2022.

As investor concerns about riskier assets and potential defaults increase, the average yield-to-maturity at issuance for BB-rated bonds climbed from 3.4% in Q1 to 5.28% in Q2 2022, and from 5.9% in Q1 to 8.6% in Q2 for B-rated bonds. Supply in the high-yield bond market continued to decline in Q2, reflected by another increase in the delta of issuance yield between BB- and B-rated from an average of 2.5% in Q1 2022 to 3.3% in Q2.

CDS activity doubles and prices soar

With rising corporate credit risk, Europe's trading volume in credit default swaps was the highest in August in 2022 in comparison to previous years.

Combined trading volume of iTraxx Europe and Crossover



iTraxx Europe and Crossover trading volume

Average

Source:
Bloomberg

Almost €120 billion of iTraxx Europe and Crossover index contracts changed hands in the first half of August, or almost double the 10-year average. Credit default swap indices returned to pandemic highs, illustrating the rising costs for investors to hedge against corporate defaults.

Allocation of corporate debt and the real estate connection

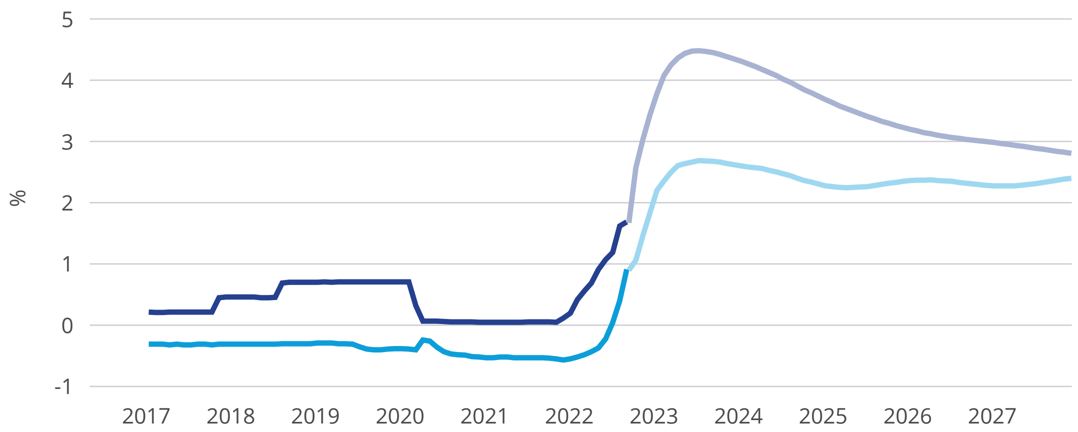
In a volatile environment real estate assets become a powerful tool for corporates to raise capital if the right structure is deployed. The key reasons why corporates raise capital usually relate to covering working capital expenses, business growth, including M&A, and marketing and capital expenditure. Typically, corporates spend a less significant amount on freehold real estate assets since capital will be tied up and leave the business with less flexibility as opposed to a lease.

Lenders are becoming increasingly selective about doing business across Europe, given market uncertainty and the possibility of a global recession. Commercial banks are stepping back from some corporate loan facilities and real estate projects, and alternative debt providers are finding more opportunities, especially in a rising interest rate environment. ESG is also now a key consideration for lenders looking to allocate capital, with low ESG-rated assets struggling to attract the right levels of liquidity.

From a real estate perspective, there is clearly a preference to finance existing buildings with well-capitalised long-term tenants, instead of providing development financing for new buildings. Factors such as rising commodity prices, supply chain disruption and soaring energy costs have an impact on the underwriting process and the risk lenders are willing to take on.

Base rates are increasing, and lenders are increasing their gross margins to make up for additional risk while reducing their loan size. SONIA and EURIBOR, the two base rates for most European-issued corporate and real estate loans, have increased significantly: the 3M EURIBOR reached positive territory over Q2 2022, while SONIA even soared above 1.5%.

Historic and projected SONIA and 3 months EURIBOR rates



SONIA

3M EURIBOR

SONIA projection

3M EURIBOR projection

Source:
Chatham Financial

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Alternatives closing the financing gap

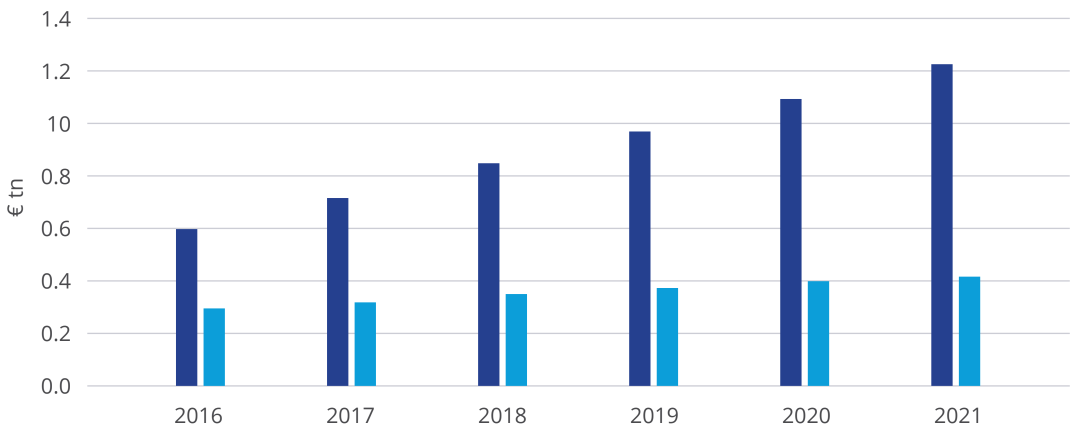
With rising uncertainty and banks becoming highly selective when underwriting loans, alternative lenders and loan structures are coming into vogue. This is certainly the case for corporate and real estate lending, given that private credit funds are still open for new transactions. Borrowers are prepared to pay higher margins to private debt lenders in exchange for the required loan size. The alternative lending space has expanded tremendously in recent years, as investors desperate for higher yields poured money into related funds.

Historic Private Debt by asset under management (AUM) in Europe and globally

Global private debt AUM

Europe private debt AUM

Source: Bloomberg



Europe-focused lenders had approximately €350 billion under management at the end of Q2, more than double the total in 2016. Despite the premium that private lenders charge, most borrowers are willing to pay for the peace of mind associated with knowing their financing will close when they require it.

Current and emerging strategies

Although we have seen yields increase since Q2 2022 due to a changing macroeconomic environment, they remain attractive from the real estate sales perspective, especially in the logistics asset class.

Yields remain relatively stable in logistics due to a shortage of investment product, and there is also a shortage in supply from an occupier point of view. This will exert upwards pressure on rental rates in the future, prompting investors to speculate on rent reversion.

In general, appetite among investors for new assets is robust as there is still sufficient capital available. The risk of upwards pressure on yields could be offset by rent reversion. This sustained appetite is fuelling a range of possibilities and considerations for corporates as they seek to develop, sell or capitalise on real estate assets, notably:

a | Buy vs Lease

Real estate can have a major impact on the performance of a company, whether a cutting-edge production or R&D facility, or an office designed to maximise collaboration and productivity. The more real estate meets the requirements of a company, the better the company will do.

Essentially there are two main options for a corporate seeking real estate: to buy a building or lease. In a buy-versus-lease analysis, from a cash perspective the acquisition costs, op-ex and cap-ex need to be modelled and compared in order to establish the cost-benefit analysis and break-even point. In a profit & loss analysis, the depreciation of the building should also be taken into account, as well as other key accounting implications where corporates seek to minimise any P&L volatility throughout the lifetime of the asset.

b | Build to Suit

There are many instances where there is no suitable building available at a preferred location that meets the corporate's needs. In this event a new building can be constructed, an option known as a 'build to suit.' Beyond finding the right plot of land, build to suit involves significant challenges and complexity. As corporate capital solutions advisors, we focus on a range of possible transaction structures and corresponding financing options. Some typical examples of these are outlined below, with variations based on:

Ownership	Freehold or leasehold
Development risk	e.g. Delays in delivery, costs exceeding budget
Funding / financing	Either self-financed, or via investors, lenders or a hybrid arrangement

	Ownership	Development risk	Financing / financing2
Self-build: The asset will be self-developed and held as a freehold for X years	Corporate – Freehold	Corporate[1]	Using balance sheet reserves or attracting debt from capital markets
Traditional lease: A newly constructed property will be leased as of the date of completion	Investor – Leasehold	Developer	Investor/ Developer
BTS Forward Purchase: The asset will be developed, but sold to an investor pre-completion and leased back for X years after completion	Investor – Leasehold	Developer[1]	Investor/ Developer
BTS Forward Funding – The asset will be developed, but sold to an investor that funds the construction. The corporate will pay a coupon throughout construction for construction financing, then a market yield on completion. It will be leased back for X years after completion. In this structure the corporate can realise a full off-balance-sheet outcome	Investor – Leasehold	Corporate/ Developer[1]	Investor/ Developer
Asset Leasing: The corporate enters into a X-year lease priced on their credit rating with a lender. This includes a residual value guarantee (RVG). At the end of the lease, the corporate has the option to (i) repurchase (ii) refinance or (iii) vacate the property. If the corporate decides to vacate, it will pay the difference between the terminal asset value and the originally agreed asset value and financing value, i.e. the principal amount	Lender – leasehold	Corporate/ Developer[1]	Lender
Credit Tenant Lease: The asset will be financed and fully amortised after X years, and loan pricing is based on the company's incremental borrowing rate	Lender – leasehold	Corporate/ Developer[1]	Lender

Other Considerations

A corporate can make the decision to either self develop or to partner with a developer. In this way it can offset the development risk, and requires less of its own resources to manage the development process. The lower risk profile of the transaction structure comes with a price: usually a so-called 'developer's margin' will be charged as a percentage over the total development budget.

Typically, there is a split between 'core-and-shell' (i.e. an empty building fitted out by the occupier) and 'fit-out' (buildings equipped with fittings and infrastructure that make them ready for use). As the fit-out does not belong to the property, meaning it cannot function as collateral, there is a limit on the amount that can be financed or funded. For instance, 20% of the loan/funding could be allocated to fit-out. The stronger the corporate's credit rating, the higher this limit can be set.

c | Sale and Leaseback

The sale and leaseback structure is already partly described within the build-to-suit options, where an investor funds the construction, and in return receives an annual rent for a defined leaseback period on completion of the project. The annual rent can be determined by adopting the required yield on the total development budget, also known as 'rentalising.'

It is also possible to sell and leaseback an existing property to unlock cash that can be used for other business activities. The theory behind this is that the return on equity (ROE) is higher than the costs that accompany the lease. For instance, if the yield that has been paid by an investor for the subject property is 6%, but the ROE of the corporate is 15%, then the spread is a 9% gain.

"In today's challenging market environment, sellers can leverage sale-leasebacks to bolster their balance sheet by paying down debt or to provide financial flexibility for future growth investments," notes Christopher Mertlitz, Head of European Investments, W. P. Carey, one of the largest diversified real estate investment trusts (REIT), with an enterprise value of approximately $25 billion.

If the leaseback period is >10 years and the EBITDA of the corporate is >€25 million, there will be appetite among what are known as 'net lease' or 'triple net' investors. These multi-billion-dollar international groups consider real estate to be a financial investment product, where the covenant strength and lease length are the two most important drivers behind pricing. Triple NNN or net lease means that all the costs that are applicable to the property belong to the tenant. It is the responsibility of the tenant to maintain the property.

In a shorter leaseback term (2-5 years), and if the property is almost at the end of its lifespan, all of the above is less important as the focus moves to the quality of the asset itself. In this case the (re)development potential of the site will be more attractive to developers.

Recent Examples

In 2022, W. P. Carey completed a €93 million sale-leaseback of a mission-critical food production and warehouse facility in Belgium. Totalling 174,000 sqm, the facility was triple-net leased to Greenyard, one of the largest suppliers of fruit and vegetables globally, and an existing tenant since 2016. The all-equity investment enabled the growing company to diversify its funding while solidifying its financial stability for the future by reinvesting the proceeds into higher-return growth initiatives aligned with the company's strategic plans.

Sale-leasebacks can be structured with any asset class, from core sectors such as industrial, retail and office, through to more specialised assets like recycling plants, fire stations, cinemas and schools. For example, Blackbrook Capital, launched in 2020, focuses on investing in supply chain infrastructure, from heavy and light industrial to logistics, point of sale and beyond into convenience retail and recycling.

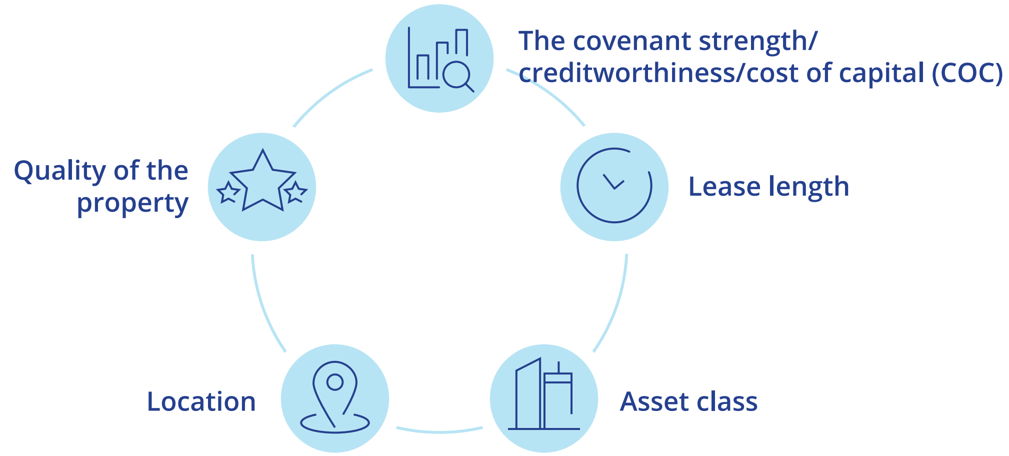
Capex, training or recruitment, R&D, reduction of debt or accretive M&A are examples of ways in which capital unlocked via sale and leasebacks can be re-deployed, according to LCN Capital, a leader in the sale-leaseback and BTS markets. The end result, it argues, is a long-term partnership between the business and the financier, as the transaction effectively only changes the business's means of ownership of the asset, not its ongoing operational access to the asset or use case.

W. P. Carey points out that compared to the U.S. sale-leaseback market, awareness and general acceptance of the model is still growing in Europe. This is part of the reason why European deal volume still trails the U.S. market, though the ease with which transactions can be executed is also a factor. In some larger markets such as the UK, Germany and France, the sale-leaseback is more established and culturally accepted, which in turn drives volume.

The question Blackbrook poses is as follows: If a company is not in the real estate investment business, does it really make sense to have massive amounts of capital tied up in real estate assets? However, Blackbrook cautions that sale-leasebacks must be done in a sustainable manner, which means ensuring at an asset level there is sufficient rent coverage. This creates enough of a cushion for economic shocks, which over the course of a long lease could otherwise make an asset unsustainable for the business.

Another issue to keep in mind is that from a P&L perspective, sale and leaseback creates a lease liability on the balance sheet for the corporate.

The price/yield that will be paid by an investor is mainly driven by the combination of:



In summary, sale and leaseback is a well-established, favourable structure to unlock cash from an existing property or attract funding for a BTS property. In a rising interest rate environment, it provides predictable accounting impact and significant liquidity compared to the corporate credit markets. Specifically for sub-investment grade organisations, it enables corporates to unlock cost-effective capital tied up in their real estate portfolios, to be allocated to higher cash-generating purposes linked to the core business, balance sheet deleveraging or growth strategies such as strategic M&A.

For higher quality credit organisations, the financing options expand from sale and leaseback to alternatives such as asset leasing and credit tenant lease (CTL) structures, which maximise ROE compared to holding ownership of real estate. Our Corporate Solutions team specialises in such alternative means to finance real estate investment and development.

Credit Tenant Lease

A CTL is a method of financing real estate in which the landlord borrows money to finance the development or purchase of a property, and pledges as security the rents to be received from the tenant and a mortgage on the property.

Unlike a typical commercial real estate loan, which is underwritten and sized based on the property value, CTLs are sized based on the underlying lessee's credit rating (minimum of BBB- and higher), lease structure and rental payments. The key benefit of CTLs is that they are treated as a bond of the tenant (corporate), rather than being priced on the real estate, and consequently can often be a considerably cheaper source of long-term funding. They can also provide up to 100% funding (LTV) for an acquisition or development opportunity.

Asset Leasing

Another option is an asset leasing structure. In this case the company enters into a long lease (e.g. 10-15 years) priced on their credit including a residual value guarantee. At the end of the term, the company has three options: (1) renew the lease; (2) re-purchase the asset; or (3) vacate the building. The key accounting benefit of this strategy is that it allows the seller to recognise a lower day-one liability balance given the reduced run rate. It also allows the company to realise part of the equity upside when the stake is sold or the structure is terminated.

> *In today's challenging market environment, sellers can leverage sale-leasebacks to bolster their balance sheet by paying down debt or to provide financial flexibility for future growth investments.*
> ***Christopher Mertlitz – WP Carey***

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III

Exploring real estate M&A and REITs

Dealmaking activity in the real estate sector will remain robust as investors work to deploy capital and unleash portfolio value.

The first half of 2022 saw an increase of M&A activity in the real estate sector due to a mix of pent-up demand, renewed confidence in the market and difficulties in sourcing direct investment opportunities at scale. Leading law firm Allen & Overy suggests the value of global real estate M&A deals hit US$236 billion across 1,642 transactions in the first half of the year – the best start to the year in over a decade - and real estate transactions accounted for over 10% of all global deals by value in the first half of the year.

M&A transactions typically offer a variety of benefits to the parties involved, including economies of scale, enhanced distribution, increased market share and ultimately value creation. A key driver of M&A activity this year has been further consolidation within the publicly traded REIT market. In Germany, Europe's largest real estate merger recently saw Vonovia take over Deutsche Wohnen for around €19 billion, while in the UK LXI REIT merged with Secure Income REIT to create a long income portfolio to the tune of £3.9 billion (US$4.3 billion).

Due to a build-up of capital from the pandemic, large-scale investment funds have also been entering the M&A market more frequently as a means to access long income real estate assets. Some of the most prominent transactions seen this year include:

Brookfield's acquisition of Hibernia REIT for €1.1 billion

Ares Management Corporation's acquisition of US car dealership specialist Capital Automotive for $3.8 billion

Blackstone's acquisition of American Campus Communities for $13 billion

We have also seen real estate M&A in sectors that are more bespoke and less established. By acquiring a business platform, investors can both unlock the income potential of real estate assets and also gain the knowledge and skills necessary to run new operations, and improve efficiencies and overall return from their real estate portfolio. A prime example of this is Brookfield's acquisition of Arlington, a UK science, innovation, and technology real estate platform, for £714 million last year. Brookfield has been able to tap the experience of the Arlington asset management team while also leveraging its own global relationships and development expertise to further build out centres of excellence.

In doing so, professionals can be best placed to extract maximum value post acquisition and assist in the down-payment of debt taken on to acquire the business. This may include advising on how to minimize the company's leasehold liabilities, right-sizing the portfolio for future operational needs and identifying workplace strategies to maximize efficiencies. However, perhaps the most valuable real estate opportunity in relation to raising funds for M&A activity, is the strategy around a company's freehold portfolio.

As an example, our analysis of the ASDA portfolio, pursuant to the £6.8 billion acquisition by the Issa brothers and TDR Capital, revealed an estimated freehold portfolio value of over £3.0 billion. Following completion of the corporate acquisition, the new owners completed the successful sale and leaseback of the real estate portfolio, which provided the capital to contribute to the repayment of corporate debt used to fund the M&A.

> *"Perhaps the most important area in relation to raising funds for M&A activity is the strategies around a company's freehold portfolio.*

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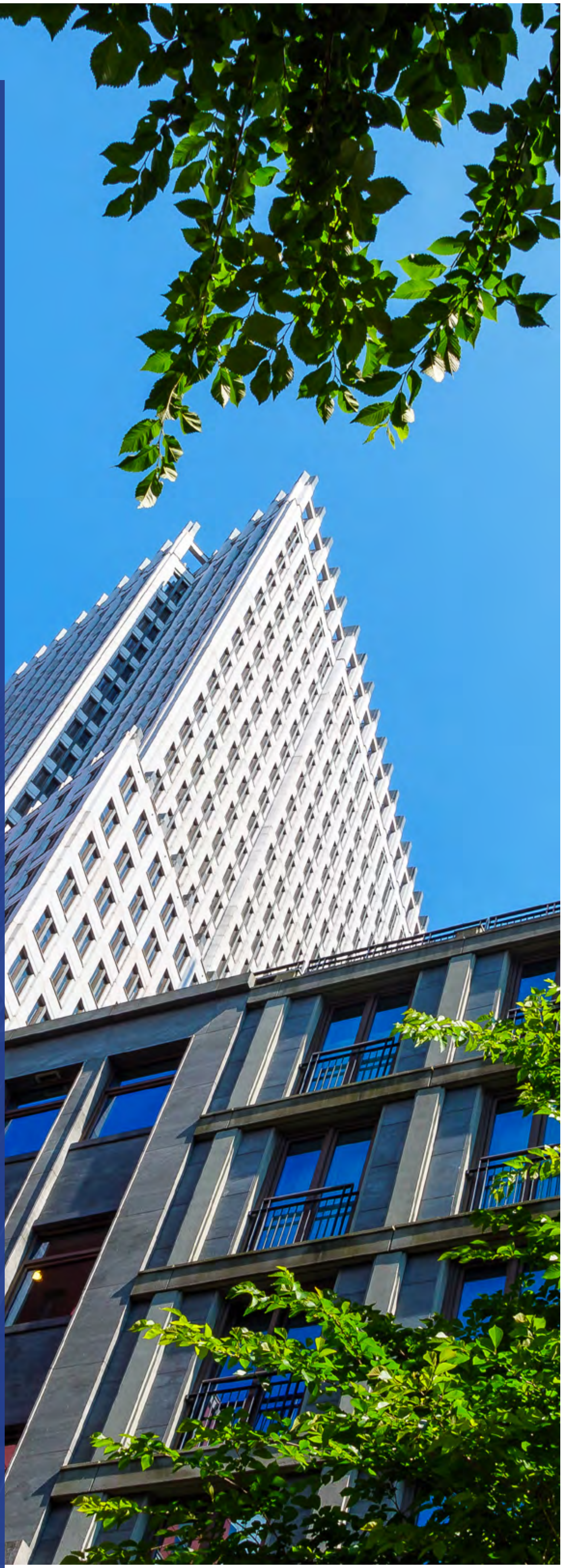
IV

Sustainability and real estate financing

Green credentials have clear potential to drive opportunities and enhance the value of assets as sustainability considerations become top of mind for investors and occupiers.



Throughout the commercial real estate sector, we are witnessing investors, advisors and occupiers elevating ESG on their agendas. Recent political and economic events have accelerated this, with rising energy costs further incentivising landlords and tenants to re-evaluate their strategies. We anticipate that the determination of both tenants and investors to reduce their carbon footprints and achieve sustainability goals is likely to lead to greater interest in green buildings, and related financing opportunities.

Green leasing

As companies take measures to cut carbon, green leases are proving an increasingly attractive tool to track and drive progress on ESG metrics. By incorporating green clauses, landlords and tenants can work collaboratively to elevate the sustainability of a building.

For corporates, this collaborative approach contributes to improved energy efficiency and reduced costs. Additionally, it helps compliance with corporate social responsibility (CSR) and statutory requirements to report on environmental matters. On the other side of the equation, investors are seeking tenants who are conscious of sustainability and engaged with their carbon footprints.

Asset value preservation

From our work with occupiers and investors, we have observed an increased focus on sustainable buildings, particularly for forward funding build-to-suit developments. Whilst each group has different financial objectives, with investors seeking value preservation and occupiers focused on reducing operating costs, they share the goal of meeting ESG targets. As a result, there is common ground for both parties to ensure the development is more sustainable.

Sustainability credentials are also important for sale and leaseback transactions where the tenant operates under a triple net structure. Although unlikely to substantially impact returns during a lease, these credentials can influence exit yields and the worst-case scenario. The sustainability credentials of the building can play a crucial role in preserving value and mitigate future risk.

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Investors can allocate funds to sustainable real estate, both in terms of construction financing as well as long term sale and leasebacks. In recent years, we have witnessed investors implementing innovative approaches to finance transactions, including green loan frameworks which aim to incentivise borrowers to continue striving to make sustainability improvements to their portfolios.

Over the past 24 months, we have noted a deeper focus on sustainability information being requested in the pre-acquisition stage of transactions. Furthermore, although the sustainability characteristics of real estate are important, many investors are also focused on the occupier's ESG credentials from a business perspective. This is particularly apparent for transactions that involve long lease commitments, as investors want to be associated with tenants that emphasise the importance of ESG. To meet the needs of investors, we now include an enhanced level of sustainability and ESG sections in our information memorandums as a matter of course.

The outlook for sustainability

Looking ahead, navigating the fast-moving ESG space will be a challenge for investors and occupiers alike. There is clear demand for global standards in this area, with a key challenge being the social element given every country has cultural differences.

Investors are increasingly conscious of the need to protect the value of real assets against the relentless march of both regulation and consumer demand for greener solutions, and are allocating accordingly. Some are also driven by self-imposed targets or see an opportunity to attract green finance.

In capital markets, players continue to strive to identify the percentage increase in value for buildings with green credentials. Colliers and W. P. Carey recently completed a €25 million build-to-suit forward funding transaction involving development of a state-of-the-art food research facility for a leading producer of plant-based spreads. Located in the Netherlands, the facility will receive a BREEAM 'outstanding' environmental rating – the highest level of certification. Research suggests that indeed there is an uplift to value for having green certification such as BREEAM or LEED.

However, there is also evidence that the greatest risk to asset value preservation is the risk of discounts rather than premiums. As we face increasing debt costs and reduced credit liquidity for low ESG-rated assets, it will be interesting to see whether sustainability and ESG remains or increases as a key part of investors' criteria, and if it is a driver for decisions or left behind as investors seek returns first and foremost. That said while in the past they might have been separate considerations, sustainability and financial performance are increasingly interlinked, and therefore we expect sustainability to stay an important metric in key investment decisions.

> *investors want to be associated with tenants that emphasise the importance of ESG.*

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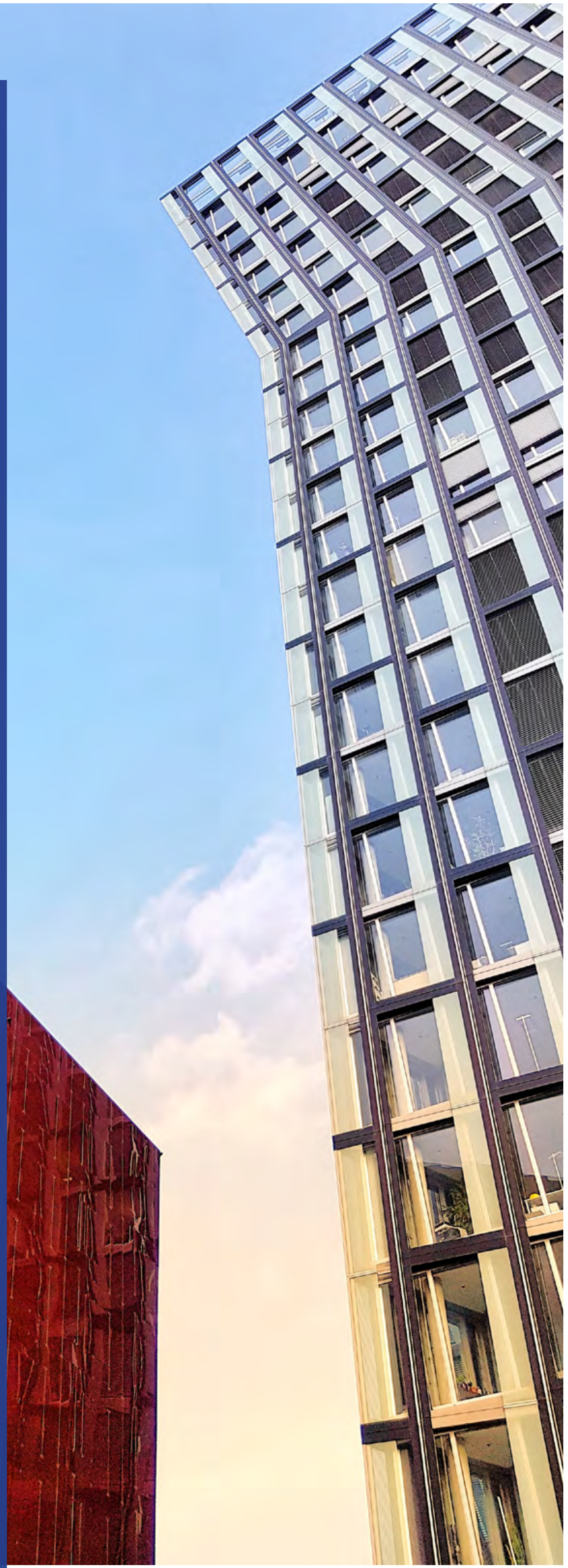
V

Accounting implications

Innovative financial structures like sale and leaseback can have positive balance sheet implications, but need to be pursued with caution.



Mechanisms like sale and leaseback have become a prominent solution for corporates to raise cash to facilitate growth objectives or service debt maturities. Holding an asset on a leaseback basis can provide the access to and use of a property without tying up significant capital. Leases are also more flexible, allowing lessees to mitigate obsolescence and residual value risk.

The accounting impact of leases has changed substantially over the years, particularly since the adoption of IFRS16 lease accounting. Lessees must now recognise on their balance sheet: (i) a right-of-use (ROU) asset; and (ii) a corresponding lease liability. This flows through the income statement through interest on the lease liability and depreciation on the ROU asset on a straight-line basis. This approach 'frontloads' the total lease expense in the income statement as the interest expense is degressive – that is, there's a larger interest cost upfront on the unamortised lease liability.

Both real-estate sale and leaseback and traditional corporate debt raising increase the size of the balance sheet, but why would a company prefer a sale and leaseback option?

Firstly, sale and leasebacks involve the straight sale of an asset and no debt is recognised on the balance sheet. Corporates that raise capital through debt such as a bond issuance must recognise a significant debt liability on their balance sheet. This detrimentally impacts their debt-to-equity ratio, a significant solvency metric that is often in the spotlight for investors. Indeed, some bond issuances and alternative financing arrangements have onerous conditions such as minimum interest coverage ratios and debt servicing ratios that must be adhered to in order to avoid default. This can hinder a company's flexibility to make structural changes.

In a sale and leaseback structure, the lease liability decreases over the life of the lease, which has further positive implications for corporates that would like to reduce the size of their balance sheet. In contrast, a typical bond issuance is a long-term liability that remains on the balance sheet until it matures.

There are also numerous cash advantages that sale and leasebacks offer as a means for raising capital:

- Depending on a company's credit quality, a sale and leaseback can offer a lower cost of capital than public debt markets
- Depending on the jurisdiction, the tax treatment of interest and lease payments may be different and beneficial to both parties of a sale and leaseback agreement
- Lease payments are not impacted by interest rate changes and can therefore be more predictable than variable rate debt

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VI

Recommendations

As this report makes clear, even in periods of market stress, there are a range of capital-raising mechanisms connected to real estate that are not just worth exploring but that have potentially become even more viable and attractive, for corporates and investors alike.

Of these options, sale and leaseback is emerging as the preferred strategy of choice in the current economic climate. Yet the complexity that can accompany these transactions, as well as the fact that for many corporates they're relatively unknown territory, requires a clear understanding of the risk issues and benefits of such structures. We advise any organisation considering accessing the capital markets in such a fashion to adopt the following strategies:

Keep a keen eye on market conditions. The current period of volatility is likely to persist until at least the second half of 2023, and as we have noted could be prolonged by factors like the interest rate trajectory or commodity shocks. This means any analysis of a capital-raising exercise should take in a range of scenarios, from best to worst case, and map out the consequent impacts on viability and the corporate balance sheet.

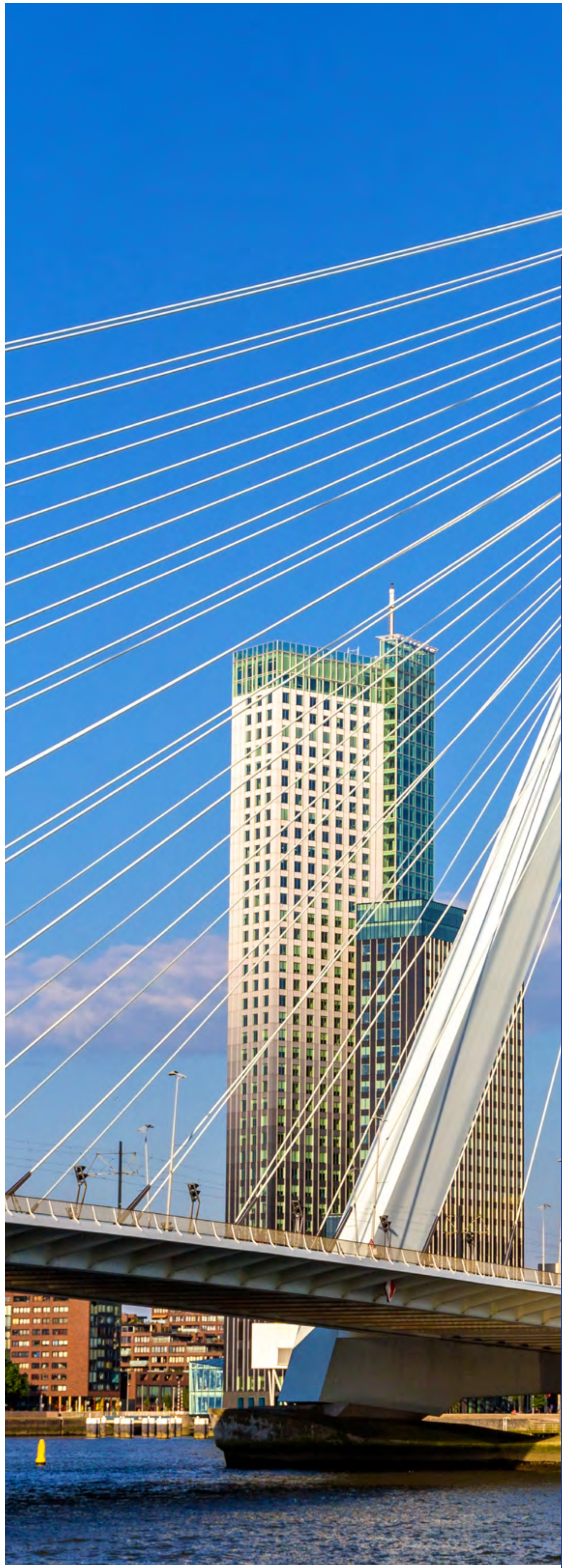
Evaluate the full range of capital-raising options. With traditional lenders growing more risk averse and bond issuance looking less attractive, corporates should consider alternative financing structures, especially as many funds and private investors have capital they are mandated to deploy to real estate. While such arrangements can be more intricate or complex to structure, in an uncertain environment they often offer better terms, reduced volatility and increased predictability for both sides.

Consider real estate's role in the organisation, and how it can support business strategies. While many companies own or develop real estate for their own purposes, the majority of corporate occupiers are not in the real estate business. Depending on an organisation's goals and priorities, capital tied up in real estate assets can often be more effectively deployed towards the priorities of the core business, whether to provide operational leeway in a downturn or power an M&A-driven expansion. Partnering with lenders and investors keen on exploring real asset opportunities can make more strategic sense for the organisation than bearing the real estate burden alone.

Strive to identify sustainability opportunities. For performance, regulatory and reputational reasons, investor appetite for sustainable assets is set to remain voracious even in tighter economic conditions. Companies with sustainable buildings in their property portfolio, or aiming to develop or upgrade real estate assets along sustainability lines, are therefore likely to find no shortage of potential investors or partners when seeking to raise funding, will often be able to command more favourable terms and may have access to a broader range of financial instruments.

When looking to leverage real estate assets, choose the right model. This report has outlined several options for corporates aiming to explore real estate-linked financing, from forward purchase and funding agreements to straight forward leasing partnerships with developers. Each of these structures comes with its own reward and risk dynamics, and it's important to identify the structure that's optimal for the organisation's specific financial and operational objectives. Given the current market dynamics sale and leaseback strategies are emerging as the preferred solution for many corporates, particularly sub investment-grade organisations seeking to strengthen balance sheets.

Seek help from the specialists. Given the complexity of structures like sale and leaseback, and the need and opportunity to tailor these structures to specific requirements, informed and independent input on the best funding options available to the organisation, and assistance structuring and executing these transactions is all but essential.



The Colliers advantage

Real estate-linked financing is a field in which Colliers Corporate Capital Solutions has deep experience, and the current unsettled market conditions present an opportunity for our team to leverage its expertise to assist companies accessing capital. A company may have substantial amounts of equity tied up on the balance sheet in real estate assets that, if managed correctly, could be utilised in capital markets to generate liquidity that could then be invested back into core operations, or in the growth of the company through M&A to generate higher returns.

In addition to traditional sale and leasebacks, we have also explored alternative real estate structures that can maximise the potential of under-utilised equity through bespoke financing mechanisms involving advanced lease accounting strategies and analysis.

These are just some examples of the innovative mechanisms and transactions we have helped structure and execute to support the goals of our corporate and investor clients. For more information on alternative financing mechanisms and opportunities to unlock capital, contact us.

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