How 3PLs Can Capitalize on the Hot Real Estate Market

By Benjamin Gordon and Arash Farin

 

What do APL Logistics, USCO Logistics, Exel, Atlas Cold Storage, and Eagle Global Logistics have in common? These companies have either created tremendous value for shareholders, reduced debt levels, or fueled strategic growth by taking advantage of high real estate valuations and partnering with real estate investors.

Of course, real estate has recently fueled numerous value added transactions across corporate America, perhaps best exemplified by the significant value unlocked through real estate sales by Eddie Lampert as he combined Kmart and Sears. Similarly, real estate values attracted private equity players to Toys 'R' Us Inc. and was a primary factor behind Cerberus Management LP's 2003 acquisition of discount chain Mervyn's. These transactions, and the preeminent role real estate enjoys in the business world, have direct implications for the third party logistics (3PL) sector. Given the tremendous price appreciation in industrial properties, they exemplify creative ways for companies to unlock hidden value.

Indeed, in the industrial sector, median sales prices have jumped 29% since 2000, growing from approximately $54/SF to approximately $70/SF. Likewise, since 2000, cap rates among all property types have hurtled downward, including suburban and central business district ("CBD") office buildings, industrial, retail, and multi-family. An overabundance of liquidity in the marketplace, a favorable interest rate environment, and a lack of investment alternatives among other asset classes, have fueled a record number of real estate transactions and put tremendous downward pressure on cap rates. These trends have helped the real estate sector outperform many alternative asset classes, including US government bonds, the S&P 500, NASDAQ, and the Russell 2000, in terms of both income and appreciation. The strength of the real estate market should heavily factor into any 3PL's long-term planning as it evaluates its strategies for growth, financing, and monetization of assets.

The Hot Industrial Real Estate Market

The industrial real estate market has experienced strong improvement in its fundamentals, leading to high investor demand for this property type. Since 2002, annual construction volumes have been below the historical average of about 100 million SF/year, leading to healthy increases in net absorption. Major transportation hubs, such as the Inland Empire in California, Chicago, Dallas/Ft. Worth, Los Angeles, and Atlanta are expected to experience the highest absorption in 2005. In addition, vacancy rates have declined and are especially low in major metropolitan centers such as Los Angeles, New York, Orange County, the Inland Empire, and New Jersey. In addition, cities with above-average job growth, such as Las Vegas, Phoenix, Orlando, and Nashville have seen drops in vacancy rates of more than 100 bps in the last year. Not surprisingly, the industrial markets have also witnessed rental rate growth, which has been especially strong in port cities such as Baltimore, Miami, West Palm Beach, Tampa, and San Diego.

These strong fundamentals have helped fuel record activity in the capital markets. The number of transactions in 2005 is expected to reach 8,500, 57% higher than the approximately 5,426 transactions logged in 2000. In fact, as of June 15, 2005, about $10.8 billion has been spent on industrial properties, an increase of 45% over the same time period last year (over the past year, transaction volume has been between about $5 - $6 billion each quarter). This frenzied pace has also helped drive down industrial cap rates, which are now below 8% as compared to over 9% in the third quarter of 2002.

Many companies have taken advantage of this environment through sale/leaseback transactions, which allow them to unlock the value of their real estate portfolio and free up cash. Sale/leasebacks entail the sale of industrial properties to various buyers and simultaneously leasing back the space from the new buyer. Some recent examples of sale/leasebacks include Lockheed Martin (736,000 SF), Mercedes-Benz (185,000 SF), Motorola (382,000 SF), Ross Stores (527,000 SF), and Xerox (101,000 SF). Although large-scale transactions usually capture the headlines, the truth is that these transactions are primarily the result of small- to medium-sized companies raising cash for expansion. Although these offerings mostly involve non-credit tenants, they have been highly popular among 1031 buyers who are deferring taxes.

It is important to note that, while large scale transactions continually occur in the industrial market, approximately 90% of all transactions and approximately 50% of total dollar volume is comprised of transactions less than $5 million. This is particularly important for middle market 3PLs, which may not have extremely large real estate portfolios, or may not own larger assets with values far in excess of $5 million. Also of relevance to 3PLs is the increasing importance of secondary and tertiary markets, which have garnered increasing interest among private REITs and tenant-in-common buyers ("TICs"), which syndicate large transactions among retail investors seeking to invest large sums of money, but mitigate downside risk by sharing it with others. Properties in secondary and tertiary markets have also attracted institutional buyers, given above average yields, although TIC buyers are also competing more and more with REITs and institutions in primary markets as well.

Recent Examples

A number of 3PLs have decided to pursue sale/leasebacks or other off-balance sheet techniques for various operational or financial reasons. For example, in September 2005, Atlas Cold Storage, which runs the largest public refrigerated warehouse network in Canada and the second largest in North America, sold two properties to Summit REIT to pay down debt, make improvements in operations, and to use the company's assets more effectively to restore distributions to unitholders. Importantly, Atlas is also planning to expand its network of facilities, and believes selling assets and pursuing sale/leasebacks would allow the company to redeploy the proceeds in new opportunities where adequate returns to unitholders can be found. This transaction was attractive to Atlas since the reduction in interest costs resulting from the debt paydown and reduced capital expenditures were expected to exceed the reduction in operating earnings. In addition, the lower debt levels will improve the company's ability to refinance the remaining debt at lower interest rates. The proceeds from the sale were about equal to 10 times EBITDA.

Other examples concern First Industrial, a leading industrial REIT, which recognized a growing trend among logistics companies seeking to maximize operating efficiencies. First Industrial has, for example, completed build-to-suits for USCO Logistics and Eagle Global Logistics, signaling another way for 3PLs to enhance operations by reducing their real estate exposure and using capital more efficiently.

In addition, First Industrial has built, leased and purchased real estate for GATX Logistics (purchased by APL Logistics in January 2001) since 1994. Since GATX prefers a leasing platform, they have been able to team up with First Industrial to negotiate long-term sale/leasebacks of various properties rather than having to spend capital on non-desirable assets. In one instance, GATX assigned its purchase rights to First Industrial in exchange for a 15-year lease, in a transaction that netted GATX more than $1 million.

Another example involves First Industrial assisting Exel, a global leader in supply chain management, in adding significant new space to its operations in Harrisburg, PA. Freuhauf Trailer was selling a sizable redevelopment property which First Industrial purchased, renovated, and leased back to Exel for a very low rent. It included three buildings totaling 775,000 SF, and 100 undeveloped acres. Exel was thus able to have First Industrial modify the buildings to serve as Excel's distribution facilities for various clients, including Lipton, Exel's largest account, and retain valuable capital to utilize on operations.

How to Capitalize

3PLs today should begin to think about the best way to take advantage of the hot industrial market and possibly sell assets while investors are still clamoring for industrial facilities. As they weigh this important strategic decision, 3PLs must give careful thought to the impact on real cash flow. Historically, 3PLs have looked at their operating company as a revenue source to cover their debt service, typically in the form of a commercial mortgage. Given the recent upward trend in real estate valuations, a significant percentage of the company's value may be tied up in its real estate.

If a company enters into a sale/leaseback transaction, although there is an immediate cash infusion, there is now a landlord in the picture, with lease payments impacting the income statement and profitability. Of course, 3PLs will have to evaluate the trade-off between selling assets now and locking in attractive valuations, or potentially waiting for even lower cap rates and more favorable conditions. However, the analysis is not binary; a company also needs to consider whether there is enough cash flow to assume market rental rates and factor in other criteria investors seek before paying top dollar. Moreover, unless the initial purchase of the property was very recent, the underlying cost basis and debt service levels may be significantly lower than market rental rates. Therefore, one must also evaluate whether the operating company generates enough cash flow to meet the new market rental rates and leave a viable operating entity intact. *The key is to balance the twin and competing goals of maximizing the real estate valuations while maintaining sufficient cash flow and strong growth prospects, for the company to continue operating and prospering into the future.*

It's also helpful for managers of 3PLs to have a keen awareness of what buyers look for and the types of buyers which are most active. There are five key factors to be considered in evaluating industrial properties: asset quality, lease term, tenant quality, location, and replacement cost:

- **Asset Quality:** Customarily classified as "A", "B" or "C" products, Class "A" properties, which typically feature high clearance, excellent truck access, high quality sprinkler systems and good divisibility, will be valued 10-40% higher than "B" and "C" buildings.

- **Lease Term:** A ten+ year lease term will generally have a cap rate that is 25-50 basis points lower than a five-year lease. Additionally, most landlords would prefer staggered lease terms to prevent a large amount of space rolling over in any given year.

- **Tenant Quality:** A credit tenant (S&P Rating of BBB or better) with at least a five-year lease term will typically have a cap rate 25-100 basis points less than a non-credit tenant. Additionally, a tenant can use any number of credit enhancements, such as a letter of credit, higher security deposit, or guarantee, to provide additional comfort to the landlord regarding future rental payments. Landlords may also check a tenant's payment history to evaluate a tenant's likelihood of default. This can be just as important as a tenant's credit, since financial statements may not completely reflect the true underlying strength of a particular tenant who is not as well known in the market.

- **Location:** Buyers prefer major markets with stable market conditions. Primary markets such as Los Angeles, Chicago, and Atlanta usually command value premiums reflecting cap rates that are 50-100 basis points lower than secondary markets.

- **Replacement Cost:** Class "A" buildings with credit tenants in primary markets will typically trade at or slightly above replacement cost. Replacement cost serves as a "governor" for Class "A" properties but has less of an impact for Class "B" and "C" properties, which generally sell well below replacement cost.

There are also a variety of buyers in the marketplace, each of whom seek different criteria and have differing return thresholds.

- **Pension Funds Insurance Companies and REITS (Institutional Group):** This group will usually pay the most for Class "A" assets in primary markets. Pension funds are generally looking for newer, tilt-up or pre-cast facilities in primary or secondary markets with average remaining lease terms of 5-7 years with limited vacancy or rollover. This buyer pool is also the most knowledgeable and reliable of all buyer groups.

- **Tenant-In-Common ("TIC") Buyers and Syndicators:** The TIC and syndicator models are meeting the needs of the individual investor by aggregating capital and primarily buying commercial assets with long leases. As it becomes increasingly difficult to purchase quality assets in primary markets, this group is starting to buy quality industrial properties in secondary markets and is paying higher prices than institutional buyers.

- **Logistics Companies:** Logistics companies may be logical buyers of real estate portfolios if they already own portfolios of their own and may seek opportunities for cross-selling its existing customers into new geographies.

- **Private Investors and Developers:** With favorable debt capital markets, many are outbidding pension fund advisors with creative financial engineering; as such, their pricing is generally driven by financing terms and they are more flexible on construction quality and secondary markets.

- **Opportunity Funds:** These funds target mid-to-high teen leveraged returns and, unless the portfolio is ripe for a value-added buyer, opportunity funds are unlikely buyers.

Taking the First Step

With extremely favorable market conditions and strong price appreciation for industrial properties, 3PLs should begin factoring their real estate into their strategic planning. If the intention is to grow the operating company, either organically or through acquisitions, freeing up cash on the balance sheet by selling real estate is an excellent way to take advantage of very low cap rates and re-deploy that capital into more productive uses core to the 3PL business. On the other hand, if a 3PL is possibly considering positioning the company for sale, other important choices will have to be made. Sequencing, for example, will be a critical component, as a 3PL would have to determine the trade-offs inherent in selling the real estate and the operating company as an integrated process or launching two simultaneous processes to two separate audiences, or even selling the real estate first. Coordinating dual processes, however, can encourage strategic buyers to pay premium prices for both the operating company and the real estate in order to effectively compete with pure play real estate buyers. No matter what a 3PL's growth plans may be, the real estate strategy should be playing an ever increasing role, and can serve as a platform for effective growth in other core areas of a 3PL's logistics business.

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