


GOVERNMENTS TURN TO PROPERTY SALES?

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OVERVIEW

The credit crunch, banking crisis and recession are all placing strains on public sector finances across Europe and beyond. Bank bailouts have raised the level of public debt at a time when many governments face falling tax revenues and rising expenditure on social welfare programmes. This is already encouraging governments to consider disposals of surplus property assets, whilst sale and leasebacks on operational real estate could currently prove attractive to risk-averse equity investors.

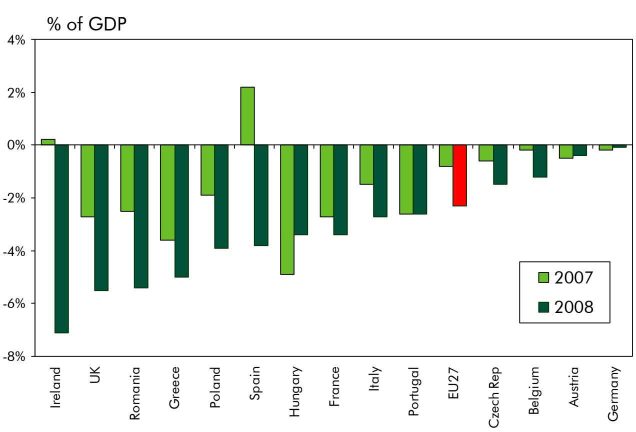
The recent decision by the UK government to sell up to £20 billion of commercial property and related assets over the next couple of years could be just one of many such announcements around the world over the coming twelve months. Most governments are seeing a deterioration of their public finances as they battle with the impact of the recession and the banking crisis. With concerns being expressed about the depth of investor appetite for government bonds, selling off real estate would be one way of raising much needed capital. In the current market, with investor demand for vacant property likely to be limited and prices at low levels relative to historic norms, sales of surplus property will be harder to achieve. However, sale and leasebacks of good quality occupied stock would be attractive to investors whilst also raising substantial amounts for governments, as many have discovered in recent years.

As we have noted in previous reports, the recent history of the "sale and leaseback" market in Europe has been one of very rapid growth. In 2004, the market totalled just €6.7 billion and was highly dependent on a small number of large deals. By 2007 the total had risen to €46 billion and comprised more than 670 separate transactions, boosting the contribution of occupier real estate disposals (including both government and corporate sales) from 6% of the European investment market in 2004 to nearly 20% in 2007. In part this growth was due to "inflation", driven by rising property values. However, in 2008 - a year of much reduced investment turnover and a fall of around 13% in average commercial property values - sale and leasebacks still totalled over €22 billion and maintained their 19% share of the total investment market.

Over the course of the last five years, activity has spread into most European countries and across all sectors of real estate. Whilst activity has been strongest in the UK and Germany, other countries including France, Spain and Italy have also recorded very significant levels of transactions. For corporate occupiers, the motivations for deals are likely to have changed somewhat in the last 18 months. Price was rarely the principal driver of such deals, even at the top of the market; however, it is likely that for at least some occupiers the decline in property values has made such transactions less attractive.

That said, in selling real estate most companies are looking to raise capital to invest in the business, and hence the price available for the property asset is usually not the main factor in the decision. For corporates, the more important comparison is with their opportunity or actual cost of capital.

Fig 1 Public Sector Deficit



Source: Eurostat

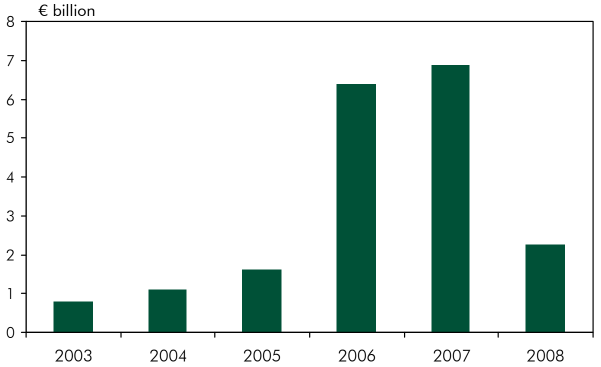
Note: Netherlands and the Nordic countries had a surplus in 2008

The credit crunch has raised the cost, and greatly restricted the availability, of conventional forms of debt finance and as a by-product, forced companies to consider other forms of capital-raising. Far from being detrimental to corporates' desires to pursue sale and leaseback transactions, therefore, the current financial environment may actually enhance it. The evidence clearly suggests that the motive still exists on the part of many occupiers to undertake these transactions.

Of course, an equally significant issue is whether there is sufficient investor demand in the current environment. From the buyer's perspective, sale and leasebacks remain relatively attractive investment propositions. Leases will typically be longer than in the wider investment market, giving the investment a more stable, bond-like performance. The lease obligations in sale and leaseback transactions are often backed by strong covenants, although in many cases the investor will be exposed to a single undiversified credit risk. In general, such investment characteristics are attractive to long-term, equity-based investors, just the type that are most likely to remain active in current financial conditions.

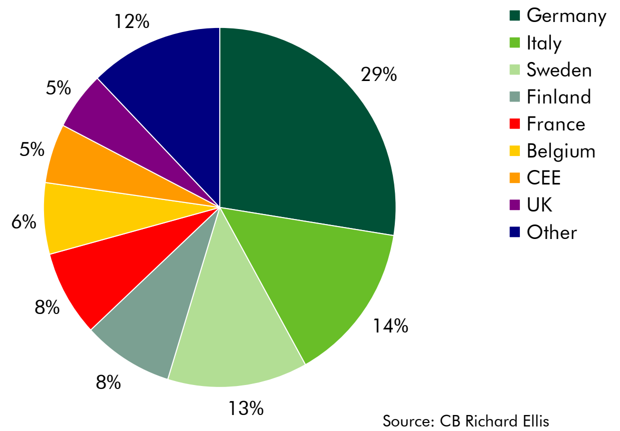
In fact, this is where governments may be able to take advantage of current conditions. Investors remain highly risk averse at present, with demand mainly focused on prime property in liquid, transparent markets. To be attractive, buildings need to have a long, secure income stream from a top quality covenant: exactly what public authorities can offer. For investors who fear the prospect of rising government bond yields and/or a higher level of inflation in the years ahead, a building let to the state on a long lease could represent an attractive form of index-linked government bond, with the benefit of owning a real asset at the end of the lease.

Fig 2 Property Sales by European Governments



Source: CB Richard Ellis

Fig 3 Government Property Sales, 2006-8 (€16 bn)



Source: CB Richard Ellis

Germany has seen some of the most significant government sales in recent years, not least the major portfolio sale and leasebacks by the State of Hesse. However, several more recent sales have been less successful, either because of market conditions or because the quality of the assets offered has been seen as too poor. In 2005 the government established a federal agency, BIMA, to operate its real estate assets. It has sold property worth several billion euros in recent years, and had a portfolio worth around €6.8 billion in 2008. It plans to sell around €4 billion over the next 5-6 years, but most of this is likely to be non-operational real estate; BIMA's assets include over 300,000 hectares of land (mainly former military establishments and forests) and over 50,000 flats. There is no explicit programme of sale and leasebacks on the operational portfolio (worth around €2 billion) at present, although the state of government finances suggests that they may be necessary eventually. However, they may well prove politically controversial, and with State and Bundestag elections coming up, 2010 onwards looks a more likely timeframe for any sales.

In the United Kingdom, the government is appointing a minister charged with driving efficiencies across all aspects of its £370 billion (€410 billion) real estate portfolio. Around two-thirds of this is thought to be owned by central government, with the remainder in the hands of local authorities. Sales of £20 billion over the next couple of years seems a somewhat ambitious target, but the intent of the programme is clear. Some of this will be surplus property, as more efficient occupation reduces the amount of space required, but there are also likely to be sales of income producing assets (including infrastructure projects) as well as sale and leasebacks.

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The Belgian federal and regional governments have been selling real estate assets since 2001 in order to improve public finances. In the five years to 2006 over 120 assets totalling nearly 1.5 million m² were sold. Initially these were office buildings, including some trophy properties, but a number of law courts and fire stations were also sold. Some of the buildings were due for redevelopment, but others involved sale and leasebacks on modern buildings on which the government took long-term fully indexed leases. The disposals are estimated to have raised nearly €2.4 billion in total. The clear political strategy to annually enhance the national budget by selling state assets attracted a lot of criticism, and following a change of government in the federal elections of 2007, the programme of sales has been discontinued. However, other forms of privatisation are still being pursued; for example, the Flemish regional government is currently outsourcing the construction of 211 "energy-efficient" schools by means of a Public-Private Partnership (PPP).

In France, the government and its agencies are believed to own around 53,000 buildings worth an estimated €80 billion. There has been an explicit strategy of sales since 2005 to improve public finances and reduce the public debt. In November 2005, specialist sale and leaseback investor WP Carey acquired a Government office building housing the Paris Traffic Department and the local police headquarters, for approximately €88 million. A target for sales is set each year, but only €395 million of the anticipated €600 million was achieved in 2008. The 2009 target of €1.4 billion looks ambitious, with some deals likely to be postponed until 2010 or beyond. However, the centrepiece remains a €1 billion portfolio from the Department of Defence.

The Italian Government is believed to own around 20,000 buildings. Sales and sale/leasebacks are being actively considered, although the volume currently scheduled for sale over the next couple of years is quite limited.

In The Netherlands, the government still tends to own a lot of its buildings and thus far hasn't pursued any sale and leaseback strategy. However, it is reviewing its portfolio from an occupational efficiency perspective which could involve moving several ministries into the same building.

The authority charged with managing the Irish Government's portfolio – The Office of Public Works (The OPW) - disposed of a number of their surplus properties in the peak years of the market in Ireland (2006/2007). The OPW are currently reviewing their portfolio to identify opportunities to release surplus accommodation and minimise their financial exposure. It is felt in Ireland that given prevailing market yields, sale and leasebacks would prove a more costly way to raise capital than going in to the bond markets, and so they are unlikely to be pursued in the short term.

In Spain, the Barcelona government has historically occupied numerous small offices across the city; however, between 2004 and 2007 it purchased several buildings into which it consolidated its presence to improve efficiency.

The Portuguese government still tends to own a lot of its property and hasn't engaged in a sale and leaseback strategy as yet. However, it is reviewing its portfolio from an occupational efficiency perspective to consolidate some public entities. This was the rationale behind the recent 65,000 sq m letting to the Ministry of Justice, to create "Justice City" within the Expo Office Park. Since 2006, the government has also been transferring real estate assets into a closed-end Special Purpose Vehicle (SPV) investment fund. The intention is to allow more efficient management of public real estate assets, but these "sales" also have a beneficial impact on the Portuguese national accounts.

In Greece, the Government has announced its intention to dispose of sufficient public sector occupied property assets to generate around €1 billion. Originally intended to be a sale and leaseback, the structuring of the transaction is currently under consideration and is intended to involve transferring the real estate assets into a SPV, which will then issue securities for sale to international investors. This structure is supposed to accelerate the procedure compared to a conventional sale and leaseback, while still having a beneficial impact on the Greek national accounts. The challenge will be to ensure that investors can be attracted to such a deal in an environment where investors generally remain averse to structured transactions.

In Russia, the Duma recently debated several aspects of the State's real estate policies. They noted that whereas governments of developed countries rarely own more than 25% of land used for civiladministrative purposes, in Russia the government owns at least 75%. For example, only about 17% of real estate assets have been privatised in St. Petersburg, which is the highest level in Russia. Noting recent transactions that had taken place in Germany, discussion suggested that the State should look at completing sale and leasebacks on at least half its portfolio.

It is not only European governments that are looking at these issues. In Australia, the Federal Government sold many of its "non-core" property assets during the 1990s; the remaining operational assets look unlikely to be sold at present. This is despite the fact that the Federal Budget has now moved seriously into deficit, which could provide the motivation to consider such transactions at a later date. In the short term, the Department of Defence is considering the sale of surplus assets to fund capital spending, but many of these sales are likely to be of surplus property, not necessarily sale and leaseback.

In Canada, the Government completed the sale and leaseback of seven office buildings for C$1.4 billion (c. €1 billion) in late 2007. A substantial asset review programme announced in January aims to raise around C$10 billion over four years. While office sales reportedly do not feature in these plans, the Government still owns around 300 buildings, so further transactions should not be ruled out. In the United States, California Governor Arnold Schwarzenegger is proposing the sale of numerous state properties (including exhibition centres, fairground sites, the Los Angeles Coliseum sports stadium and San Quentin State Prison), in a bid to raise up to $1 billion (€725 million) to help offset the state's c. $21 billion (c. €15 billion) budget deficit.

CONCLUSION

Sale and leasebacks are only likely to form one part of any government's strategy. Vulnerable to accusations of selling public assets at the bottom of the market, state authorities will need to make the case for such sales with care. Equally, at a time of economic hardship when tax increases would be both politically unpopular and economically counter-productive, governments may feel that the climate is right for introducing such proposals. Attention will be focussed not only on operational office space, but also on infrastructure and public service facilities such as schools, hospitals and student accommodation.

Whether investors will find such opportunities attractive in the current environment remains to be seen. Those equity investors and debt providers currently active in the market are focusing on the quality of tenants and length of income streams above all other considerations. From this perspective – and despite some of the concerns that have been raised about the financial stability of various central and local governments – it seems likely that state sale and leasebacks would be viewed relatively favourably by the market. Given the potential attractions to buyers and sellers alike, transactions involving Government buildings could remain a significant feature of the market over the next few years.

For further information or copies of our other reports on the subject of sale and leasebacks please contact:

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