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MODERATOR

Danielle Fugazy,
Contributing Editor,
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The M&A market is busier than ever. As dealmakers compete to close deals that will be profitable down the road, many are looking more carefully at their financing options. To explore this notion, M&A put together a roundtable, which focused on what financing options private equity firms are using, what role sale-leasebacks and other financing tools are playing in today's market, and how private equity firms are taking advantage of their different options to win deals and create value. Sponsored by W. P. Carey, what follows is an excerpted version of our conversation.

Fugazy: How do you characterize the private equity industry today?

Bryan Cummings: Capital superabundance. There's \$1 trillion to \$1.8 trillion out there looking for a home, depending on the source you look at. As a result, we are seeing tremendous competition in the market for quality assets. There is a lot of creativity being deployed to give investors the opportunity to win these businesses. Capital is not the constraint. We see a lot of processes where you have one outlier bid at the top, who may or may not get there, and then two to five folks within a relatively narrow five to 10 percent band. Sure, you'd like to be that guy at the top, but if you aren't you've got to have an approach that distinguishes you from the competition.

PARTICIPANTS:

Danielle Fugazy, Contributing Editor, M&A

Bryan Cummings, Managing Director, D.A. Davidson & Co.

Eric Korsten, Managing Director, Branford Castle Partners, LP

Joseph Marger, Partner, Reed Smith

Gino Sabatini, Managing Director, Head of Investments, W. P. Carey Inc.



Joseph Marger: Historically, in the real estate business, if you were representing a developer or someone who's vying for the space, there was a smaller universe of people willing to invest in that risk. But now, because of the abundance of capital, there are either family offices who never used to dabble in the space coming in, or hedge funds and high-net-worth individuals who don't know what else to do with their money to get yield. They are now willing to throw crazy prices at real estate today.

Gino Sabatini: If you're a private equity firm that owns the portfolio company that has real estate on its books that you know will be important to the company long-term and for the next owner, taking advantage of that multiple arbitrage makes a ton of sense. It makes sense to do a sale-leaseback transaction ahead of the sale of the company so you can take the dividend yourself, and then put the lease in place long-term. If it's a critical asset, a buyer will not see it as a problem.

Fugazy: What are some key components of the capital stack for the initial buyout and for add-on acquisitions?

Eric Korsten: Building the ideal capital structure is an art and it's unique to the buyer and the underlying company. Anyone who's been around a long time has a deep appreciation for getting it right and not having to renegotiate with lenders in a down market. Today you can almost always refinance; likely not a problem. However, the music can stop quickly and you can be the last in the line. As a result, you need to make sure that what you're doing today likely works for at least the duration of your expected hold period.

Fugazy: How do you think about finding the right partners who will work well with you in a downturn?

Korsten: Ideally, you have good past experiences with them, although that's not always going to be the case. There's a certain amount of gut instinct involved. Properly structuring your credit agreements and all of the ancillary agreements that go along with it is essential. If the covenants, and other restrictive terms, feel really aggres-



Our sellers are becoming more sophisticated. They hear things from their friends and they say, I've seen a sale leaseback and they want to know their options.

Bryan Cummings,
Managing Director,
D.A. Davidson & Co.

sive today, they probably will be even worse when things aren't going right.

Marger: As a lawyer, I would want to counsel someone by noting that even if you don't have prior experience with that company yourself, you can look at the track record and make some inferences. A company with 40 years of long-term investment history and many years of working with their tenants to see them grow is quite different than a Johnny-come-lately that's just looking for instant yield because they can't find it anywhere else. Who knows how they're going to react in the next down cycle.

Korsten: A 40-year history, like you just mentioned, is definitely an important lender selection consideration. Somebody who started lending recently can potentially buy our deal if their terms are materially better than everyone else; but they likely only get one chance to do right by us.

Fugazy: How do the capital stacks for deals differ depending on the asset?

Korsten: I looked at information provided by GF Data. Going back to 2016, specifically for lower middle-market deals, there's no clear, conclusive trend that leverage has really gone up or down much during that time. There's always been about three to four turns of leverage available. Sometimes it's slightly more and sometimes it's slightly less. It doesn't necessarily follow the bigger market trend, which is that available leverage has gone up a lot. Our smaller-end of the market hasn't changed much, which means there is likely only a reasonable amount of available debt. As a result, we have to make our returns not just from financial engineering but by really growing the business and taking them to the next level. If you're just counting on higher leverage to generate returns, that's just not going to consistently do it in the lower middle-market.

Cummings: How are debt providers competing for that business? Leverage really isn't that different between groups, and most folks are in that three and a half, four times range. Rates are what they are and you don't

necessarily want to choose the cheapest guy out there. How do they think about convincing you to work with them?

Korsten: We're often getting one percent per year amortization on debt deals. That makes you say, 'okay, this company can just basically choose to pay interest only.' They can always voluntarily choose to pay down debt but today it's their choice.' Having that high degree of flexibility makes us feel more comfortable. We'll often pay a bit more for that flexibility because we want the company to be able to grow and not feel like they have their hands tied generating liquidity and meeting covenants.

Sabatini: The stability of the cash flow has a lot to do with the capital stack and what the market will allow you to put together in terms of the capital structure. If you have a very long history of very steady cash flows, both on the leverage side and certainly on the sale-leaseback side, that will allow you to lever up a bit more. With regard to a sale-leaseback, we often look at rent coverage, and the longer the history we have, the better. Even a very levered company, for example, a building products supplier, if they've shown the ability to go through a cycle in the last 10 years and maintain their cash-flow generation, that gets us more comfortable that they can handle it, and we're willing to take a bit more of a risk on the credit side.

Korsten: Lender diligence doesn't seem to be getting too much lighter. Even though the market is a bit frothy, lenders are still trying to take their time on diligence because they know things can be cyclical. Especially if their terms are great, they're going to make sure they dot their "i"s and cross all of their "t"s. It's not uncommon in private equity to provide the lender a quality of earnings report in conjunction with an acquisition or refinancing. Often lenders will do their own homework on the quality of earnings report. They don't just take the report as-is, put it in a folder and move on. They ask real, hard questions. Questions that tell me that they're really thinking about the "what-if" scenarios.



The extra cash that a sale leaseback provides to the capital stack that a mortgage wouldn't could be the difference between the success or the failure of the company going forward.

Joseph Marger, Partner,
Reed Smith

Fugazy: What is the ideal capital stack?

Sabatini: I would say the ideal capital stack has changed over time. W. P. Carey was part of one of the first sale-leaseback financed LBOs in 1982 when William Simon bought Gibson Greetings. The sponsors — there were three of them — each put \$330,000 into the deal and within two years they each pulled out an estimated \$70 million, making it one of the highest return deals of all time. We provided approximately \$34 million of capital proceeds to Simon and his partners through a sale-leaseback of Gibson's corporate real estate totaling three million square feet. By arranging a pre-closing sale of the assets, the investment group was able to secure the balance of the financing required to complete the LBO. That was at a time when private equity shops could do that and generate enormous returns on equity, which has changed. Clearly, it's a much more competitive business today, but for the last 45 years W. P. Carey has been a cost-efficient part of that initial capital stack in deals where there's real estate involved. It always makes sense to do a sale-leaseback at essentially a 13 or 14 times multiple if you're paying six, seven, eight times for the company. That hasn't changed.

Korsten: I'd agree with you, the multiple arbitrage is potentially compelling; unless you're paying 13 or 14 times for a business. Absent that, you have to look and say 'okay, we have added considerable rent expense to the business. We are now effectively more levered. The business now really has to perform.' One bad investment can take a lot of your time and energy so you have to be very thoughtful.

Marger: The extra cash that a sale-leaseback provides to the capital stack that a mortgage wouldn't could be the difference between the success or the failure of the company going forward. And so you say, I've got the rent obligation, but now I have the cash to grow the company beyond the rent obligation.

Sabatini: That's the idea. Furthermore, rent payments are fully tax-deductible, so the multiple arbitrage,

coupled with the value of the full deductibility of rent payments may in many cases be a critical factor in structuring a successful bid for a new investment or in refinancing an existing portfolio company. The capital can then be put to higher and better use than staying trapped in your real estate and generating eight percent or nine percent.

Fugazy: Does it matter whether that sale-leaseback happens before or after a sponsor buys the business?

Sabatini: Sale-leasebacks can happen at any point in time with a company. We're happy to participate on the front-end like we did with Gibson Greetings and in many other LBOs. We can also participate after the fact, which is often easier for the private equity shop because they have time to figure out what the critical assets are going forward and what they want to commit to in a long-term lease. If it's a very real estate-intensive company, a sale-leaseback is often the best source of financing and consequently, it's typically done in conjunction with the initial acquisition. In fact, some PE firms may be able to get their lenders to carve the value of the sale-leaseback out of their credit agreement and have it preapproved so we're ready to go.

Korsten: I read an interesting bid letter recently. It was for a consumer services company and they owned all the buildings. Included with the bid letter it said "in your bid please consider that a potential sale-leaseback we expect would produce X millions of dollars in net proceeds". It was a car wash company.

Cummings: Half our deals are with family-owned businesses. We're finding in certain cases that there's a benefit to being able to come to them with a conversation around how they can spark a competitive auction by allowing the PE firm to get a little more benefit from a sale-leaseback. Or, we can have a conversation about whether it make sense to do a sale-leaseback on their terms, even if you then sell for a different price point because now you've got a rent expense lowering your EBITDA.



Some PE firms may be able to get their lenders to carve the value of the sale-leaseback out of their credit agreement and have it preapproved so we're ready to go.

Gino Sabatini, Managing Director, Head of Investments, W. P. Carey Inc.

Sabatini: A sale-leaseback makes the most sense in situations where the asset is critical to the company or the life of the company. A car wash is a perfect example.

Korsten: It's not going anywhere. You can't operate a car wash business without the car wash building.

Sabatini: Manufacturing companies are another good example. If the private equity firm is purchasing a company that has a critical manufacturing facility with unique characteristics, a long-term lease makes sense. Same with companies that have a distribution network that they don't foresee changing in the near future.

Marger: Let's just hope so. With the pace of disrupters your diligence efforts are even more difficult for the long-term. There was a time when we thought that CDs were going to save the world, and now they barely exist. Uber is another example. We don't know what it's going to be in next five years, the world can be dramatically different.

Fugazy: How does the pace of change affect you when you're looking at deals?

Sabatini: As part of our underwriting, we evaluate each company's ability to pay us rent over the long term because we're entering typically into a 15 or 20-year arrangement. To the extent that we don't have real estate that's very fungible and that can be repurposed into a different use, the company's future business opportunities are extremely important to us.

Fugazy: Some private equity firms are holding onto investments longer. How is that impacting the initial financing structure?

Cummings: I'd argue there's something of a bifurcation in the market. You're certainly seeing both funds exit earlier than they used to, as well as later. Given the strong market you're seeing folks exit after three to four years or two to three years, simply because the market's strong. The business has perhaps executed on

seven of its 10 strategic goals, and they think waiting two more years to complete the rest of that performance plan is not worth the market risk. In those cases, how do you avoid prepayment penalties and how do you think about building that option into the structure? There are other companies that people are buying and saying 'I'm going to be able to invest in a slightly lower entry multiple, because I know this will take longer, and the market does too.' We're seeing both sides impact structure.

Korsten: There's an unfortunate tendency with some in the private equity investment world to sometimes sell your good companies too soon and hold on to your bad ones. Managers want to feel like they can get themselves paid and by selling a bit early they can do that but that doesn't mean that it's the right decision. Funds do have an artificial life span. When somebody makes a commitment to us, eventually they want their money back; that's natural. For us, if we achieve something really big, we'll let the next buyer do the next big thing. However, there isn't always something big to do, in which case you may hold it for longer. But if we buy a company and we are then able to buy our biggest competitor a year or two later, we have created something with more scale and substance. What's next? We'll often let somebody else figure that out.

Fugazy: How does the sale-leaseback differ from other capital structures including ABL financing?

Sabatini: The biggest difference is it's very long-term. A sale-leaseback is a 15 or 20-year obligation. We don't have a refinancing risk in a few years. The second biggest difference—and the most important difference—is the amount of proceeds a seller can garner. An ABL deal will give you 50 to 55 percent loan-to-value. With a sale-leaseback the seller gets 100 percent of the fair market value of the asset. The hope is that the money is put to a higher and better use. Private equity investors are looking for 15 to 20 percent annual returns, which real estate by its very nature doesn't generate. So what makes the most sense is if there's real estate on the books, pull that money out and redeploy it into what your company does best.



Building the ideal capital structure is an art and it's unique to the buyer and the underlying company.

Eric Korsten, Managing Director, Branford Castle Partners, LP

Korsten: ABL availability also varies over time. With the sale-leaseback, we have a single transaction and we know the price; it's done. With ABL, our collateral is constantly moving and so availability is constantly moving. One has a higher degree of certainty, the other can change significantly as the business's performance changes. ABL is a riskier form of financing in that regard.

Fugazy: Does having a 15-year lease impair the seller's ability to sell?

Korsten: We often consider, would a strategic buyer be less interested in the business because there's a very long-term lease attached to it? For example, perhaps they wouldn't be able to combine that facility with their existing facility. It may ultimately reduce our exit options. So, we really have to think, what's the likely universe of buyers, before we enter into a long-term agreement.

Sabatini: If you have a mission-critical property then it's always going to be an important asset to the company and is unlikely to impair the seller's ability to sell. For example, we did a deal with a pharmaceutical packaging company that had a license from the FDA to package one product. It took them three years of testing and approvals to get this singular drug approved for packaging in this one plant, and the license was plant-specific. It would be very difficult for them to ever package the same type of product in a different plant because they would need FDA approval. They're not going to go through another three-year FDA approval process to move that license to a different facility. So I would say it's company-specific, but if it's a critical facility then it's not going to hold you back.

Fugazy: How is the sale-leaseback generally structured?

Sabatini: Typically we create a new lease when the sale-leaseback is initiated. The company gets the full fair market value of the asset at that time, and they sign a lease committing to the payment of rent for the 15 or 20-year period. As we just mentioned, in particular

situations there may be certain things which are important to the company which then get negotiated into the lease. The lease is then put on a shelf and the tenant maintains full operational control of the facilities, while gaining a long-term financial partner and landlord with the capital and expertise to support any future growth needs.

Korsten: How often do you see any restrictions on the rest of the capital structure or who you can sell the business to?

Sabatini: Some of our best deals are those in which the tenant is sold to a larger entity. As a long-term partner to our tenants, we try our best not to restrict them in this regard. Ultimately, as long as the new tenant can assure us that they'll continue to pay rent for the duration of the lease, we're happy to accommodate their changing needs.

Marger: It also depends on how far up the chain of the corporate structure that the transfers are taking place. If you've done your underwriting under the entire company, and that entire company is being bought by somebody even bigger that could be a positive, not a negative. You'd be very happy to take a look at that. If someone just wants to chop out your company and move to someone with questionable management skills, you're not going to be as inclined to go along.

Korsten: There are a lot of oil and gas companies that have been hitting the market recently. Some of these companies had some pretty rough times, such as in 2016, when their EBITDA may have gone to zero. How would you look at a company like that who owns their real estate if we want to do a long-term sale-leaseback?

Sabatini: With a situation like that we would really look more at the asset and try to understand what our alternative would be in a downside scenario. Is it a nice industrial building in Houston that we can repurpose if necessary, or is it an oil service field out in Midland that will have no alternative use?

Fugazy: It's been such a busy time in the market. Are you seeing an uptick in sale-leasebacks today?

Cummings: We're seeing more opportunities to think about, and work with private owners, on things like sale-leasebacks. It's a more common part of the market today. It's evolved in its maturity even in the past four

or five years, and frankly, our sellers are becoming more sophisticated. They hear things from their friends at the country club and they say, I've heard about this sale-leaseback - and they want to know their options.

Sabatini: We often get calls from private equity shops that want to buy the former owner out. Likewise, many sellers think they are the only ones who can run the portfolio company, and they don't want to take a risk that their rent won't get paid going forward, so they want out. From both sides sometimes having a third-party real estate owner makes sense.

Marger: There may be more deals happening, but they're more diversified across more bidders. The higher you go, obviously you're going to get less bidders at certain price points. But in the lower-end market I think we're seeing a lot of activity from family offices who have these long-term triple net portfolios.

Fugazy: When you're acquiring a company and you're assessing the quality of the business, the company's longevity, and the purchase price—all the ways you can add value—how important is the capital structure?

Cummings: It makes a big difference because ultimately there are a lot of sales to the private equity community and they look very hard at what kind of leverage makes sense. There is no one-size-fits-all in the middle market. As such, finding the right partner, or partners, who can put the pieces together is really important to us.

Korsten: We once won an auction for a company that had somewhat lower growth prospects but we saw two great things. One, they owned their own plants and those plants definitely had value in a sale-leaseback. So even though the business was not going to grow really quickly, we could hopefully help achieve our equity returns through a sale-leaseback transaction.

Sabatini: Financing is obviously a critical piece of any deal, both at acquisition and almost more importantly going forward. It's imperative that the owners set up a capital structure which makes sense for that company so it can handle the inevitable ups and downs.