LCN Capital Partners

Financing the Resurgence of American Manufacturing and Addressing the Debt Maturity Wall

Historic Opportunity

Over the years, sale-leasebacks and build-to-suits have grown as a financing source and investment strategy as more companies and investors understand the benefits of the structure.

Recently, however, we are seeing two major factors driving corporate interest in these transactions to historic levels, creating a greater number of attractive opportunities for investors.

The first is an impressive boom in the construction of US manufacturing facilities. Spending on US manufacturing construction doubled in 2022 vs. 2021 – a "striking surge" according to the U.S. Department of the Treasury.[1]

Geopolitical pressures and post-Covid supply chain disruptions are pushing US corporations to bring their manufacturing onshore. The increase in shipping costs and cheaper US energy makes manufacturing in the US more attractive from a cost perspective. And recent US legislation including the Infrastructure Investment and Jobs Act (IIJA), Inflation Reduction Act (IRA), and CHIPS Act all provide funding and tax incentives for manufacturing construction.

Source: US Department of Treasury

The second factor is a painful liquidity crunch. A debt maturity wall of $1.8 trillion in corporate debt is coming due in the next two years, including over $500 billion in high yield bonds and leveraged loans.[2] Much of this debt was borrowed in 2019 through 2021 when rates were low. Today, when corporations try to refinance this debt, they find that credit is much less available and much more expensive.

Financing American Manufacturing

Building a US manufacturing facility is capital intensive. It involves the cost of the land, building and equipment, and in many cases also requires adjacent distribution and office facilities. Through a build-to-suit, a company can finance 100% of the cost. The investor funds the construction of the facility and owns it, and in return the company commits to a long-term lease. This is an attractive solution for a company that would otherwise need to borrow.

However, even cash-rich companies that don't need to borrow or that can borrow at lower rates also pursue build-to-suits for new facilities (as well as sale-leasebacks for existing ones). Over the last decade, the financial markets have shown a clear preference for "asset light" companies. Such businesses generate high ROE and focus capital on their core business. Amazon and Microsoft

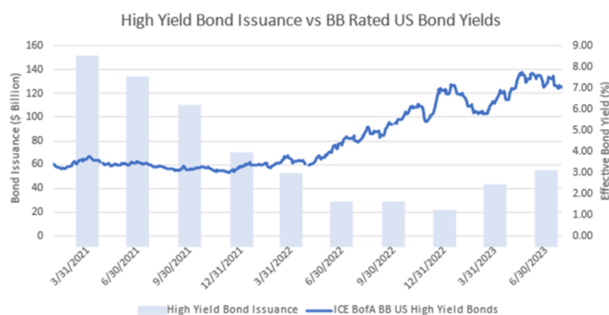
[1] Unpacking the Boom in U.S. Construction of Manufacturing Facilities. U.S. Department of the Treasury, 2023

[2] S&P Leveraged Commentary & Data, 2022

have demonstrated that it is possible to run a capital-intensive business without owning the majority of their hard assets and have been richly rewarded for it.

Liquidity Crunch

While the corporate credit crunch impacts those needing to build new facilities, it's also impacting those needing to refinance existing debt, a large amount of which is maturing over the next couple of years. Companies that financed at 5% a few years ago are now finding that today's rate may be as much as three times higher. This is particularly true if they are forced to turn to private credit lenders, where rates can be in the mid to high teens. Some companies simply can't afford to borrow at today's rates. Accordingly, as rates have gone up, we are seeing a precipitous drop in high yield bond issuance.



Source: Federal Reserve Bank of St. Louis; Debtwire Par

For companies that own real estate, sale-leasebacks allow them to realize 100% of the value of a property and unlock capital to repay maturing debt and reduce leverage. Sale-leasebacks also have more favorable tax treatment for companies. Lease payments are 100% tax deductible, whereas in the US the 2018 Tax Cuts and Jobs Act limited the deductibility of interest payments.

Hybrid Between Credit and Real Estate

For investors, build-to-suit and sale-leaseback transactions represent hybrid investments that combine the advantages of credit and real estate and offer a double layer of protection that mitigates the downsides of each investment class. Like a bond, a sale-leaseback or build-to-suit has long-term contractual cash flows. However, unlike a bond, the cash flow from lease payments increases contractually due to rent escalations. Another advantage is that in a bankruptcy situation, where the investor owns a critical asset that the tenant business cannot operate without, lease obligations can effectively take priority over debt.

Build-to-suits and sale leasebacks also are preferable over a pure real estate investment. The property is 100% leased on a long-term basis, under triple-net terms, where the tenant pays all maintenance, taxes and insurance costs. This shields the investor from the administrative burdens and fluctuating operating costs typically associated with real estate investing. Importantly, the investor still benefits from any property appreciation, yet protects their downside through locked-in cash flow from a long-term lease with no termination options for the tenant.

Primary vs. Secondary Market

It's important to note, however, that there is a significant difference between primary market and secondary market sale-leaseback investments. In primary market sale-leaseback and built-to-suit investments, the investor directly negotiates the long-term lease as part of an agreement to purchase or build a property. In secondary market investments, an investor purchases an already leased property from another investor.

In a primary market investment, the investor has the power to ensure that the investment meets several core requirements. First, it is critical to differentiate between a company that has financial stress because of its capital structure, versus one that is troubled because its business does not work on a fundamental level. This requires deep experience and credit underwriting skills.

Second, to manage downside risk, it's important to only pursue transactions involving high quality, mission critical assets – properties that are essential to a company's ability to operate. Even in a worst-case scenario of a bankruptcy, companies must keep paying rent on mission critical properties to keep those facilities operating. It's even better if the property is also important to the industry at large (examples would be a modern manufacturing facility, or real estate in a highly favorable location). Should the tenant go into liquidation, such properties will be in high demand from competing firms.

And finally, the primary market investor has the ability to create leases that build in downside protection through financial covenants, cross defaults, subletting restrictions, corporate guarantees and other terms.

Expanded Opportunity Set

Over time, various sectors have driven demand for sale-leasebacks and build-to-suits. For example, until recently, US distribution facilities were a core area of activity (with Amazon famously building a massive distribution infrastructure while owning only a small fraction of the assets). Europe is seeing a similar wave, as it builds warehouses and distribution centers to handle e-commerce demand.

However, the potent combination of a looming corporate debt maturity wall, the resurgence in American manufacturing, and a growing liquidity crunch are driving a broader range of companies to consider sale-leasebacks and build-to-suits. For primary market investors with extensive sourcing networks, credit expertise, and real estate skills, this means an expanded selection of high-quality opportunities across company sizes, industries, and property types.

When structured optimally, primary market sale-leaseback and build-to-suit transactions offer stable returns that exceed unsecured bonds and provide meaningful upside potential. They also offer strong downside protection – for example, in a typical primary market transaction in today's market, an investor would need to see a 900 basis point increase in a property's cap rate in order to experience a loss on that investment.

In conclusion, primary market sale-leasebacks and build-to-suits are one of the few ways that investors can directly capitalize on two major trends – the resurgence of American manufacturing and the corporate credit crunch – while at the same time providing investors with the double layer of protection inherent in this hybrid investment.

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