FINANCE

Are Today's Valuations Sustainable?

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Valuations for convenience stores and retail petroleum marketing assets are, by almost any measure, at an all-time high. This "bull market" for these assets has continued almost unabated since the start of 2003. Even as we were selling off assets in bankruptcies caused primarily by inflated valuations and too much leverage during the last bull market, we were watching asset values increase dramatically, signaling the beginning this next cycle. To understand whether these valuations are sustainable we first need to understand what is causing them.

Competition

In many geographical regions of the United States, there is tremendous competition for convenience and retail petroleum marketing assets. This competition comes from the convenience store consolidators, including the public companies, from jobbers anxious to grow or perish, capital-rich investors based overseas (including Israel and India) and from single-store operators, primarily New Americans, who are creating business opportunities for themselves and their families. In addition, we now have companies engaged primarily in the manufacture and/or distribution of biofuels that are looking to acquire captive retail assets through which they can market their products.

the gist

- Environmental issues have not affected the desirability of petroleum-use real estate in relation to other multi-site retail purposes such as restaurants and hotels
- There does not appear to be any serious reduction for assets competition on the horizon and the demand will likely continue to exceed supply

More Demand Than Supply

There are many more buyers than sellers today and the supply of assets and companies into the marketplace has not come close to meeting demand for these assets. Even with the major oil companies selling assets at a record pace, the supply of assets remains well below demand. Of course, this excess demand adds to the competitive frenzy.

Capital Availability

Today, capital is available from many sources, including large, regional and local commercial banks; industry knowledgeable commercial finance companies; new specialty lenders specializing in convenience store and other multi-site retail businesses; insurance companies; the Small Business Administration; mezzanine funds; private equity funds; and hedge funds. In addition, Real Estate Investment Trusts (REITs) and 1031 investors are increasing the amount of capital available through sale-leaseback funding mechanisms. Through these entities, buyers of all types can acquire financing for store purchases.

The Cost of Capital

The cost of debt capital remains low versus historical measurements and, in addition, the amount of leverage available remains generous. For the first time in many years, serious equity capital is looking at the industry fueled by the successes of the public convenience store companies. Historically, it has been very difficult for private equity investors to get the returns they seek, but with the generous leverage available today lowering the overall cost of capital, returns on equity are possible. In addition, the potential for an exit for private equity through an IPO makes the convenience store industry more attractive for these investors.

An example of an exit through IPO is Hospitality Properties Trust's recent acquisition of Travel Centers of America (TA), which closed on January 31. Hospitality Trust purchased TA for a reported $1.9 billion. In conjunction with the acquisition closing, Hospitality Trust spun-off TA as a publicly traded operating company. Hospitality Trust consummated the spin-off in order to retain its REITs status and to unlock the value of TA. As of March 14, TA's publicly traded enterprise value was approximately $3.25 billion. The primary driver behind this series of transactions is excess market liquidity created from the low cost of capital.

Real Estate

It is no coincidence that an industry whose primary asset is real estate will enjoy improved valuations during a boom in real estate values. In some cases, the low capitalization rates offered by REITs and 1031 investors have allowed buyers to arbitrage the real estate purchased in a transaction. The TA transaction is an excellent example of arbitrage where the sum of the parts is greater than the original whole. What is interesting in this cycle is that environmental issues have not seemed to affect the desirability of petroleum use real estate in relation to real estate used for other multi-site retail purposes, such as restaurants and hotels.

Ability to Get MAI Appraisals

Typically, lenders will finance a certain percentage of the appraised value of a property or the purchase price, whichever is less. The ability of purchasers to obtain financing to fund purchases would not be possible if it were not possible to get Member of the Appraisal Institute (MAI) appraisals on the properties that are at least equal to the purchase price paid for them, especially the real estate portion of the value.

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Turmoil in the Crude and Refined Products Markets

While low motor fuel margins will never improve valuations, a choppy market for crude and refined petroleum products does increase the opportunity for marketers to have more and sustained periods of decent margins, thereby improving valuations for sellers and increasing the internally generated capital for buyers.

What Does the Future Hold?

The sustainability of this bull market is directly dependent on at least most of these factors remaining favorable. While it is impossible to predict the future, the good news is that there does not appear to be any serious reduction for assets competition on the horizon and the demand for assets will likely continue to exceed supply for the foreseeable future. At this writing, the residential real estate market is beginning to see problems with the demise of sub-prime lenders, but commercial real estate, at least for the time being, remains strong.

Perhaps the most serious risk to the continued bull market is the availability and the cost of capital. The demise of the securitized lenders removed nearly all liquidity from the market almost overnight in 2000. This loss of liquidity contributed to an immediate reduction in valuations of at least one-third and, in some cases, valuations dropped by 50 percent, evidenced by bankrupt assets being sold a for less than one-half of what buyers paid for them just months before. While it is unlikely in this cycle that all lenders to the industry will collapse, it is certainly possible and probably inevitable, that lenders will decide to reduce exposure to this asset class at some point as this business cycle continues to mature. This, combined with any significant reduction in advance rates or increase in the cost of capital, will quickly remove liquidity from the market and have a serious detrimental effect on valuations.

Furthermore, motor fuels profitability, or lack thereof, poses a significant near-term risk to the value of petroleum marketing assets. A long-term supply disruption that substantially changes the driving habits of the public would, of course, decimate valuations. However, a sustained period of low or negligible motor fuels margins poses the greatest likelihood of default by marketers. And defaults will trigger a quick, drastic reduction in capital availability to purchasers and result in a substantial reduction in liquidity and corresponding reduction in valuations.

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