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"Hot Button" Lease Terms

Fourteenth in a series on CTL financing.

Tenant Estoppels

In general, credit tenant estoppels confirm the basic terms of the lease (i.e., term, rent), that the tenant has accepted the property and the absence of any defaults under the lease by the landlord or tenant.

Because the due diligence process of the loan often coincides with the construction of the subject property, a CTL lender must be assured by the tenant that it is satisfied with the construction and that there are no conditions at the site that might give rise to a rent abatement or termination. Some retailers have been reluctant to make this affirmative statement. We can accommodate that reluctance by attaching to the estoppel an additional page of punch-list items which need to be completed and then take an appropriate reserve for such items at closing.

For those leases which are guaranteed by a parent entity or other entity, an affirmation of the guaranty of the lease by such guarantor is required in the form of a guarantor estoppel. A CTL lender must confirm that, as of the date of closing, the guaranty of the lease is in full force and effect and has not been modified or amended in any way.

Borrowers should agree with the tenant during the lease negotiation process that tenant and the lease guarantor (if any) will be obligated to provide detailed tenant and guarantor estoppels upon request.

Stability Begins to Return to Markets After "Liquidity Jolt"

After literally being shutdown by the worldwide margin calls which took place this summer and early fall, the CMBS market has begun to recover—faster than many expected. Spreads have tightened significantly from their September levels when AAA 10 yr. bonds were selling at 200 over and there was no bond market for BBB and below tranches. In the latest $1.1 billion DLJ transaction, which came to market the last week of November, the AAA 10 year priced at 128, AA at 153 and BBB at 245. Offsetting these tightening spreads is the fact that the 10 yr. treasury rate increased from a low of 4.15% to 4.75%. As a result, the overall cost of capital for CMBS issuers had improved by proportionally less than the tightening in spreads. Nonetheless, CMBS buyers are back in the market. The recovery in CMBS markets should bode well for borrowers seeking to finance properties in '99. While several real estate conduits are not likely to return, some of the large conduits such as Lehman and CS First Boston who withdrew from the market in the second half of '98 will again be making loans. The primary difference from the "go go days" just before the "meltdown" in capital markets, is that loan pricing is likely to continue to be quoted with a floor coupon of between 7-8%. At the same time, borrowers can expect tougher underwriting standards in '99 as investors are being more discerning as to the quality of collateral supporting a pool.

While borrowers can expect the larger real estate conduits who disappeared in '98 to resurface in '99, it is unlikely that the credit tenant lease (CTL) lenders who withrew from the market will return any time soon. The reason lies in the fact that CTL lending is a highly technical, specialty business requiring credit and lease specialists, national CTL origination, specialized enhancement programs and the ability to market securities with long maturities. With the exception of CLF, conduit competitors who entered the CTL market did so as an adjunct to their commodity real estate business with disappointing results.

As a result, CLF was the only CTL capital markets lender to both continue to fund loans and commit to new loans throughout the second half of '98.

Downgrades Outnumber Upgrades in 3rd Quarter

S&P downgraded 57 U.S. industrial (including retail) companies in the 3rd quarter and upgraded 32. Energy, healthcare and forest products contributed to almost half of the U.S. downgrades. 40 out of the 57 downgrades were in non investment grade companies.

Interestingly upgrades out paced downgrades 15 to 11 in BB credits but downgrades outnumbered upgrades 24 to 5 among B credits.

CREDIT UPDATE

Rite Aid Corp's corporate rating was affirmed at BBB+/ negative outlook after Rite Aide announced it would purchase PCS Health Systems from Eli Lilly & Co. for $1.5 billion. The possibility of downgrade increases if Rite Aid does not finance the PCS acquisition with equity in the next six months or accomplish expected synergies.

Winn Dixie's commercial paper was downgraded from A-1 to A-2 due to declining lease adjusted cash flow protection and a somewhat less conservative financial policy.

Mobil Corp. has been put on positive watch (AA/Positive) after its announced merger with Exxon (AAA).

Pep Boys—Manny, Moe & Jack (BBB+) was put on negative watch because of declining profitability and S&P's concern that a turnaround may take longer than anticipated.

Dayton Hudson Corp. was upgraded from BBB+/ positive to A-/stable as a result of the success of its **Target** stores.

Federated Dept. Stores, Inc. was upgraded from BBB-/ positive to BBB+ as it reestablished itself as a retailing power.

Kohl's Corp. was upgraded from BBB to BBB+ as profits and cash flow increased because of their merchandising strategy, low-cost structure and a young and growing store base.

Foundation Health Systems, Inc. has been downgraded from BBB/negative to BB+/ stable as a result of declining earnings.

Vulcan Materials Co. rated AA- will be downgraded to A+ upon the completion of the company's acquisition of Cal Mat Co.

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