Demand Grows For Credit-Lease Financing

by Upendra Mishra

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Wall Street involvement and a booming need for single-tenant buildings have pushed credit-lease financing to center stage.

Remember the booming 1980s when money flowed cheaply in the marketplace? In the 1990s, money may not be so cheap, but there are plenty of resources to turn to. One financing vehicle becoming increasingly popular in retail real estate is credit-lease financing and its variations - synthetic leases and sale-leasebacks

Real estate developers, owners, investors and tenants are starting to see advantages of credit-lease financing, in which a property is leased to a single, creditworthy tenant with a "BB" or better credit rating. These properties, in turn, qualify for financing of between 95 percent and 100 percent loan-to-value and a low debt service coverage with competitive rates.

The major focus of the lender in these transactions is financial conditions and credit standing of the tenant - rather than the value of the underlying real estate. Inorder to qualify for credit-lease financing, properties must be leased 100 percent by a single tenant with good credit standing.

Not new, but newly popular Industry experts attribute the growing popularity of credit-lease financing to two coinciding factors: securitization of commercial real estate debt and involvement of Wall Street; and explosive growth in freestanding retail outlets, creating a big demand for single-tenant buildings. Freestanding buildings are the real estate format of choice for many retailers - and the most desirable for credit-lease financing.

Credit-lease financing has existed for years with traditional portfolio lenders such as life insurance companies, thrifts, commercial banks and institutional investors, but it became popular after the involvement of Wall Street about two to three years ago, says Warren Ashenmil, senior vice president of New York-based Daiwa Finance Corp.

"Wall Street is very good in marketing and promoting. There is now growing awareness about credit-lease financing on the part of real estate developers and owners," Ashenmil says. "The economy is strong, and a lot of development is going on."

Daiwa, in a joint venture with Legg Mason Mortgage Capital Corp. of New York, last year provided about $1 billion in credit-lease financing for nearly 300 properties net-leased to 30 different tenants in 20 different industries. Richard A. Jacobs, managing director at Legg Mason, notes that his firm was involved in credit-lease financing long before the launch of the joint program with Daiwa.

"There is a healthy appetite for credit-lease financing," says Jacobs, who heads Legg Mason's Real Estate Debt Capital Markets Group. "It can be extremely attractive financing as opposed to traditional mortgage financing. ... Although credit-lease financing is so interest-rate-sensitive, we hope to replicate that number [$1 billion] this year."

Net Lease Capital LLC - as the joint venture of Daiwa and Legg Mason is marketed - offers up to 100 percent financing for properties net-leased to investment-grade and below-investment-grade tenants. Eligible leases include bond, triple net and double net, and loan amounts more than $1.5 million. The firm also provides construction/permanent financing, forward commitments, and amortization terms longer than base lease terms.

Barclay G. Jones, vice chairman of W.P. Carey & Co. Inc., which invests in sale-leaseback properties, says securitization of real estate - both through mortgage pools and real estate investment trusts - are dramatically changing the landscape of credit-lease financing.

Wall Street not only has become a new funding source for credit-lease financing but also has been able to collect mortgages on various types of properties into one pool, securitize and rate them. Wall Street can take on more difficult properties and are willing to take more risks, Jones explains.

"The credit-lease market is very strong. There is a very strong demand for income-producing properties nationwide," Jones says. "The retail environment is better than it was two years ago, and we are getting better pricing on retail properties than industrial in terms of spreads to treasuries."

Proliferation of freestanding stores Other factors fueling the appetite for credit-lease financing are a sound economy, low interest rates and rising demand for freestanding stores by many high-performance retailers. Most of the fast-growing retailers - from small ones to category-killers - are opting for the freestanding format.

"There has been a big expansion among retailers, particularly among new drugstores and grocery stores," says Fred Berliner, senior vice president and director of acquisitions for United Trust Fund, a Miami, Fla.-based investment firm that specializes in the development of single-tenant build-to-suit projects and corporate sale-leasebacks.

"There was a great demand for big-box retail a couple of years," he says. "Today, it's drugstores, followed by convenience stores. You are also seeing a lot of movie theaters being built."

Another trend, Berliner notes, is toward freestanding stores. "There is a strong demand for freestanding stores," he says. "We see this demand continuing in the future."

About 2,000 new freestanding stores - ranging from 7,500 sq. ft. to 100,000 sq. ft. - were built in 1997, says Gary M. Ralston, president of Commercial Net Lease Realty Inc., a real estate investment trust in Orlando, Fla. The number of new freestanding stores is expected to rise to 3,000 this year, he adds.

In 1987, shopping centers accounted for 55 percent of all retail development, while freestanding stores accounted for only 30 percent, Ralston says, noting a reversal in those statistics just 10 years later. In 1996, he says, shopping centers represented only 29 percent of all retail development and freestanding stores accounted for 53 percent.

Freestanding stores will continue, Ralston says, because consumers prefer stores providing overwhelming assortments, high visibility, value pricing, distinctive identification and convenient parking.

"Fifty percent of all new retail construction in 1998 will be freestanding buildings," Ralston says. "Drugstores and a variety of other retailers are opting almost exclusively for freestanding formats. More than half of these freestanding stores are owned by occupants themselves and the rest by public or private investors. It's a very big market."

A vast majority of these freestanding stores are likely to opt for credit-lease financing or any of its variations, industry experts say.

Tenant credit is critical "Credit of the tenant is the key factor in credit-lease financing," says Paul McDowell, senior vice president of New York-based Capital Lease Funding L.P., the nation's first capital-market-based credit-lease funding provider. "You have to look for two things: First, what is the credit rating of the tenant and is the tenant likely to stick around? Secondly, is there any ability of the tenant under lease to terminate the lease? That would be a casualty, failure of the landlord."

Three types of net leases qualify for credit-lease financing: Bond-type is the most desirable, followed by triple-net (NNN) and double-net (NN). McDowell says the challenge for lenders is to be able to determine the credit risk of the tenant in deciding how to make the loan.

"You try to eliminate real estate risk with the policy by enhancing the leases. Loans rise or fall based on credit quality of the tenant and quality of the lease," McDowell says. Lenders can take protective measures, he says, by purchasing specialized insurance designed to pay the mortgage holder the rent in case something goes wrong with the real estate or the tenant.

Capital Lease Funding's core product is its Hybrid Bond Lease Program, which finances double- and triple-net leases and enhances them to bond-type status if necessary. The firm also offers a variety of add-on programs such as Extended Amortization Program, an expanded Hybrid Bond program that provides additional financing and tax benefits for net-leased properties. Under this program, borrowers can finance net-leased properties through the first lease renewal period (generally five years) on a self-liquidating, non-recourse basis. It can net loan proceeds by 5 percent to 20 percent, depending on the lease term.

The comeback of the sale-leaseback Sale-leaseback financing also has come roaring back, says Jonathan Molin, president of U.S. Realty Advisors LLC, New York. The real estate adviser purchases and finances single tenant properties on behalf of institutional clients, insurance companies and pension funds.

Sale-leaseback, a variation of credit-lease financing, is a transaction in which property owners sell the property to an investor who, in turn, leases back the property to the seller for a long term - usually for 15 years or more.

These leases are preferably "net" or "triple net," under which the tenant pays a specified rent to the owner and is responsible for payment of all operating expenses of the property, including insurance, taxes and maintenance. The rent received by the owner is the "net" of operating expenses.In some cases, double-net leases, under which owners have some obliga tions, such as roof and exterior wall maintenance, also are used for sale-leaseback financing.

"We only invest in first grade and sub-investment grade properties with 15-year leases or more," says Molin, whose firm has about $15 billion single-tenant properties under management. "Sale-leaseback and credit-lease financing have really picked up during the last 18 months."

New converts, new products The new breed of investors flocking to single-tenant freestanding properties include real estate investment trusts (REITs), baby boomers and 1031 Exchange Buyers, says Christian S. Marabella, president of The Marabella Co. The Laguna Niguel, Calif.-based firm offers first-mortgage financing for single-tenant retail buildings, with starting mortgage arrangements at $400,000+.

Under section 1031, Marabella explains, a property held for productive use in a business is exchanged for likewise property, allowing the taxpayer to defer payment of capital gains taxes.

"Most investors are looking for 8 percent to 10 percent cash-to-cash return," Marabella says. "A lot of baby boomers are investing in real estate, but they don't want to manage these properties themselves. For them, sale-leaseback investments make perfect sense."

He says lenders are becoming quite liberal, going back to the 1980s when their underwriting standards were very relaxed.

"As a result, competition between REITs, exchange buyers, partnership buyers and individual investors has intensified," Marabella says. "Still, there is no other investment out there like NNN if properly structured."

Jeff Wakeman, president of Centurion Development Corp., a Charlotte, N.C.-based developer of freestanding retail sores, says synthetic lease financing is also gaining momentum in the industry.

The synthetic lease is similar to the sale-leaseback but with an off-balance-sheet deal of shorter duration, usually five to seven years. In a synthetic lease, the parent company sets up a third party or a single-purpose entity to book the loan. Proceeds from the loan are used to purchase the real estate. The special-purpose entity, which is controlled by the parent company, then leases the property to the parent company.

The benefits of synthetic leasing are especially attractive to fast-growing tenants that are relatively new and are unable to obtain long-term debt.

"The result is that the bank is making the loan to the tenant on the basis of the tenant's credit rating," Wakeman says. "Tenants have come to us and told us, 'We would like you to still manage the development process and we will give you a fee.' We have really noticed this activity since last year." Synthetic leases, he notes, can be loosely described as "outsourcing."

Wakeman says his firm is expected to do between $25 million and $30 million in synthetic-lease development this year.

Can everyone compete? Life insurance companies and other traditional lenders will continue to offer credit-lease financing in the market, says McDowell of Capital Lease Funding, which last year financed more than 100 credit-lease loans with investment-grade tenants totaling $500 million.

Wall Street, however, has changed forever the way credit-lease financing is used.

"Insurance firms and thrifts have been there for years in this business, but we are the first one to enter originating these mortgages on a flow basis and pool them and securitize them," McDowell says. "We are the only one to have ever issued a stand-alone pool of credit-net mortgages in the country."

Capital Lease Funding originates credit-lease mortgages, funds them with warehouse facility with NationsBank and at the appropriate time securitizes them. In the winter of 1997, it issued $130 million. The second pool of credit-net mortgages was ready for securitization last fall, but was postponed because of uncertainty in the stock market.

"We will do a much larger pool in late spring this year. It will be north of $300 million," McDowell says. "Credit-lease financing, however, is not for everyone."

Knowing the key criteria, understanding credit leases, dedicating resources necessary to process the complex loans, and understanding rating agencies' requirements - all are crucial to success in the credit-lease financing business, McDowell says.

"Being able to provide the fastest, most efficient and dependable level of service to the borrower, consistent pricing on these loans and the ability to offer innovative new products on a routine basis are a must," McDowell says.

"There is no margin for error in the credit-lease financing business," he cautions. "A lot of competitors have come in the past year and some have remained, such as First Union and Daiwa, but many have scaled back or withdrawn completely. At the end of the day, you will have probably two or three that are capital-market-based lenders that have committed to the resources necessary to compete in this specialized market niche."

Although credit-lease financing is still in its infancy in the capital markets with not-yet-solid underwriting standards, Wall Street has added a new dynamism to developing new stores and financing existing ones.

... to retailers: -- It frees their real estate. The money invested in "brick and mortar" suddenly turns into cash that be used to finance or expand their primary business.

-- Leases are treated as operating expenses and appear as a footnote on balance sheets.

-- Leasing gives tenants flexibility. After the term expires, they can move.

-- It is fairly cost effective.

... to investors: -- Since the credit standing of the tenant -- not the real estate -- is the primary focus of the transaction, a developer or investor can obtain up to 100 percent financing with a non-recourse loan and still retain the value of the property.

-- There is a long-term lease with a solid tenant.

-- The tenant's long-term occupancy minimizes leasing and management requirements and risks.

-- The tenant is responsible for increases in operating expenses.

-- Stipulated increases in net rentals can provide a growing cash flow.

-- Capital appreciation can be realized from growth in the income stream and, if appropriate, amortization of prudent amounts of mortgage financing.

Credit-lease financing -- A real estate transaction in which the primary focus of the lender remains credit standing and financial strength of the tenant rather than the value of the underlying real estate. The property is leased to a single, creditworthy tenant for a long term, usually 15 years or more. The tenant pays the net rent.

Synthetic-lease financing -- In synthetic lease, the parent company sets up a single-purpose entity to book the loan. Proceeds from the loan are then used to buy the real estate, which later is leased to the parent company. Such leases are generally for shorter duration, between five to seven years.

Sale-leaseback -- In sale-leaseback transactions, the property owner sells the real estate to an investor, who in turn leases back the property to the seller for a long term, usually for 15 years or more. These leases are preferably "net" or "triple net."

Credit standing -- Credit of the tenant is a key factor in all these types of financing. Three types of net leases -- bond-type, triple-net and double-net -- qualify for credit-lease financing, with bond-type most desirable, followed by NNN and NN.

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Daiwa Finance Corp. and Legg Mason Mortgage Capital unleashed their joint financing program targeting single-tenant net-leased properties in February 1997. Since then, it has done more than $1 billion in deals.

Headed by W. Kyle Gore at Legg Mason and Warren Ashenmil at Daiwa, the Daiwa/Legg Mason program (marketed under the name "Net Lease Capital LLC") offers up to 100 percent financing for properties net-leased to investment-grade tenants. Eligible leases include bond-type, triple-net and double-net.

Debt service coverage as low as 1.0x is available for loans secured by bond-type and triple net leases. Individual loans from $1.5 million to $100 million are considered.

"Legg Mason's and Daiwa's credit-lease financing experience and Daiwa's capital and commercial trading commitment ensure that this program will become a preeminent source of net-lease financing," says Legg Mason's Gore.

"Members of the Daiwa/Legg Mason team had financed well over $750 million of these transactions prior to creating this program," says Ashenmil, who amassed significant net-lease financing experience at CS First Boston before joining Daiwa in 1996.

Among the bigger retail sale-leaseback transactions done last year by the venture was a series of financings totaling approximately $400 million for the Rite-Aid Corp. Other retailers connecting on a Daiwa/Legg Mason deal last year were Heilig-Meyers furniture stores and Fred Meyer Corp., the supermarket chain.

The Staubach Co., a Dallas-based real estate services firm, has been active in acquiring sale-leaseback real estate, and Daiwa/Legg Mason has been the funding mechanism behind $250 million in loans the company did last year. Most of Staubach's acquisitions have been in retail, including more than 100 Rite-Aid buildings and a few Heilig-Meyers showrooms.

"Daiwa/Legg Mason is not the only one out there doing this," says Brett Landes, a partner at The Staubach Co. "But for our purposes - speed, creativity, ease to close and availability - they were what we needed. All those criteria are critically important to us because we are in a very competitive market."

Landes also liked working with Daiwa/Legg Mason because it was willing to experiment. "On a portfolio acquisition, we did the very first residual value insurance product."

Typically, on a long-term bond lease, the financing term equals the lease term (it has been almost impossible to sell any loan with a maturity beyond the lease term). Daiwa/Legg Mason worked with Staubach on a product that will amortize the debt beyond the lease term. "It is unusual," Landes says, "but now that it has been done, a lot of people are going to get into it."