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IS THE NET LEASE BOOM SELF-SUSTAINING?

Upland Real Estate Group predicts continuing growth in the net lease sector.

Michael K. Houge

Over the past 10 years, the net lease segment has been a booming market. We have watched and aided the net lease industry as it has grown from a handful of players to a multi-billion dollar industry that has spawned publications; specialty financing; conferences; and a multitude of specialty industry insiders, including lenders, developers, investors, brokers, qualified intermediaries, appraisers and REITs.

Houge

Net Lease Activity

When Upland Real Estate Group first entered this area, we analyzed our competition among brokers and found about 20 — nationally. This count did not consider multiple offices of national real estate brokers, but only included those whose core business was the sale of net lease investments. A decade later, the numbers have more than doubled as the segment continues to attract attention and a notable share of investment dollars.

There were similar increases in numbers of institutional sellers, developers, lenders and mortgage brokers. Why? Let's look at some of the following factors.

Development — There has been a significant increase in single-tenant development. Restaurants, auto parts dealers, drugstores and other national retailers have found the stand-alone building to be very conducive to increasing their revenues. This, coupled with a growing economy and a seemingly unabated housing boom, has created demand for retail development.

Demographic — As a contributing factor to development, the population growth and the maturation of the baby boomer generation is creating demand for the new product development and, interestingly, the end product as investment vehicles. In the near future, this generation will reach retirement age. These boomers are already seeking real estate investments, and, as inheritances are passed to them, the demand will not slow. There is an estimated $10 trillion in inherited wealth projected to pass to this group. To put that number in context, consider that approximately $39 billion was invested in commercial real estate by private investors in 2003. In the first 8 months of 2004, private investors invested $47 billion. (This statistic is based on tracking of 57 major markets.) REITs saw $20 billion invested over the same period and had a total market capitalization of approximately $200 billion.

Diversification — The rush to investment portfolio diversification is also leading to demand for net lease investments. Most credible investment advisors counsel their clients to have 7 to 10 percent of their portfolios in real estate since many investors experienced great losses in the stock market boom/bust of the 1990s.

We are all seeking investment products in many categories, including commercial real estate. Many average investors saw their 401Ks change to 101Ks, virtually overnight. Real estate, if well positioned and fundamentally sound, can be a very satisfying foundation to an investor's portfolio. The continued success stories of the REITs, good "buzz on the street" and favorable media coverage of commercial real estate overall feed demand for net lease properties.

Unsophisticated Buyers — Many investors seeking investment real estate properties are not necessarily sophisticated real estate players. These buyers are seeking high quality investments with little or no property management responsibilities. They definitely do not want to deal with the "three Ts" (tenants, toilets and trash). Net lease investment properties, by definition, are virtually maintenance free. Also, since most of the development is and has been for

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nationally recognized credit tenants, the investor can usually sleep easy, knowing his/her real estate investment is relatively safe.

1031 Tax Deferred Exchange — According to Deloitte Touche, an estimated $180 billion in 1031 transactions were completed in 2003 — up from approximately $65 billion in 2002. Once a West Coast/East Coast phenomenon, the Starker or IRC section 1031 Exchange is a nationwide tax strategy fueling extreme interest in net lease investments. Simply put, the 1031 exchange allows a seller/taxpayer to sell an investment property and — using a very specific set of IRS rules — "trade" into a replacement property (or properties), deferring any capital gains taxes due on the sale. This strategy has spawned a shadow industry of service providers who assist in this complex process. Their marketing, industry trade and general media coverage have all contributed to the exponential growth in the use of the IRC section 1031. I contend that sellers of skyscrapers in Midtown Manhattan, sellers of neighborhood strip centers in Las Vegas and sellers of farmland in rural Minnesota will at least consider utilizing IRC section 1031, and many will. Once these sellers become "trade" buyers, net leases become a high commodity. The 1031 Exchange has some very daunting timelines and replacement property identification considerations. If the specific rules set forth are not followed, the seller/taxpayer loses his/her ability to exchange and the 1031 fails.

In 2002, approximately $25 billion in 1031s failed. I contend that most were a result of failing to properly identify the replacement property (or properties). The IRC rules put significant time pressures on the sellers/taxpayers to identify properties, so extensive due diligence, analysis and leader underwriting is difficult, if not impossible. The net lease investment again rises to the top — net leases are easier for the 1031 exchange investor to get his/her arms around, since it is usually one credit-worthy tenant leasing long-term in a new, desirable location. Investors and lender underwriting can be swift — a much-needed factor in today's market.

Predictions

The aforementioned influences will continue to drive investor interest in net lease investment properties into the next decade and beyond. There may be some bumps along the way, but the net lease market segment is here to stay. Interest rates may increase, but cap rates will eventually follow. The stock market will rise, but it will also fall. Retailers and other net lease tenants will default and fail, but new, well-financed tenants will replace them. Neighborhoods and locations will decline only to cause revitalization and expansion into new areas. The net lease market boom is self-sustaining.

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