MacDonald Expects Slowdown To Benefit Net Lease Business

By Jennifer D. Duell, Field Editor

Orlando, FL- Amid rumblings of an economic slowdown, the net lease industry continues to flourish. So while technology firms shudder, retailers seek to recover from a tough holiday season and the Federal Reserve reduces interest rates to deflect inflationary risk, net lease players expect another year of increased volume from both sale-leasebacks and 1031 exchanges.

"It's a wonderful time to be in net lease," said Gary Ralston, president of Commercial Net Lease Realty Inc., which acquired $200 million of net lease product, an increase over 1999, and sold off $65 million worth of assets last year. He expects the net lease option to be an increasingly important capital tool over the next 10 years.

Interest in the product comes from all sides. "As many companies experience compressed margins and balance sheet stress, they will focus on de-leveraging and selling real estate assets for increased financial flexibility, which allows them to focus on their core competencies," Ralston explained.

Bruce MacDonald, president of Net Lease Capital Advisors Inc., agrees. "With a slowdown in the economy and companies becoming more balance-sheet sensitive, I expect to see a greater interest in net leases, specifically in sale-leasebacks," he said.

More companies are beginning to realize the value of sale-leasebacks, according to U.S. Realty Advisors L.L.C. president Jonathan Molin. "Companies want to be able to better use their capital."

Molin also noted that the sale-leaseback option is becoming a competitive advantage. "When a company sees its competitor doing a sale-leaseback, it starts to make sense to enter into the same low-cost situation," he said. In fact, Molin noted that a structured annual rent charge often improves various key financial ratios on the balance sheet, including return on investment, return on assets and return on equity.

Additionally, MacDonald said he expects to see more corporate players getting involved in net lease from an end-buyer perspective for 1031 exchanges. His firm uses 1031 exchanges and credit tenant property as a tool to implement investment strategies. For example, one client recently sold a $65 million property and exchanged it for a $45 million credit tenant property, which saved the client more than $15 million in capital gains tax.

Marcus & Millichap Real Estate Investment Brokerage Co. completed several restaurant net lease transactions last year, primarily through 1031 exchanges, according to Bernard Haddigan, managing director & national director of retail. "We're doing huge volumes of 1031 exchanges," Haddigan said. "Companies are getting very tired of managing properties that are a pain in the neck."

These 1031 exchanges are also attracting investor interest. "There are so many 1031 investors, it's almost like an auction," said Paul Domb, asset manager for United Trust Fund. "I get 10 calls a week from investors who have millions and want to buy into a net lease situation. They're looking for trades and want a passive investment to replace a property that requires hands-on attention."

Investors are growing more interested in other transactions, as well, contributing to the market sector's heat. "Several of our clients have aggressive goals," Molin said. "One client alone needs $300 million."

"From an investor standpoint, now is a great time to get involved with net lease," added W.P. Carey & Co. executive director Ed LaPuma. "With the uncertainty in the stock markets, net lease is an attractive alternative with stable, consistent returns and minimal risk. It offers protection that another kind of investment choice doesn't."

Nor are investors encountering difficulty finding capital. Haddigan anticipates new capital will enter the marketplace, while Capital Lease Funding L.P. senior vice president Paul McDowell noted that securitization is expected to grow substantially during the next couple of years, given the increased interest in net lease transactions. According to McDowell, Capital Lease Funding plans to securitize about $500 million this year. "We hope to have steady originations of about $750 million and two or three securitizations as well," he observed.

The result of such widespread interest in net leases is high expectations for 2001 among those most actively involved in the market. After increasing its business last year to 19 sale-leaseback transactions totaling $525 million, compared to $300 million in 1999, Net Lease Capital Advisors is expecting 2001 to be "a good year," MacDonald said. It already has a large sale-leaseback slated for completion in the first quarter.

United Trust Fund has several transactions closing in the first quarter, with other deals already in the pipeline for the second quarter, according to Domb. United Trust Fund completed 25 net lease acquisitions worth $350 million last year, up 20 percent from 1999. "I keep waiting for a downturn in the net lease market, but I don't expect it to happen this year despite the overall economy," Domb said. "The ball will keep rolling."

Similarly, W.P. Carey expects 2001 to match 2000's strong numbers. The company closed 30 transactions during the fourth quarter of 2000, more than in any other quarter in the history of the firm, according to LaPuma. "The market is there," he noted. "Companies need capital to continue to grow and pay down debt. Net lease is all about maximizing the capital frontier."

But upward movement is by no means guaranteed. Market volatility has been exacting some price for net lease players. According to Corporate Real Estate Investment Co. executive vice president Ethan Nessen, the "roller coaster" market has hampered the effective execution of net lease transactions.

"With bond spreads changing on a day-to-day basis, the challenge is how to consummate the transactions," Nessen said. "We have to be careful to structure transactions to suit the marketplace."

CRIC increased its volume over 1999 last year, completing $175 million in net lease transactions, but it did not meet its goals. And Nessen expects the challenges associated with the capital markets to escalate, necessitating an increased level of creativity and diligence to complete net lease deals. "It's impossible to have a cookie-cutter deal to get transactions done," he said.

And while Molin expects his company to perform well in 2001, the volume he expects is equal to what U.S. Realty Advisors experienced in 2000. It was a "good, solid year," with completions of about $1 billion in acquisitions and sales of between $40 million and $50 million, including a CVS, a Wal-Mart and a The Home Depot. Its total acquisitions, though, numbered four fewer than those in 1999. "We bid quite aggressively and sometimes we didn't get what we wanted," Molin noted.

The cost of financing clearly is higher than it has been in the past, noted Richard Jacobs, managing director of the real estate capital markets for Legg Mason Wood Walker Inc. "The challenge is the fixed cost of doing business, which requires you to be in tune with the pricing and sharper with the pencil," Jacobs said.

According to Molin, the lack of liquidity in the debt market made it difficult for companies with subinvestment-grade credit to obtain financing. "Both investment-grade and subinvestment-grade companies are experiencing wider spreads than ever before-at least 120 to 125 basis points above Treasuries. For less stable companies, the spread is even wider-200-plus points above-and companies are interested in any kind of financing at that point," Molin said.

Jacobs agreed. "With the volatile spreads, it's not as easy for a CFO to pull the trigger,' he said. "Overall, it's a judgment call. Is now the right time to execute on a net lease? Will you be applauded or booed for your decision?"

However, Jacobs expects volume to increase this year as more corporate tenants get in the game rather than sit on the sidelines. And McDowell believes a downturn in the economy would make net lease even more desirable and perhaps offset any concerns related to the volatile capital market. "Economic slowdowns make net leases look even better," he said. "There are benefits to net lease from a tenant perspective and an investor perspective."

"There is a demand for net lease," added Nessen. "And during a recession it never decreases. There's been no decline in enthusiasm. In fact, it's been just the opposite."

For net lease investors, a recession or just a downshift in the economy also brings with it increased risk of tenant default. Indeed, the biggest challenge this year continues to be the pure credit risk element, according to Jacobs. "In some circumstances there is an institutional bias against a particular tenant's credit and industry," he said.

A great number of companies experienced a significant credit downgrade last year, Haddigan noted. "A lot of tenants that were perceived as strong and stable had their credit rating knocked all over the place," he said.

The retail industry in particular has been hit very hard, Nessen noted, making it difficult for many retailers to obtain financing. In addition, the retail arena is more mature than office or industrial, McDowell observed, and the result has been reduced interest in that sector.

Indeed, Commercial Net Lease Realty, which traditionally focused on the sector, is seeking to diversify its portfolio this year and is interested in industrial and office product. It is currently negotiating with an industrial company to acquire 160 locations worth $250 million. Another deal involves the acquisition of a headquarters facility for $35 million, according to Ralston.

Legg Mason Wood Walker, for its part, is moving away from retail altogether while continuing to focus exclusively on the credit side of bond lease transactions, Jacobs said. "Retail is the low-hanging fruit of the net lease industry," he noted. "This year, the determination of success will be the quality of the products. We plan to focus on deals that require more work and result in larger dollars per property, and are concentrating on greater diversification of tenants and industries."

McDowell, however, believes there is room for growth in all sectors-even retail. He noted: "It's of critical importance to differentiate among retailers. It's too easy to paint all retailers with the same brush stroke. There are big differences among the various retailers." His firm is interested in retailers with strong investment-grade credit ratings, those that are posting significant growth. Indeed, McDowell believes the retail segments of drug stores and supermarkets are "recession resistant." He pointed out, "Everybody has to eat and wear deodorant."

Ultimately, diversification is most likely to provide strength, Nessen advised. "The market did away with commodity products," he added. "You can't generalize on an industry. You have to focus on the company. It's still about credit and it will continue to be about credit."

RVI Group has taken that diversification route. According to executive vice president Tom Cox, in 2000 his firm guaranteed a mix of products including fast food, office and small industrial, and its insured volume doubled from 1999. He expects this year's volume to be flat or grow marginally over 2000.

Domb's firm has become increasingly interested in headquarters facilities and finds industrial and office product highly desirable. For example, the firm recently negotiated a 20-year bond-type lease with an investment-grade client involving a 250,000-square-foot industrial facility in Oklahoma City. The firm also completed an acquisition of a headquarters facility in Atlanta.

Jacobs said increased investor scrutiny is the impetus behind this diversification. "Investors will be more judicious and more selective in their investment decisions," he observed. "There's a greater buy-side diligence where everything is negotiated and investors are digging through the prospectus for answers to their questions."

United Trust Fund is also willing to take a risk on lower-grade credit. It will continue to focus on "every type of product and every type of credit," Domb said. "We'll take a look at anything because anybody can do investment-grade deals. It takes more creativity to work with subinvestment grade."

W.P. Carey focuses on companies with emerging credit regardless of industry, said LaPuma. In fact, the firm believes it receives the most value from subinvestment-grade credits and evaluates companies anywhere on the credit spectrum. It recently completed a $19.5 million acquisition of three new megaplex/stadium-seated movie theaters operated by RAVE Reviews Cinemas L.L.C. Additionally, the firm completed a $57 million acquisition of five facilities operated by lifestyle retailer Galyan's Trading Co. On the industrial side, W.P. Carey acquired five facilities from Applied Power Inc. in a sale-leaseback transaction worth $29.1 million.

As the net lease industry continues to mature, Ralston anticipates a "vertical integration," with the equity and debt components of a transaction unified through partnerships like the one between Commercial Net Lease Realty and First Union. The REIT's goal for 2001 is to invest between $500 million and $1 billion in net lease acquisitions through its partnership with First Union, Ralston said. He explained that the two companies joined together to provide equity and lowest-cost debt on assets of replacement equity in 1031 exchanges.

Similarly, Capital Lease Funding has established a strong relationship with Deutsche Bank to provide warehouse financing and to act as the firm's investment banker, McDowell said.

Companies are also looking overseas for business. In fact, W.P. Carey completed its first net lease transaction abroad last year and has plans to expand its reach in England and France. "W.P. Carey is looking abroad to grow its business," LaPuma said. "The international markets are not saturated by net lease firms and possibly offer higher returns from sale-leasebacks and build-to-suit transactions." LaPuma also noted the importance of market diversification to minimize economic risk. For example, if the United States experiences a slowdown, W.P. Carey will have operations in other markets that continue to flourish.

U.S. Realty Advisors also plans to look abroad to Europe for future net lease opportunities, Molin said. "As the world becomes more unified, we hope to create opportunities beyond the United States," he said.

RVI likewise plans to expand its business to the United Kingdom, as well as to Canada and Mexico, according to Cox. It will also broaden its focus by looking at new types of product.

Perhaps one of the reasons behind international expansion is increased competition in the United States. Ralston noted that while there are quite a few established net lease players right now, he expects to see several more enter the market to take advantage of the sector's growth.

Certainly, the net lease market is healthier today than it was a year ago, noted Molin. "As net lease receives more recognition and establishes a greater awareness, the market will expand with more competition and liquidity," he said. Each transaction has at least 10 to 12 bidders today, whereas five years ago there were only three or four bidders. "From the standpoint of the buyer, it's frustrating," Molin said. "But it's good for the seller."

LaPuma also lauded the increased competition. "The more people (there are) out there beating the net lease drum, (the more it) should increase awareness of the industry and create a bigger pie, not necessarily smaller pieces."

[Back to Top]
[Back to Table of Contents]