Shopping Center World

NET LEASE FINANCE: Diving for Deals

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Going into 2001, net lease finance firms were primed for a banner year. The net lease business had grown steadily for a long time, and with the economy slowing it seemed that corporate America would have no choice but to embrace net lease in a big way.

It didn't quite work out that way. An empirical survey of net lease finance companies shows that, for the most part, 2001 was a good year but not a record one. In addition, some net lease companies turned away from the struggling retail sector toward healthier asset classes such as office and industrial buildings, even hotels (see sidebar, p. 24).

Here comes the snowball

Net lease companies operate under the theory that when capital for financing dries up, corporations can free up dollars by monetizing such passive assets as real estate. The problem was, the economy during the first half of 2001 was declining at such a rapid pace it was difficult for companies to adjust quickly. Only in the second half of the year did the pace of net lease deal-making explode.

“It was like a snowball coming down the mountain,” observes Leo Schwartz, executive director of acquisitions for Corporate Realty Investment Co. LLC in Boston. “As the snowball progresses to the bottom, it gets bigger and bigger. What I was seeing was more deals done in the last two months of the year than I had seen in the year prior. Many investment-grade companies wanted to get transactions done by the first quarter of 2002.”

In the second half of 2001, interest rates plunged to levels not seen since the 1960s. “This wasn't a record year for us, but it had been a very good, solid year,” observes Brian Tracy, a managing partner of El Segundo, Calif.-based Net Lease Properties LLC, which specializes in retail net lease deals. “Interest rates in the last half of 2001 dropped and that helped fuel things, keeping the opportunities open.”

This end-of-the-year sentiment was echoed by CB Richard Ellis Corporate Partners, a specialized net lease operating unit performing under the umbrella of CB Richard Ellis Investors in Los Angeles. “Companies were slow to take action in 2001,” says Scott Tracy, an executive managing director at CB Richard Ellis. “Toward the end of the year we saw a huge increase in activity. We have a tremendous amount of deals in the pipeline and we are picking up additional sources of capital.”

What some companies didn't realize, says Tracy, is that when there were opportunities in recent years to do net lease deals and those opportunities ended, they couldn't be resurrected at a later time. The dynamic of the market changed along with the flailing economy.

One downside was that many of these same companies in a softer market suddenly faced credit issues that made completion of a deal much harder. “If they had taken decisive action prior to the soft economy, they may have had more leverage,” explains Tracy. “A lot of companies where the credit had been downgraded tried to do net lease transactions, but didn't have the leverage they would've had if they had done it a year earlier.”

The problems for retailers with weakening credit are twofold: deals become more expensive, and with so many companies suddenly wanting to do deals, net lease finance companies can pick and choose the better credit risks.

“It was a good year, I don't know about great, but we did a lot of business in 2001,” says Jonathan Molin, president of U.S. Realty Advisors LLC in New York. “There has been a lot of demand from buyers. And, businesses looking to raise cash have been willing to do deals at numbers that made sense."

Molin has a good sense of what big investors are looking for in net lease because U.S. Realty Advisors represents a number of institutional players, including the pension systems of San Diego County, the City of San Diego and Los Angeles Fire & Police. To be specific, he says, there has been a "flight to quality" as investors perceive credit tenant lease transactions with long leases to be good investments.

W. P. Carey & Co LLC did about $400 million in net lease transactions in 2001, "which is certainly one of our best years," says Gordon Whiting, the New York company's deputy director of acquisitions.

Whiting attributes the healthy net lease market in 2001 to two factors: the growing popularity of net lease in general and a liquidity crunch. When institutions clamped down on traditional lending as they did in 2001, companies looked for alternative methods of finance such as sale-leasebacks.

In fact, there appeared to be a flood of potential deals in 2001, which, again, meant net lease finance firms were more selective. "When the economy slows, the number of deals you look at increases tremendously," Whiting says. "Our job is to analyze the credits because tenants need to be able to survive in a slow economy. We focus on credit underwriting and trying to get the best-quality assets."

Miami-based United Trust Fund (UTF) reports it did about $280 million in net lease deals in 2001, about the same as the year before. "I wouldn't say a record year, but a good year," says Paul Domb, UTF's vice president of asset management. "We are doing business in a low-interest-rate environment and corporations are taking advantage."

As for 2002, Domb maintains the benchmark for estimations will be how much business is in the pipeline going into the first quarter — and that means UTF has reason to be optimistic for the new year because its pipeline has "a lot" of deals in it.

"2002 will be as strong as 2001," predicts Frederick Wehba, president of Century City, Calif.-based Bentley Forbes Group LLC.

According to many, 2002 may very well be a record year.

Steve Bergsman is a Mesa, Ariz.-based writer.

Where were the retail deals?

The net lease industry initially prospered on the rapid expansion of retailers, whether it was drug stores, eateries, gas stations or big-box vendors like Wal-Mart. But with the economy in a recession and a number of retailers going out of business, finance companies that do net lease deals have turned to other asset classes such as office and industrial buildings, even hotels.

"We did no retail in 2001," notes Frederick Wehba, president of Century City, Calif.-based Bentley-Forbes Group. The company boasts a net lease portfolio of almost $1 billion with most of it in industrial and office properties.

"We have done in the past quite a few retail deals, but retail was down for us in 2001," adds Paul Domb, vice president of asset management with Miami-based United Trust Fund. "Over the past five years, retail expansion had been tremendous. If a store opened on one corner, a rival would open on the other." Unfortunately, that strategy was financially unhealthy and a number of quick-growing retailers incurred tremendous losses. When the economic slowdown set in, stores began to close.

Gordon Whiting, deputy director of acquisitions for W. P. Carey & Co. LLC in New York, says that, in regard to retail, his company prefers headquarters, distribution and warehouse buildings as opposed to actual stores. "Retail in a down economy is not necessarily your first choice," he notes.

"I don't know if we acquired any (retail) in 2001. We did distribution facilities; you might classify that as retail," says

Leo Schwartz, executive director of acquisitions at Corporate Realty Investment Co. LLC in Boston.

The problem is, in a slow economy, net lease companies look for deals with creditworthy tenants and a lot of retailers are no longer at credit grade. "There were several retail opportunities offered to us, but they were marginal investment grade, a BBB-, and they would be treated as non-investment grade anyway," Schwartz explains. "I'm not sure I know of a lot of retail deals that got done in 2001."
— *Steve Bergsman*