NET LEASE forum

The On-Line Newsletter from the Editors of Real Estate Forum and GlobeSt.com

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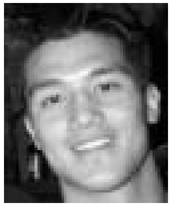
INDUSTRY UPDATE

Norseman, KeyBank Offer New Loan Product For Shorter-Term, Single-Tenant Properties

Specialty finance firm **Norseman Group LLC** has created a new loan product geared toward single-tenant properties with shorter lease terms than would qualify for traditional credit-tenant lease financing. Essentially mezzanine loans to bridge the gap between first mortgages and investors' equity, the product, dubbed Credit Tenant Note, is being funded with partner **KeyBank Real Estate Capital** of Cleveland.



"Where there's excess cash flow and credit, we can finance it."

▸ **Joe Yiu**
Norseman Group LLC

The Credit Tenant Note—the name is trademarked and a US Patent Application is pending—is fully amortizing over the lease term and does not require a real estate lien. It monetizes excess cash flow from rents after the mortgage debt service is paid, and can bring an owner's financing to as much as 90%, perhaps even 100% or beyond. "What we saw in the marketplace was net-lease deals trending to shorter-term, seven- to 15-year leases," says Joe Yiu, managing director at Jersey City-based Norseman. "It's very hard to get those types of deals done with CTL financing."

Yiu says the Credit Tenant Note is especially suited for two types of borrowers: build-to-suit developers who can realize tax-free profits through permanent financing while holding a property for future appreciation, and 1031 exchange buyers who can leverage shorter-term deals like the longer-term ones they typically look at. The loan may also be suitable for other investors to finance above-market rents, above-standard tenant improvements and dark properties, as well as to cash out equity on existing properties with restrictive first mortgages.

Underwriting for the loan is based solely on tenant credit and lease cash flow, not appraised value. The program is targeting loans of $2 million to $10 million for tenants with credit of BBB and higher, priced at 6% to 9.5%. However, if KeyBank feels comfortable with larger deals, it will lend on its balance sheet and syndicate them through subsidiary **McDonald Investments**, Yiu says. Norseman/KeyBank's ultimate exit strategy is to securitize the Credit Tenant Notes in a CDO structure through McDonald. In addition, Norseman has a relationship with **Provident Bank** of Cincinnati for loans that fall outside of the Norseman/KeyBank box.

Yiu says there is $200 million worth in the pipeline. "Where there's excess cash flow and credit, we can finance it," he adds.

CRESA Partners Reps Tech Client In Structuring Three New Synthetics

Cresa Partners Capital Markets in Dallas has structured three new synthetic leases valued at $112 million for a client whose identity has not been revealed. The national high-tech equipment company, which had three synthetic leases expiring, financed new synthetics with a new lender that Cresa Partners principal Cathy Sweeney describes as "a well-known name."

Each Libor-based deal covers R&D/office buildings, at least one of which is vacant.

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NETLEASE INSIDER

Corey Bialow

*The **Vitamin Shoppe** chain, purchased by Bear Stearns Merchant Banking at the beginning of the year, is one of the fastest growing retailers in the country. It now has 144 stores in 20 states. **NET LEASE forum** spoke with the North Bergen, NJ-based company's director of real estate **Corey Bialow**.*

Q: What kinds of leases does Vitamin Shoppe typically use?
A: A lot of the deals we did during our initial growth mode were freestanding buildings with true net leases. Now that we're expanding into other parts of the country, we're doing a lot of new construction pad sites or out parcels of shopping centers with traditional leases. We sign long-term deals, typically 10 years plus options.

Q: And do you prefer a net lease?
A: If it's a single-tenant building, we prefer to maintain the property ourselves

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The pricing was virtually unchanged from the company's expiring synthetics, roughly half of what a conventional lease would

"The accountants had to educate their clients on what the interpretation said."

▸ **Cathy Sweeney**
Cresa Partners Capital Markets

cost, Sweeney adds. The deals show that synthetic leases are still a viable option for corporations, she says, and illustrate the scrutiny accountants are giving synthetics as they seek to comply with the Financial Accounting Standards Board's Interpretation No. 46.

"It seemed that the bankers and the leasing real estate professionals, and even the treasurers, were very comfortable with how they were proceeding," Sweeney relates. "But the accountants had to educate their clients on what the interpretation said—and some of them took a long time in doing that—and educate their internal staff on what their expectations were to audit whatever might come up."

Particularly on the West Coast, where there is a high exposure to synthetics, the accounting firms "tend to be a little more stringent upfront and are requesting a lot more documentation," Sweeney concludes.

AFRT Closes IPO, Sale-Leaseback; $188M of Assets Under Contract

The last few weeks have been busy for Jenkintown, PA-based **American Financial Realty Trust**. On the heels of its successful IPO, which raised $740 million after expenses, the REIT closed on a $769.8-million sale-leaseback with **Bank of America NA**. According to Securities and Exchange Commission filings, AFRT has another $188.7 million of properties under contract with closings expected in the third quarter.

Though its shares were priced at $12.50 on June 24, they opened at $14.25 when listed on the New York Stock Exchange the next day. The offering closed five days later

Executives from AFRT and friends celebrated its IPO by ringing the NYSE's opening bell on June 27.

with more than 64.3 million shares sold, including a more than eight-million-share over-allotment option granted to its under-

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RATINGS UPDATE

▸ Standard & Poor's Ratings Services placed the long- and short-term ratings of **Eastman Kodak Co.** on CreditWatch with negative implications following its announcement that second-quarter income could be less than half of a previous forecast. Fitch Ratings said a review of Eastman Kodak was likely, though it still expects the company to reduce leverage.

▸ The outlook for **Best Buy Co.** was revised to stable from negative by S&P, which also affirmed the retailer's BBB- corporate credit rating. S&P cited "Best Buy's divestiture of its troubled Musicland business segment, no expected significant acquisition activity over the next 12 months and positive same-store sales trends."

▸ Fitch downgraded the senior unsecured debt of **General Motors Corp.** and related entities to BBB+ from A-. The outlook remains negative. Weaker than expected performance in the US light vehicles market and concerns over health-care and pension obligations were among the factors.

▸ The ratings of **Fleming Cos.** were withdrawn by Fitch, following policy for companies that file for Chapter 11.

▸ Moody's Investors Service downgraded the senior unsecured debt ratings of **Sony Corp.** to A1 from Aa3. The outlook is negative. Moody's noted concern "that Sony may take longer than expected to regain its previous strong profit and cash flow generation patterns."

▸ Fitch lowered the senior unsecured debt rating of **Tenet Healthcare Corp.** to BB+ from BBB-. It remains on Rating Watch Negative. The downgrade is based on pressures on operational performance, while the Rating Watch relates to outstanding investigations and shareholder suits.

▸ The outlook for **J.P. Morgan Chase & Co.** and subsidiaries has been revised to stable from negative by Fitch. "JPMC's financial situation has stabilized, with improving signs evident in key businesses," the ratings agency notes.

▸ **Goodyear Tire & Rubber Co.**'s senior unsecured rating of B was placed on Rating Watch Negative by Fitch, based on labor negotiations that have been at a standstill.

▸ The corporate credit and senior unsecured debt ratings of **May Department Stores Co.** were lowered to BBB+ from A by S&P.

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writers. President, CEO and vice chairman Nicholas S. Schorsch is limited in what he can discuss about his firm's IPO so soon after. But he did say, "We are pleased with the market's response to our company."

While AFRT has its roots in an entity formed in 1996 by Schorsch and his wife, SVP of corporate affairs Shelley D. Schorsch, it started going after institutional capital with a REIT structure formed in 2002. It raised about $400 million in a private placement last year, and has been working on going public while focusing on its investment niche of properties net-leased to large financial institutions ever since.

"We looked at the segment and focused totally on large market banks," says Nicholas Schorsch, noting that FDIC-insured commercial banks and savings institutions owned about $92.5 billion of real estate at the end of 2002. "We focused our ability and efforts on the needs of financial institutions. This is a market that has been underutilizing its assets."

Bank of America, one of AFRT's two largest tenants and co-lead book runner of its IPO, seems to agree. The most recent transaction between the two parties encompasses 158 office, banking and operations center assets totaling 8.1 million sf and resulted in the leaseback of 5.2 million sf under 20-year triple-net terms. The bank leased back another 804,000 sf on a short-term basis; 813,000 sf is leased to third parties; and the remaining vacancies will be leased by AFRT to other financial firms.

The deal "will enable Bank of America to generate immediate cost savings as well as to increase our operating efficiency and reduce our role as a property manager for third-party tenants," the bank's SVP of corporate real estate, Robert M. Patterson, said in a statement.

Is Recent History Repeating Itself? Another HPT Lessee Said to Default

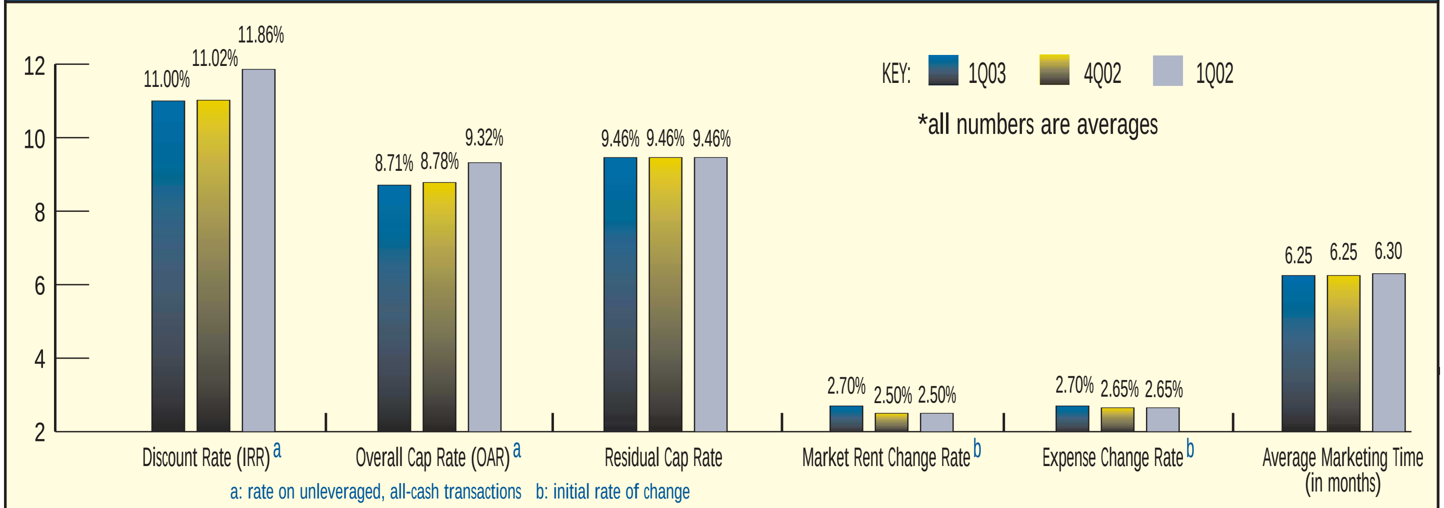
Three months after **Hospitality Properties Trust** notified Wyndham International Inc. that it had defaulted on its rent for 27 hotels, the Newton, MA-based REIT has sent out a similar notice, this time to **Prime Hospitality Corp.** According to the REIT, Prime, which through a subsidiary leases 24 AmeriSuites owned by HPT, failed to pay almost $2 million of rent due July 1.

In response, Fairfield, NJ-based Prime stated that "for the past 12 months, lease payments have exceeded operating cash flow by approximately $9 million."

HPT has the right to install a new manager and re-brand the properties. Both companies have said they will meet to discuss the future of the hotels, located in 14 states. The lease and guaranty for the lease obligation are secured by $42.1 million of deposits, and Prime's obligation to maintain the assets is secured by about $4.2 million on deposit. HPT intends to retain the security and reserve account funds.

After notifying **Wyndham** in early April that its subsidiaries had defaulted on rent payments, HPT terminated the leases. It also exercised its right to retain security deposits and capital replacements reserves, totaling $40 million, and selected new management companies for the properties.

National Net-Lease Market Rate Trends



a: rate on unleveraged, all-cash transactions b: initial rate of change

Source: Korpacz Real Estate Investor Survey ®, published by PricewaterhouseCoopers www.pwcreval.com

Does FIN 46 Represent a Shift Toward Principle-Based Accounting?

Does the **Financial Accounting Standards Board**'s Interpretation No. 46 represent a shift toward more European-style, principle-based accounting standards? The question, much like FIN 46 itself, raises issues and implications far more sweeping than the synthetic lease business. But it is worthy of consideration

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in the context of synthetic lease financings and the new guidelines.

In Europe, says Ethan Nessen, principal of Boston-based **CRIC Capital**, synthetic leases do not exist; the structure does not fit within principle-based accounting standards. Indeed, he says the synthetic lease could be a poster child for anti-principle-based accounting. But the debate over synthetics may point to tension between European and US rules-based accounting standards, he concludes.

"There is a cultural chasm between how the Europeans have really taken on a principle-based approach versus US accounting," says Nessen. He says the drive behind FIN 46—disclosure of the kinds of off-balance-sheet financing that led to Enron's

demise—did represent a shift toward more principle-based accounting, even though "the net results of FIN 46 are that it hasn't."

The FASB doesn't see it quite the same way. "This standard has been characterized as being more principle-based than most," says Sheryl L. Thompson, spokesperson for the Norwalk, CT-based board. "But all of our standards or accounting guidance are a mix of principles and so-called detailed rules. And depending on the complexity of the issues, there will more than likely be a greater number of detailed rules.

"There has been some interest in producing standards that have more of a principle-based approach, but there has also been plenty of disagreement or criticism about that," Thompson continues. "I think that in the future, while the book is still somewhat open on this, you will continue to see a mix of principles and rules."

RECENT TRANSACTIONS

▸ A 51,351-sf distribution facility leased to **Airborne Express Inc.** was purchased by **One Liberty Properties Inc.** The REIT paid $3.9 million in cash for the Melville, NY property.

▸ The 321,836-sf class A office building known as Xerox Centre in Santa Ana, CA was purchased by **Triple Net Properties LLC** on behalf of tenant-in-common investors completing 1031 exchanges. **DL Cabrillo LLC** sold the property for $60.5 million. A $45.4-million loan was arranged by **Cohen Financial** through **Fleet National Bank**.

▸ **Parlex Corp.**, a designer and manufacturer of flexible interconnect products, completed the sale-leaseback of two properties for $12 million. The properties, in Methuen, MA and Cranston, RI, were purchased by **Taurus Methuen LLC** and **Taurus Cranston LLC**. The company must maintain irrevocable letters of credit totaling $1 million to ensure lease performance.

▸ The 141,000-sf, two-building Sunset Corporate Plaza complex in Reston, VA was purchased by **Wells Real Estate Investment Trust Inc.** for $29.3 million. Tenancy includes the headquarters of **IBM**'s government consulting group, which occupies about 100,000 sf on a long-term basis.

▸ According to Reuters, **AOL Time Warner Inc.** has agreed to buy another 100,000 sf of office space in the AOL Time Warner Center at Manhattan's Columbus Circle. A spokesman for co-developer **Related Cos.** could not confirm. The media giant already purchased 879,000 sf, which according to previous reports was financed through a synthetic lease.

▸ **ARC Properties Inc.** announced two recent tenant-in-common investment transactions. The company sold a 49% TIC interest in its 80,000-sf office building at 216 Route 17 North in Rochelle Park, NJ that is leased to the **Bergen County Board of Social Services**. And affiliate **ARC Corporate Realty Trust** purchased a 40% TIC interest in a 154,000-sf retail property on Route 17 in Paramus, NJ leased to **Levitz Furniture** and **Babies "R" Us**.

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Publisher: Jonathan A. Schein
Editor-in-Chief: Michael G. Desiato
Editor: Michelle Napoli
Creative Director: Scott Thompson

For Editorial Feedback & News Leads:
Contact Michelle Napoli at 212.628.9254 or netleaseforum-feedback@remediainc.com

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because it's easier and we're accountable to no one. There's really not a whole lot of maintenance when you're a freestanding building. But in a shopping center, we prefer that a landlord maintain the property and be responsible for everything. We've gotten into situations where we're in two three-tenant buildings and the tenants themselves are supposed to work out agreements on maintaining the property, and it's a formula for problems. There are always tenants that want to maintain a property better than others.

Q: How has your expansion affected real estate planning?
A: We've grown tremendously. Five years ago, we were a 20-store chain. We've developed a lot more clout in terms of our ability to negotiate. Now that we're becoming more nationally recognized, landlords are a little more willing to work with our lease form. We're dealing with the bigger players, the larger shopping center owners, and we're starting to get those phone calls first when spaces become available.

One of Vitamin Shoppe's new stores, in Niles, IL.

Q: How does your lease differ from the typical landlord lease?
A: The landlord forms are often geared toward mall tenants and have a lot of clauses that really aren't applicable to our particular deal, but you have to spend time and money negotiating. For instance, we don't sign percentage rent deals. And there'll be 16 pages on how to account for gross sales, things of that nature.

Q: What's your future growth plans?
A: We're putting together our schedule for '04. We see ourselves by the end of this year with approximately 175 stores open. And for next year we're going to do another 75 new stores. We'll probably increase that number in '05. We wanted to grow at a much quicker rate for the past couple of years, but we were smart about it. We put into place a pretty solid infrastructure. We just moved into a new distribution center here in North Bergen, a 230,000-sf warehouse with new, fully automated systems.

Q: What are some of the primary drivers of your site selection?
A: We focus only on regional shopping areas, markets in close proximity to the malls or big-box shopping centers, the category killers. We don't go into supermarket-anchored neighborhood strips. We like to be across the street from the regional mall, near major highways. In terms of demographics, we're looking at densely populated areas that have above-average incomes. It doesn't have to be real high-end for us to be successful, but we do better with an educated, slightly higher-income customer. Traffic counts are important; we like to be located on the major commercial highways that have 40,000-plus cars a day going by.

EXECUTIVE POSTINGS

Jim Noack

Jim Noack recently joined **1031 Exchange Options** in Lafayette, CA as its new CEO. Noack, formerly founder and president of Monument Mortgage, will help manage 1031 Exchange Options' 300% annual growth rate, according to the company. His past experience also includes positions at Wells Fargo Mortgage, IMCO Realty Services and Fannie Mae. Meanwhile, 1031 Exchange Options' former CEO, David Waal, has taken over the position of managing director to focus more on cultivating business relationships with the company's associates, partners and clients.