RETAILTRAFFIC
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Net lease financing

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MOST RETAILERS BELIEVE THEY CAN GET A HIGHER RETURN ON CAPITAL BY PUTTING MONEY BACK INTO THEIR CORE BUSINESS RATHER THAN INVESTING IN REAL ESTATE.

Retail deals continue to dominate the net lease finance market. Net lease finance has long been considered a reliable source of capital to fund additional growth. But the volume of transactions has picked up as retailers seek alternative ways to finance expansion amid battered stock prices. “Retail has always been an active segment of the net lease sale-leaseback market because retailers are capital intense,” says Richard Ader, chairman of New York-based U.S. Realty Advisors LLC.

The volume of net lease transactions in 2001 is expected to outpace that of last year. “First quarter tends to be a quiet quarter,” Ader says. But that has not been the case this year. “We have seen first quarter volume close to $1 billion, and it is mostly retail or retail-related deals,” he says.

“We're seeing a very strong flow of activity,” agrees Paul McDowell, CEO of New York-based Capital Lease Funding LP. Capital Lease Funding provided about $700 million in credit tenant lease finance in 2000, and the firm expects that volume to increase by about 10% in 2001.

One reason for the increase is that competition has diminished as some players, such as investment banks, have scaled back activity in net lease finance, McDowell notes. In addition, investment grade retailers continue to expand and relocate from inline formats to freestanding stores.

Dropping interest rates and downtrodden stock prices also have helped to spur net lease financing. “Financing is tied to the 10-year treasury market. So a substantial drop makes these investments easier to finance and more attractive to investors,” says Randy Blankstein, president of the Boulder Group in Northbrook, Ill. Meanwhile, declining values on Wall Street have made it very expensive to raise capital through initial or secondary public offerings.

Retailers are focusing on ways to unlock value from existing real estate assets. Most retailers believe they can get a higher return on capital by putting money back into their core business rather than investing in real estate. “As capital markets get tighter, more companies are looking at the benefits of sale-leaseback transactions,” McDowell says. The drop in stock prices has given retailers an extra incentive to keep real estate off the books.

And the retail building boom of the past several years has created an ample supply of potential net lease sale-leaseback properties. “Over the past three years the economy has been phenomenal, so the expansion has been phenomenal,” says Sidney Domb, president of Miami-based United Trust Fund. Some exceptionally large deals have surfaced in the last year as companies strive to unlock capital from existing real estate. CVS, for example, sold 96 properties for $288 million to Dallas-based Wolverine

Equities Company in fourth quarter 2000.

SALE-LEASEBACKS

Investor demand remains high for net lease sale-leaseback properties. “Real estate is a more attractive asset class due to the stock market and declining interest rates,” Blankstein says. Blankstein says he expects the volume of sale-leaseback transactions in 2001 to increase by about 10 to 20% compared with last year.

A true sale-leaseback is a property already owned by a tenant that sells the real estate with a single, double or triple net lease in place. The majority of sale-leaseback investors are people looking for 1031 Tax Deferred Exchanges. “Net lease deals are similar to bonds because of the long-term stable payment and low management,” Blankstein says. So sale-leasebacks are ideal for investors that are moving into retirement and want to avoid paying capital gains, he adds.

Sale-leasebacks also emerge in new construction. Developers who contract with retailers to construct new stores often flip those properties into investors' hands as a one-off transaction or several stores that are sold as a package.

United Trust Fund, for example, has a division devoted solely to building retail properties for single tenant sale-leasebacks. In the last two years, United Trust Fund has developed sale-leaseback projects for several retailers around the country, including CVS and Eckerd. One recent project was a new freestanding store for Sterling Jewelers at Tyson's Corner in the Washington, D.C., metro area.

During the recent expansion boom, many retailers found it faster to go to a developer to build stores for them. “Normally, a company would prefer to build their own properties, and then do a sale-leaseback because it gives them complete control,” Domb says.

But the frenzied expansion pace prompted retailers to seek out developers that could provide turnkey service from construction to financing. But along with a slowing economy, sale-leaseback driven development deals are expected to wane as retailers once again resume control of development and sale-leaseback transactions.

“We have seen a slowdown in new development,” says Ronald Max, chief investment officer at Captec Net Lease Realty Inc., Ann Arbor, Mich. The slowdown started in third quarter 2000. “More and more of the deals that we have are not new construction, but sale-leaseback of existing portfolios,” Max says. Captec Net Lease Realty is a publicly traded REIT that invests in net leased restaurant and retail properties.

SLIPPING CREDIT RATINGS

Deteriorating credit ratings among some retailers continue to spark worries in the net lease finance market. Downgrades have been popping up in almost all retail categories from office supply to supermarkets. Office Depot was downgraded from a BBB to a BBB- in December by Standard & Poor's, while U.S. Office Products Company saw its credit rating slip from a B to a CCC- by year-end. (Investment grade is considered to be BBB or above.)

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Video retailers such as Hollywood Entertainment Corp. also have struggled as its Standard & Poor's rating dropped from a B+ to a B-. “Blockbuster Entertainment is the only bright star in the video rental market, and they continue to fight the ever-present investor concern that technological advancement may cause their retail model to be obsolete within their lease term,” says Michael Houge, a principal at Minneapolis-based Upland Real Estate Group Inc.

Even the “golden child” of retail — grocers — has taken a hit, notes Ethan Nessen, an executive vice president at Boston-based Corporate Realty Investment Co. Albertson's Inc. was downgraded twice in 2000 from an A to a BBB+, while names such as Big V Supermarkets Inc. dropped from a B+ to a D rating.

The entire retail industry felt the aftershocks of Rite Aid Corp.'s dramatic fall from an A to a B rating. Another drugstore chain to be downgraded in 2000 was Eckerd. As a division of J.C. Penney Co. Inc., Eckerd was impacted when J.C. Penney was downgraded from a BBB+ to a BBB- by Standard & Poor's.

“The recent credit downgrade of J.C. Penney, combined with the continued fear hangover caused by Rite Aid's woes continues to haunt the industry,” Houge says. But there are also bright spots in the drugstore sector with companies such as Walgreen's and CVS. The two retailers continue to expand as planned; their credit ratings remain investment grade; and both are still considered excellent long-term, safe investments, Houge notes.

“These conditions have great appeal to many individual investors, most of whom are involved in 1031 Tax Deferred Exchange transactions,” Houge says. The 1031 investors are snapping up chain drugstore properties because they offer reasonable returns, involve little or no property management, and are usually easy to finance. “At the end of 2000, and much of the first quarter, we had more drugstore properties to sell than ever before, so we see this trend as very positive,” Houge says.

COST OF CAPITAL

The retail industry is certainly not alone in falling credit ratings. Downgrades are occurring across the board in corporate America, and more adjustments are expected to materialize in the months to come. The downgrades impact both pricing and structure on net lease finance deals. Quality credit tenants will not necessarily feel the pinch, but lesser credit tenants will see changes such as increased focus on the bricks and mortar real estate, Nessen notes.

“A lot of retailers that have been historically good investment grade companies have been downgraded to marginal ratings,” Ader says. The slip in credit ratings is impacting cost of capital. Historically, retailers have been able to borrow substantial portions of the purchase price — upwards of 90% loan-to-value ratio. In the past, even BBB and BB companies were able to secure the large loan-to-value ratios. That same higher percentage financing is not available today. Today's lenders are requiring more equity participation, and loan-to-value ratios are closer to 75%.

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Corporate Realty Investment Co.

“Over the last nine months, it has become more and more difficult to find financing for less than BBB+ rated companies,” says Charlie Corson, president of Dallas-based Staubach Structured Assets Group.

Lenders are more conservative. Debt markets want deals with investment grade credit. “In potentially bear market times like we're seeing now, there is a flight to quality,” Corson says.

Most financing paper that is originated has to be sold to somebody, and most buyers are interested in better than investment grade transactions, he says. Investors are concerned with the higher default rate among less than investment grade companies.

“I think the market has been skittish since the fall of 1998,” says Bruce MacDonald, president of Net Lease Capital Advisors in Boston. “A whole bunch of credit downgrades have shifted the market, and debt markets are more selective,” he says. Nevertheless, lenders that can get comfortable with the credit rating are willing to do the deal.

“Recent downgrades shouldn't put a damper on the net lease finance market, but it probably contributes to the fact that debt markets are becoming more selective,” MacDonald says.

OUT OF FAVOR?

Investors and lenders alike are keeping a close eye on the retail industry. The sector has taken some hard knocks in recent months as it relates to drops in credit ratings, stock prices and consumer spending. “There is a fear of recession, and retailers do get hurt in times of recession,” Nessen says.

Lenders are concerned about overbuilding and the impact of an economic slowdown. “Bigger box retail continues to be the leader in what worries people the most,” he says.

However, those fears may turn out to be unfounded. “A year ago, some thought the Internet was going to wipe out retailers. Now all of these Internet companies have disappeared because they didn't have the infrastructure that traditional retailers have,” Nessen says. Fears about an economic slowdown also are likely to dissipate. “Even in a recession, we are a consumer-based society and we will continue to buy goods,” he says.

“There is a lot of rhetoric about people being down on retail,” MacDonald agrees. That talk has been around for the past five years as critics talked about everything from the dangers of overbuilding to Internet competition. Now the big concern is how the slowing of the economy and shaky consumer confidence will impact the retail sector. “Retail is certainly not as much in favor as apartments or industrial, but I think you have to look at individual deals,” MacDonald says.

Nevertheless, retailers are finding a more difficult time lining up financing, in part because there is less liquidity in the net lease finance market. One reason is the weaker credit ratings. A second reason is that some investors, such as insurance companies are saturated with certain property types. Many large retailers have expanded rapidly in recent years with hundreds of new stores added each year. “Some investors are getting filled up on particular names,” McDowell says.

An abundance of CVS deals, for example, are on the market. “No one disputes that CVS' credit is outstanding, and that they remain a dominant player in their segment,” McDowell says. But CVS has been developing new properties and rolling them into sale-leasebacks at a high rate. As a result, many investor portfolios, such as those held by life insurance companies, are filled up with CVS properties and they do not want to take on any more, he says.

INDUSTRY OUTLOOK

Industry observers remain optimistic about strong net lease finance activity in 2001. “We will definitely see an increase in sale-leasebacks as companies work to get that real estate off the books,” Corson says. “Whenever stock price is under pressure, companies react positively to ways that can improve their balance sheet.”

“First quarter was very strong, and we hear about a lot of deals on the horizon,” Ader agrees. “I think this will be one of the biggest years the industry has seen in the last five.” Ironically, that spike in activity is due in part to the slowing economy.

In recent years, retailers were consumed by aggressive expansion strategies. “Now that things are slowing, the focus shifts to how companies can monetize these assets,” Ader says.

Tenant credit remains a key component in assessing the value of a net leased property. “We think it is as important as the property's location and the terms of the lease,” Houge says. But because of the downgrades, the quality tenants with the best leases at superior locations will be the hot commodities for investors — even if the returns remain lower, Houge says. Investors will buy properties with less than investment-grade or non-rated credit leases, but the location, lease and availability of desirable financing will drive those deals, he adds.

Ultimately, the 2001 outlook calls for good activity in a more challenging environment. “Deals will get done, but people need to move quickly because the market shifts literally from day to day,” Nessen says.

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