



NET-LEASE FINANCING KEEPS TENANTS' REAL ESTATE: OFF THE BOOKS

by Beth Mattson-Teig

National Real Estate Investor, Mar 31, 2000

The net-lease financing industry is getting a boost from capital-hungry corporations. Companies looking to maximize profits are finding net-lease financing an ideal option that is a win-win situation for both the tenant and real estate operator.

Last year was exceptional for Boston-based Net Lease Capital Advisors Inc. "Our transactions went from \$125 million in 1998 to \$280 million in 1999," says Bruce S. MacDonald, president of Net Lease Capital Advisors. Those transactions were split into equal thirds comprised of retail, office and industrial, and hospitality properties. "Barring a dramatic increase in interest rates, I think we're going to have a solid year in 2000," he says.

A variety of factors drive that activity. A substantial property supply exists, while the demand for net-lease deals remains strong, explains MacDonald. Investors ranging from REITs to private investors are chasing deals. In addition, corporate America is warming up to the idea of the sale-leaseback structure, and innovations in credit-tenant financing are creating new business opportunities, he adds.

Retail has been the dominant property type to embrace net-lease options, primarily because retailers have been using the capital to fuel additional store expansion.

"1999 was a great year," says Brian Tracy, managing partner at Net Lease Properties LLC in Manhattan Beach, Calif. "It's pretty well documented that shoppers are less and less interested in fighting the malls, and the street has once again become an attractive shopping environment." Meanwhile, retailers are expanding during this unprecedented wave of economic prosperity, explains Tracy. "The market has been hot. We're in good times, and we don't anticipate any changes in 2000."

A growing market Across the real estate board, the net-lease option has taken hold, but retailers find net-leases to be especially viable.

"Because retailers are voracious users of real estate, they tend to be the highest profile users in the net-lease arena," says Paul McDowell, a senior vice president at New York-based Capital Lease Funding LP. However, net-lease financing is used throughout a variety of property types. "At Capital Lease Funding, we've done properties as diverse as parking lots, a cement factory, office headquarters, and medical office buildings," says McDowell. In 1999, deals ranged from the U.S. Postal Service to Chase Manhattan Mortgage.

Corporations across industries are recognizing the advantages of pushing real estate off their balance sheets and "monetizing" those assets, MacDonald notes. "Why have \$50 million tied up earning a rate of 8%, when you can get that asset off your balance sheet and into your core business where you will make a greater return?" he says. Due to increasing competition among corporations, as well as

pressures from Wall Street to enhance performance, companies are likely to adopt the net-lease concept even more in the future. "Each year [net-lease financing] is gaining wider and wider acceptance," he adds. One major financing transaction Net Lease Capital completed in 1999 was on the \$29 million Alabama Gas Building in Birmingham, Ala.

There is a consistent trend to move real estate assets off the balance sheet, and the incentive is straight math, agrees McDowell. A real estate asset might assume a 7% to 10% return - numbers that do not impress today's stockholders. "Companies are finding that they are able to get a much higher return on their investment by monetizing real estate and putting that money back into the core business whether that's manufacturing coat hangars or computer chips," says McDowell.

Net Lease Capital is currently helping one client evaluate several net-lease buys that include a \$54 million headquarters building in California, a \$40 million retail portfolio and even an oil refinery. "The common denominator is that all three involve investment-grade tenants," says MacDonald. "It's more like financing corporate bonds than it is real estate. That's what makes this method of financing so unique."

Optimists & critics While many firms interviewed agree 1999 was a good year, net-lease finance specialists have mixed projections for 2000. On the positive side, the real estate market appears to be in good health for some time to come. "It won't slow for our business because there is well over \$1 billion in property out there that has financing available or in place where rates are locked in," says MacDonald. "So those rates are not going to be affected by current interest rates."

Ethan Nessen, an executive vice president at Boston-based Corporate Realty Investment Co., believes that the current economy has demonstrated its resiliency. "We're through our apocalyptic gauntlet. We survived the [CMBS] crash in 1998, Y2K and the economy didn't burst last year," Nessen says. That confidence will bolster retail expansion, he believes, and the economy in general in 2000.

However, the underlying factor in net-lease finance activity in 2000 will be the cost of money. That cost does not necessarily depend on the interest rate, but more so on underlying Treasury rates and corporate spreads. "As long as interest rates and spreads don't go horrendously high, I think you're going to have a huge amount of activity in 2000," says Nessen. Net-lease transactions will be driven by pent-up demand and strong corporate earnings, as well as retailers' ongoing strategy to keep real estate assets off their balance sheets, he adds.

Meanwhile, other industry experts anticipate a more cautious 2000 due in part to more expensive pricing. "I believe that the higher interest rates and widening spreads on mortgages have had a dampening effect on the net-lease business at the moment," says Gary Ralston, president of Orlando, Fla.-based Commercial Net Lease Realty Inc.

Another effect on credit-lease deals in 2000 will be a degree of polarization - a growing gap between best-quality credit transactions and border transactions, Ralston says. Not only will there be a larger price gap, but also some of the deals that are on the border will experience difficulty coming to fruition, he adds.

Hurdles ahead A variety of factors could slow net-lease financing activity in the coming months. The Federal Reserve Board is constantly debating another interest rate hike as a means to curb inflation. Real estate lending in general slows as interest rates rise. Rising interest rates put more pressure on borrowers, which includes investors and developers, McDowell says.

The trend for corporations to move real estate off their balance sheets tends to ebb and flow with interest rates. Higher interest rates put a damper on net-lease financing, because higher interest rates mean that investors will charge higher rents to recoup the same sale proceeds. "If interest rates are up and stay up, that could have a negative effect on a company's willingness to enter into a sale-leaseback," says McDowell.

Overall, interest rates are still reasonable, inflation is low, employment is at an all-time high and people are continuing to spend money. So from an investment point of view, sale-leasebacks continue to be a highly desirable investment vehicle.

The collapse of the CMBS market in the third quarter of 1998 has altered the flow of debt available to finance net-lease transactions. "You are dealing with a marketplace where the level of debt in terms of loan-to-value ratios is less available today," says Nessen. However, a conservative shift among the debt community is aimed primarily at non-investment grade tenants, who have been forced to accept finance terms at 70% to 75% loan-to-value vs. a more favorable 90% loan-to-value ratio not so long ago. In some cases, those loan-to-value ratios are comparable to what traditional bank lenders are offering.

Capital constraints continue to tie the hands of REITs that specialize in acquiring net-lease properties. New York-based Lexington Corporate Properties Trust battled the capital crunch in 1999 to close \$145 million in acquisitions. "The major thing we accomplished in 1999 was to put together a joint venture with a major pension fund," says Richard J. Rouse, co-CEO at Lexington. The REIT secured a commitment with New York Common Retirement System for \$100 million in equity, while Lexington will contribute \$50 million to the venture. "It's a great way for us to further leverage our equity," says Rouse.

Lexington closed on its first two joint venture acquisitions in late 1999 with the purchase of headquarters facilities for Vastar Resources Inc. in Houston and Structural Dynamics Research Corp. in Cincinnati. Currently, the joint venture is funding the construction of a new building for Owens Corning in Charlotte, N.C. "I don't think rising interest rates will be a significant factor in 2000," says Rouse. "What will continue to be a factor is the lack of capital available to the REIT industry." Lexington plans to continue to seek new equity sources through joint ventures.

Skittish over downgrades In addition, a few high-profile slips in credit ratings for firms such as Pittsburgh-based Allegheny General Hospital and Camp Hill, Pa.-based Rite Aid Corp. have made lenders more cautious. The most prominent example is the rapid downgrade of Rite Aid Corp. Standard & Poor's dropped the company from a BBB+ rating to BB. Rite Aid's aggressive expansion, coupled with some internal management problems, is responsible for the downgrade.

"My view is that at the end of the day, Rite Aid has a very strong market franchise, the right management team in place and it will return to investment-grade status," says McDowell. Nevertheless, the precipitous downgrade has made lenders more cautious, and some credit-lease deals have become more difficult to finance.

Ann Arbor, Mich.-based Captec Net Lease Realty Inc. has reigned in its Rite Aid development program. The net-lease REIT had planned to finance 15 new Rite Aid developments, but ended up doing five. "We put [Rite Aid development] on hold because there is some uncertainty with the company," says Ronald Max, Captec's chief investment officer. Captec specializes in providing financial support to developers that are building the stores for tenants, and then Captec buys the stores following completion.

"Rite Aid was a very big element of a couple of big securitizations, so lenders are a bit skittish," says Jonathan Molin, president of New York-based U.S. Realty Advisors LLC. The downgrading of Rite Aid has made it more difficult to borrow against credit-lease financing deals. "I think lenders would be wise to underwrite the real estate, but they're still looking mostly to the credit of the tenant," he says. Even though the bulk of the credit-lease financing market is healthy, slips such as Rite Aid and Allegheny General Hospitals have had an adverse effect.

The downgrades, as well as the CMBS shakeout, have widened spreads. AAA deals are experiencing spreads of 120 to 130 basis points over Treasuries, while BBB properties are in the range of 250 to 260 basis points over Treasuries. Prior to the collapse of financial markets in August 1998, spreads were much tighter. AAA spreads were at 80 to 90 basis points over Treasuries, and BBB spreads were 150 to 160 basis points over.

"So the market has widened dramatically," Molin says. But those spreads may narrow slightly in 2000, he notes.

More expansion ahead The good news for the net-lease financing industry is that expansion momentum is still strong. Retailers in particular are expected to continue on a growth track in 2000, and freestanding stores appear to be their property of choice. Charlotte, N.C.-based Centurion Development Corp. is one of the top developers of freestanding, triple-net leased facilities in the country.

"A lot of those retailers that have traditionally been in mall locations or shopping center locations are now going to outparcels and freestanding locations," says Parker W. Neely Jr., a principal at Centurion. Some of the retailers that have been successful in their move from in-line locations to freestanding stores include Payless Shoe Source, Blockbuster Video and Kinko's Copy Centers. Retailers find that sales volumes are higher at freestanding locations due to improved visibility and accessibility.

"What we're seeing is that revenues run 125% to 150% more than at in-line locations," says Neely. "If the economy dips at all, most retailers are going to look to high-producing locations as a way to stay afloat in a declining economy."

Despite the growth in freestanding stores, retailers are less inclined to own those stores. Retailers do not want to tie up capital in real estate. "If they went into a bank direct, they would have to leave 25% of their equity in that store," says Chris Marabella, president of Marabella Commercial Finance, a boutique loan broker based in Escondido, Calif. The 100% financing of sale-leasebacks allows retailers to expand without diluting the earnings of the company, and it provides more liquidity for expansion, he adds.

Developer's perspective Net-lease finance also is popular among developers. Developers have two options when financing a credit-tenant property for development. The developer can finance the deal based on the real estate. For example, a developer that is building a \$20 million Wal-Mart may borrow \$10 million to \$15 million based on a typical 50% to 75% loan-to-value ratio.

A second option is for the developer to go to the capital markets with credit-tenant financing. One of the big advantages is the higher loan-to-value ratio. A developer may be able to secure \$18 million with a 90% loan-to-value ratio on a \$20 million project. Essentially, the developer can finance a project substantially more on a credit-tenant basis compared with the standard real estate-based mortgage, MacDonald says.

Centurion Development relies on net-lease lenders to provide financing for about two-thirds of its

projects. Net-lease financing providers are more predictable and have larger amounts to lend, Neely says. In addition, traditional bank lenders typically do not understand the net-lease business as well, and they are not as aggressive in their lending, he says.

New ways of thinking More sophisticated models are emerging amid a growing acceptance of the net-lease financing mechanism. "What we are seeing is specialized lenders creating new financing programs and structuring techniques that enable us to open the basket wider," agrees McDowell. Capital Lease Funding, for example, is forging ahead with innovative new structures that target double-net vs. the typical triple-net lease deals. "For a long time, Wall Street could not manage those types of leases," says McDowell.

Another new program initiated by Capital Lease Funding is aimed at providing credit-lease financing for shopping centers that encompass mixed-credit tenants. "The trend is for a few specialized lenders who understand what they're doing to look at how credit tenants own and operate real estate," says McDowell, "and then develop products to efficiently finance those credit leases."

Corporate players' increasing sophistication has led to a search for more techniques to help those firms monetize their real estate holdings. For example, Capital Lease Funding's flex-lease product targets the corporate market by combining the best aspects of the synthetic lease and a sale-leaseback. "It gives corporation's off balance sheet treatment, yet they retain significant flexibility with respect to how they occupy or dispose of the real estate asset," McDowell says.

"I think you're seeing some people look at the business and realize there's a maturity factor to the business, and we want to do something a little bit differently," Nessen says. Such innovations in the world of net-lease finance, coupled with the desire to remove real estate from corporate balance sheets, is expected to fuel additional net-lease finance transactions in 2000.

© 2001, IndustryClick Corp., a PRIMEDIA company. All rights reserved. This article is protected by United States copyright and other intellectual property laws and may not be reproduced, rewritten, distributed, disseminated, transmitted, displayed, published or broadcast, directly or indirectly, in any medium without the prior written permission of IndustryClick Corp.