Net-lease industry prepares to capitalize on `soft landing' soft? a slow down

by Ben Johnson

National Real Estate Investor, Dec 1, 2000

If corporate earnings slow, sale-leasebacks may actually accelerate in 2001 and beyond.

Over the past few years, the terms "net lease" and "sale-leaseback" have crept into the vernacular of more and more corporations as a way to unlock cash from their tangible real estate assets. But times have been good, and by most accounts the U.S. economy will likely have, at the least, a soft landing in 2001.

So what happens if the economy has a harder landing than many expect, or if the earnings season for corporations continues to take a hit in early 2001? How will the net-lease financing marketplace be affected?

Interestingly enough, a slowing economy - coupled with a general overbuilding of retail properties across the country - actually points to better times ahead for the biggest companies involved in the net-lease finance arena.

How so? First, you have to consider that the hottest property for the typical sale-leaseback transaction in the past few years has been retail. In fact, the retail industry has experienced tremendous growth in freestanding facilities as well as grocery-anchored neighborhood centers and even big-box properties. But most industry observers agree that both retail construction and sales will likely slow in the near term and be replaced by more activity in the office and industrial sectors, when the net-lease vehicle will be in the driver's seat.

Second, as more companies experience ongoing earnings crunches, in theory at least, they will be even more inclined to rid their balance sheets of what has become most companies' second-highest cost center - their real estate. And they may just turn to net-lease finance firms to help them do it.

Shifting gears from retail "The one trend which has been extremely active the past five years is retail, and that will slow down," observes Fred Berliner, senior vice president and director of acquisitions for Miami-based United Trust Fund (UTF). "You see a drugstore at every corner, and there has been lots of big-box retail. That marketplace will slow down substantially. We're seeing more industrial and office right now.

"The individual deals [in office/industrial] are larger for sure, but on a transaction size it may not be bigger than retail because you don't have numerous locations," adds Berliner. "One important difference is, if a retail location isn't good for one tenant, then it probably isn't good for another. For industrial, it doesn't matter. In office, it's similar, because there is quite a bit of pent-up demand for new space."

Bruce MacDonald, president of Boston-based Net Lease Capital Advisors, echoes those sentiments. In fact, the firm's business has shifted dramatically from the retail side. Last year, Net Lease Capital accumulated $300 million in transactions, of which $80 million was in office and industrial properties. This year the firm is on course to do approximately $500 million in deals, a hefty $300 million of which will be in office and industrial.

Joining in the chorus is Jeff Shell, senior director of financial services in the Detroit office of New York's Cushman & Wakefield, who sees a shift from retail properties to other net-lease properties. "Retail has long used net-lease financing which, generally, has tended to be more of a credit-based underwriting. Going forward, I think that we will see more activity for general office as well as more specialized facilities that combine office, R&D and other uses."

Shell notes that net-lease sales will be driven more by developers than corporate users for general office product because users aren't thinking about financing costs for these deals, but are looking for a more traditional lease structure. "More specialized product will likely see both developer and corporate user look at different financing structures, with corporate users becoming directly involved in securing capital for assets," adds Shell.

To some, though, there is a big market ahead no matter what the property type. "The net-lease financing industry should be facing increased business the next five years," says Gary Ralston, president and COO for Orlando, Fla.-based Commercial Net Lease Realty Inc. "The market is rather large - corporations own $1.7 trillion of an estimated $4 trillion commercial real estate market in the United States. Nearly 60% of that, or around $1 trillion, would be suitable for net-lease financing."

Slow growth signs ahead So just how would a slowing economy impact the net-lease business and the major players who deal in it?

"The chairman of our company, Robert Nessen, once wrote in an article, `The net-lease business is the Old Man River of real estate. It just keeps rolling along,'" says Ethan Nessen, executive vice president at Boston-based Corporate Realty Investment Co. (CRICO) LLC. "Economic slowdowns tend to increase the demand for net-lease financing. Typically the capital markets become more conservative, and the challenges and inefficiencies of our industry become greater. Overall, economic slowdowns are of benefit to our industry because the need for alternative sources of capital increases throughout corporate America," adds Nessen.

Cushman & Wakefield's Shell says that, in general, an economic slowdown could accelerate sale-leasebacks as businesses try to prop up earnings in the face of declining revenues from core business areas. "This activity would dampen if interest rates rise, thereby reducing the economic benefits to corporations for these transactions," he says.

"For net-lease sales by developers, a slowdown could increase the appetite for deals that have a significant remaining lease term, as investors look more to certainty of income and away from potential opportunity through lease-up or rollover," says Shell. "This could reduce spreads on these deals, which could increase developer profit and/or reduce occupancy costs to the user."

Brant Bryan, president of financial services for Dallas-based The Staubach Co., is already counseling clients to look ahead.

"A slowdown would cause more companies to consider selling their real estate and free up cash," he says. "If a slowdown occurs or a company's credit deteriorates, it's much more difficult to access

capital. That is why we are advising our clients to take advantage of sale-leaseback while it is still an opportunity and not a necessity," notes Bryan.

That's the bottom line for many corporations - it's all about freeing up their assets by moving real estate off their balance sheets.

"An accelerating trend in the net-lease area is the continuing movement by companies to move real estate off their balance sheets and monetize those assets," says Paul McDowell, senior vice president and general counsel of New York-based Capital Lease Funding LP (CLF). "As the corporate bond and equity markets have stumbled, many companies have started to focus on the advantages of the sale-leaseback arena. At the same time, major retailers such as The Home Depot, CVS and Walgreens continue to expand, and the owners of those leased properties require financing," he says.

For Ed LaPuma, executive director and institutional head of New York-based W.P. Carey, the biggest trend is more deals. "The fact is, there is a huge tightening on the credit side occurring. Banks aren't willing to lend in the abundance they were before as credit becomes the key piece of the lending equation," he says. "The money access is diminishing. That creates a need for new sources of financing because it has accounting advantages. It's also an alternative source of capital and is consistent with the outsourcing trend, which is prevalent in all businesses now," adds LaPuma

Ralston of Commercial Net Lease Realty points to several key reasons corporations will be doing more net-lease financing in the future.

"First, technology will impact corporate profit margins," says Ralston. "Although technology can result in greater margins via the increasing efficiency of their supply chain, we believe the Internet empowers the consumer. Thus, corporations will be facing increased pressure on pricing, which translates into lower margins. In order to remain competitive, corporations will need to invest in new technology and infrastructure improvement," he says.

There is also corporate America's never-ending search for alternative sources of capital. Where will they get their capital? Lower margins result in less cash flow - so they will have less available internally generated cash for infrastructure investment.

"Since they are facing lower margins, profit growth will slow and it will be more difficult to issue new equity," says Ralston. "Access to capital via issuance of debt will be limited by the ever-conservative posture of the rating agencies. There are already more rating agency credit downgrades than upgrades. Corporations will need to seek alternative sources of capital. One of the best alternative sources of capital for real estate assets is net-lease financing," Ralston explains.

In this era of huge daily stock-market movements, Kurt Rosene, senior vice president of Lincolnwood, Ill.-based The Alter Group, says doomsayers should be careful in making any dire economic predictions. "For all the concerns that attended the Nasdaq irregularities in March and the specter it raises of an economic slowdown, pundits should be wary of making a direct correlation between a corporation's real estate needs and its market valuation," he says. "Overall, companies are still absorbing space at a rapid clip, for both regional headquarters and for back-room offices."

Obtaining the money gets harder Just as corporate America faces capital constraints, one of the biggest challenges facing firms that deal in the net-lease business is actually finding the capital to get the deals done.

"Clearly the challenge for players in the capital markets segment is to be able to attract capital into the arena to satisfy the growing demand by corporations and borrowers for financing," says McDowell of Capital Lease Funding. "At CLF, we see these trends as having a long-term positive effect for investors. As the supply of very high-quality, leased-backed paper grows, liquidity in the segment will improve."

McDowell adds that as more and more traditional commercial real estate has been securitized, liquidity has improved, and for the first time CMBS AAA is starting to trade inside of generic A-rated corporate bonds.

"Net-lease loans are far superior in credit quality and cash-flow stability than are traditional real estate loans," says McDowell. "We believe that as the supply of the product continues to increase, the market will begin to recognize the advantages of bonds backed by net-lease loans, particularly as the economic cycle begins to slow and credit quality becomes ever more important," he adds.

Staubach's Bryan agrees situations may get a bit more dicey. "In 2001 it will be more difficult to arrange financing for net-lease transactions. You will see more deals fall apart when financing becomes unobtainable. Profit margins for equity and service providers will continue to erode," he says.

Ralston of Commercial Net Lease Realty sees a possible shift to more securitization of net leases. "Historically net-lease financing has been along the lines of the credit-tenant lease (CTL) - the real estate debt for net lease has often been directly placed with lenders and institutions based on the credit of the tenant. In the future, we believe there will be more securitized pools of net-lease loans composed of CTL loans. This will result in less pressure on the bonds of an individual credit," he says.

At least one major new player has emerged on the scene in a big way. CB Richard Ellis Corporate Partners LLC, a $500 million fund sponsored by CB Richard Ellis Investors, the investment management unit of Los Angeles-based CB Richard Ellis Inc., is ready to step in with equity to invest in the net-lease business.

"Corporate Partners was established to focus exclusively on corporate real estate strategies and capitalize on the accelerating trend of corporations seeking to reduce their real estate ownership," says Scott Tracy, executive managing director of Corporate Partners.

"CB Richard Ellis Corporate Partners is a well-capitalized program that has equity capital available necessary to acquire major net-lease portfolios," adds Tracy. "We don't have to raise capital every time a transaction is structured with 20% or 25% equity. With fewer CTL financings, more net-lease transactions require real and significant equity to get the deal done. We are perfectly structured for these opportunities," he says.

If corporate mergers and consolidations continue, Tracy says the company is in the right place. "These often produce redundant facilities leading to disposition efforts to achieve efficiencies. These sales can lead to a significant capital gains tax. We have a program that enables a corporation to tap into the value of appreciated property to obtain economic and accounting benefits without current recognition of taxable gain. We see this program as one that provides major benefits to corporations involved in mergers and consolidations," notes Tracy.

Gimme the pluses & minuses Ultimately, as with any type of real estate financing, there are pros and cons to the net-lease business. Most industry insiders are focusing on better education of Corporate America.

"The marketplace will continue to be dynamic, which means that corporate lessees will either have to make decisions quickly in order to lock into pricing structures that are proposed to them, or be willing to be flexible and adjust their expectations based on actual market fluctuations," says Nessen of CRICO.

"The net-leasing industry must educate the corporate lessee marketplace and show them how market factors specifically affect a transaction," explains Nessen. "Both lessors and corporate lessees need to have an alignment of understanding, otherwise corporate lessees will perceive that the net-lease industry practice is to bait and switch. This requires a discipline by lessors not to always tell the corporate lessees what they want to hear in order to win a transaction, but instead educate them on the reality of the marketplace and to offer the best possible transaction within that marketplace," he says.

"One of the cons of net leases for corporations is the flexibility factor," according to Shell of Cushman & Wakefield. "It's difficult for businesses to predict occupancy requirements over a lengthy lease term, which many net leases require. Likewise, they may not have contemplated extended terms into the original lease, making renewals potentially expensive. A lessee should try to build in as much flexibility as possible in order to accommodate the `what ifs?' that can occur over time," notes Shell.

According to Shell, an additional problem for corporations is that they often are unaware of their alternatives. Example: A corporation requires a build-to-suit of a strategic asset that it plans on occupying long-term and would have historically owned but has decided not to load up its balance sheet with real estate.

Shell adds that a bond-lease structure provides pricing that is near the corporate cost of funds but requires that most, if not all, of the debt amortizes over the term. "This means that the developer's building is essentially paid for during the life of the lease with the lessee having little ability to take advantage of the low basis because of accounting rules (assuming an operating lease), he says.

"A synthetic lease, on the other hand, will likely result in an even lower interest rate and no amortization, (because synthetic leases are often priced off floating rates) making the annual lease payment much lower than a bond lease," says Shell. "The residual exposure of a synthetic lease should be taken into account in the analysis and can be quantified."

MacDonald of Net Lease Capital Advisors shares that sentiment. "Companies have to determine their cost of capital and what their alternatives are," he says. "If given an alternative, people will do a synthetic lease before a sale-leaseback. Particularly for companies in the range of BBB- to single-A [credit], there is tremendous potential. People need to understand how it works, and a lot more people would do it if they really understood the mechanics of it," explains MacDonald.

Certainly the state of the nation's economy is a key barometer of the future health of commercial real estate financing, but it also serves as a good gauge - and one to keep a watchful eye on - when it comes to examining the net-lease financing option.

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