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Non-Credit Tenants Are a Hot Commodity

By Beth Mattson-Teig

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Competition for net-lease properties among investors has grown so intense that they are increasingly seeking out non-investment grade tenants to enter into sale-leaseback transactions. The risks are certainly greater, but so too are the returns. Non-investment-grade deals can generate returns 200 to 500 basis points higher than investment-grade transactions, according to New York-based W.P. Carey & Co. LLC, a real estate investment firm that specializes in this niche.

The pendulum could swing back in 2004, if the economic recovery gains traction and investment-grade firms opt to get off the sidelines and start doing real estate deals again, say industry experts.

For non-investment-grade tenants such as Plano, Texas-based American Pad & Paper LLC (Ampad), a sale-leaseback provides a welcome source of capital. In September, the office supply manufacturer and distributor sold four of its manufacturing facilities totaling 924,000 sq. ft. The deal provided a much-needed cash infusion to Ampad, which is in the process of exiting bankruptcy.

Ampad sold its facilities to W.P. Carey while maintaining operations at the facilities with a 20-year lease. “There is a lot more risk when you're dealing with single-tenant properties. You either have a tenant or you don't,” says Sean Sovak, chief acquisitions officer at W.P. Carey. The firm seeks to offset that risk by investing in tenants that have a promising future, emphasizes Sovak.

“In Ampad, we saw a company with good market share and good product,” Sovak says. In addition, Ampad has new management that W.P. Carey believes will do an effective job in turning the company around.

A Burgeoning Market

Single-tenant property sales represent a fraction of the overall real estate investment market — about 10% to 15% of all office, industrial and retail acquisitions, according to New York-based Real Capital Analytics. Yet deal flow is on the rise as corporations and buyers alike recognize the rewards of net-lease financing.

Single-tenant property sales greater than $5 million reached $7.9 billion during the first three quarters of 2003. That volume is up 25% from the $6.3 billion recorded during the same period in 2002 and up 43% compared with $5.6 billion in 2001, according to Real Capital Analytics.

“What you're seeing is an enormous influx of capital into this sector,” says Laurie Hawkes, president of New York-based U.S. Realty Advisors LLC. The company is an equity investor in net-lease properties, specializing in larger transactions, often acquiring over $1 billion of net-lease properties per year. That capital is coming from REITs, individual investors disenchanted with the stock market, 1031 Exchange buyers and commercial investors turning to single-tenant deals because returns have become less attractive on the multi-tenant side, Hawkes notes.

The biggest problem facing the burgeoning net-lease investment market is too few properties to satisfy the hunger of an increasingly crowded field of investors. The imbalance between supply and demand also fuels interest in non-investment-grade companies.

In light of the weak economy, the net-lease market has been segregated into two vastly different categories — investment-grade and non-investment-grade corporations. Cash-strapped, non-investment-grade tenants, rated BBB- and below, have driven a large share of the net-lease market, while many cash-rich, investment-grade firms have put financing decisions on hold.

The good news for hungry investors is that they could have a larger inventory of net-lease properties from which to choose in 2004. A number of corporations that have been sitting on the sidelines likely will be tempted to make a move next year. Why? Interest rates are expected to rise over the next few quarters in response to a resurgent economy that grew at an annualized rate of 7.2% in the third quarter. Such healthy growth in turn may spark more corporate expansion activity, which has been relatively dormant to this point.

“Frankly, we expect to see even more volume in the future,” says Gary Ralston, president of Commercial Net Lease Realty, an Orlando-based REIT specializing in triple-net properties. Commercial Net Lease owns a portfolio of net-leased properties valued at $1.3 billion.

Untapped Market

Most non-investment-grade companies are not in a situation where they have excess cash, and they are taking advantage of a hungry net-lease investor market to pull money out of real estate.

“Because there is an imbalance today with a lot of capital and not a lot of product, non-investment-grade companies are getting very attractive pricing simply due to supply and demand,” says Jim Leslie, a principal with CRESA Partners Capital Markets in Dallas. “That market will continue to go strong as long as investment-grade credit tenants continue to sit on the sidelines.”

Non-investment-grade companies are able to enter sale-leasebacks because their cost of funds on the deal is typically 8% to 8.5%. “For these tenants that is very attractive financing,” Leslie says. Although non-investment-grade firms are able to obtain traditional mortgages at 7% interest rates, most banks are offering 65% to 75% loan-to-value ratios compared with the 100% available through sale-leasebacks. “It's a great market for sub-investment-grade tenants to be out looking for net-lease capital,” Leslie adds.

Investment-grade companies with positive cash flow have not been aggressively pursuing sale-leasebacks primarily because there is not a significant incentive to do so, according to industry experts. The historically low interest rates provide investment-grade companies with ample financing options, and favorable short-term interest rates offer little incentive for firms to lock into the long-term rates of a sale-leaseback.

At the end of October, the one-month LIBOR (London Interbank Offering Rate) registered 1.17%, while the 10-year Treasury was yielding 4.4%. That spread of 323 basis points is high by historical standards, which contributes to investment-grade firms' lack of interest in sale-leasebacks, Leslie says. The spread would need to narrow considerably — to about 125 basis points —

before CFOs of investment-grade firms would feel compelled to initiate a sale-leaseback, he says.

In addition, firms with positive cash flow have little motivation to raise money. “If companies are sitting on idle cash, a lot of these treasurers can't deploy capital into their business because the economy is slow,” Leslie says. So, they are sitting on that cash and getting a 1% to 2% return based on short-term Treasury rates. A sale-leaseback would give them more cash, but the minimal return does not justify the 6% to 7% they will end up paying on their leaseback rate, he adds.

Motivating Factors

Several factors could add to net-lease deal flow. One key factor is a need for capital, such as financing mergers or acquisitions. Companies also could enter a sale-leaseback transaction as a way to get depreciation off the books and improve their balance sheet. “That happens more on a case-by-case basis to dress up income statements,” Leslie says.

Bernie Haddigan, national director of the retail group for Encino, Calif.-based Marcus & Millichap Real Estate Investment Brokerage Co., predicts that deal flow will continue to increase in early 2004. Firms that had put net-lease financing decisions on hold due to pending regulatory changes *(see related article, page 44)* are revisiting net-lease options as a financing strategy. “Medium to large firms, in particular, are interested in having financial statements that survive scrutiny, and they are going back into sale-leaseback positions to clean up their balance sheets,” Haddigan says.

A rise in interest rates, almost a certainty in the minds of most observers, could push more deals into the marketplace as short-term interest rates become less attractive. “We are hoping that will be a spark for additional flow into the supply side,” says Sovak of W.P. Carey.

Premium sale prices already are luring investment-grade firms back to the sale-leaseback market, according to one industry source. “There was a dynamic earlier in the year among non-investment-grade transactions. But now even investment-grade firms are being tempted by the pricing, and recognizing that the low interest rates are not going to be here forever,” says John Hirschfeld, an executive vice president at U.S. Realty Advisors.

One roadblock for some potential net-lease deals is the slumping real estate market, where ample space is available at attractive lease rates. Once that excess space is absorbed, the volume of development and expansion will return and spark additional net-lease financing activity, notes David Sickle, a partner in the real estate practice in the Chicago office of Piper Rudnick, a national law firm.

"As space gets absorbed, that will spark some new buildings," Sickle says. Hybrid leasing structures such as net lease will be in even more demand when expansion occurs.

A Voracious Investor Appetite

Long-term, fixed returns have investors salivating over net-lease transactions. "There is more volume than ever on the sale-leaseback side, although that is offset by a disproportionate number of investors," Sovak says. "Given the amount of competition, it is harder to find interesting deals."

Corporations use sale-leasebacks to convert real estate assets into cash while still retaining use of the properties — often through a long-term, triple-net lease. Investors are drawn to the stable income streams that often come with net-lease properties. Current cash-on-cash returns for net-lease properties range from 7% to 12% — not including potential gains from a future sale of the property.

Those returns are particularly attractive given the volatile stock market and low returns on fixed-income investments such as bonds and certificates of deposit (CDs). The current rate on a five-year CD is 3.5%, while riskier junk bonds yield about 7%.

"Predictable income streams are highly desirable in the marketplace today," says Ralston of Commercial Net Lease Realty, which is increasing its buying activity in order to diversify its largely retail portfolio with office and industrial properties. In 2003, the company expects to acquire about $350 million in net-lease properties — more than double the volume purchased in 2002. "From our perspective, we see robust deal flow in the marketplace," he says.

Driving Forces

Net-lease transactions are in vogue among both institutional and individual investors. W.P. Carey, for example, is one of the largest acquirers of net-lease properties. The firm completed more than $542 million in sale-leaseback transactions during the first nine months of 2003 compared with $500 million during the same period last year, an increase of about 9%.

Another key driver to net-lease transactions is a surge of 1031 Exchange capital coming into the market as individual investors seek to roll money from one real estate sale into the purchase of another property to avoid the capital gains tax.

Based in Minneapolis, i-Metro Property.com Inc. is one 1031 Exchange buyer that has discovered the advantages of net-lease properties. Traditionally a multi-unit residential investor, the company began selling off its apartments in favor of net-lease retail properties about two years ago. “We wanted a similar return, but with less management time on our part so we could be freed up to grow the business,” says Michael Roess, president and CEO.

Most net-lease transactions are structured with a triple-net lease, which require less direct management because it leaves the tenant in charge of taxes, insurance and maintenance costs. In addition, because most net-lease properties involve a single tenant with a long-term lease, owners rarely have to deal with tenant rollover, minimizing leasing and marketing responsibilities.

i-Metro quickly discovered why net lease was such a hot commodity — the attractive returns. When the firm made its first-net lease acquisitions two years ago, annual cash-on-cash returns before debt service were ranging between 15% and 18%, depending on the property. Although increased competition has compressed returns due to higher sale prices, i-Metro is looking at deals where cash-on-cash returns are 8% to 9%, Roess notes.

“These returns are far better than we would see in other types of investments,” Roess says. Currently, i-Metro owns about $15 million in net-lease retail properties such as Old Country Buffet, Hollywood Video and Blockbuster in the Twin Cities.

Effects of Heightened Competition

The net-lease market is following much the same pattern as conventional real estate sales activity in which aggressive investors are driving up prices for apartment, retail, industrial and even office properties. “There is too much capital out there from an investor's standpoint,” Sovak says.

The supply-demand imbalance is squeezing returns as prices creep higher. Single-tenant CBD office buildings, for example, are selling for an average of $257 per sq. ft. as of the third quarter of 2003 compared with $243 in 2002. Single-tenant industrial properties sell for $40 per sq. ft. compared with an average price of $38 per sq. ft. last year, reports Real Capital Analytics.

With rising prices, it is no wonder that investors such as U.S. Realty Advisors are finding it an opportune time to sell. The company has sold roughly $2 billion in net-lease properties over the past 24 months, paring down its portfolio from about $5 billion to $3 billion.

Declining cap rates reflect the rising prices and lowered expectations of investors. Cap rates have dropped 100 to 200 basis points in the past two years. Cap rates are averaging between 9% and 10%, while some transactions are trading as low as 7% or 8%. “Obviously, the better credit-worthiness and quality of the tenant, the lower the cap rate,” Ralston says.

“We're seeing properties trade at cap rates as low as many people in the industry have seen in their entire careers,” says Ethan Nessen, a principal at Boston-based CRIC Capital, a buyer of single-tenant net lease deals. Some institutions will go below a 7% cap rate on certain deals, he adds.

Aggressive 1031 buyers are largely to blame for cap rates that are on the verge of historic lows. Cap rates on Jack in the Box restaurants, for example, are down to 6%, says Christian Marabella, president of Marabella Commercial Finance in Escondido, Calif. Marabella Commercial Finance specializes in arranging permanent financing for net-lease properties priced at $500,000 and higher.

Small investors are comfortable with 7% yields — particularly when you factor in the savings from capital gains taxes and compare it to alternatives such as a CD that yields 1% or 2%, Leslie says. CRESA Partners Capital Markets advises corporate clients on real estate financing options, such as sale-leasebacks.

Despite continued investor competition, the net-lease investment market looks promising for 2004. “I think next year will be another strong year from a supply standpoint,” says Sovak of W.P. Carey. “I'm hoping we'll see increased supply driven by the fact that corporate tenants will recognize that this is the best time to monetize corporate assets from a price perspective.”

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