Net Lease Financing

By James B. Frantz
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Jonathan Molin, President, U.S. Realty Advisors

Retail Corporations Capitalize on Their Real Estate

Despite some short-term market volatility, the long-range health and popularity of net lease financing and sale-leaseback transactions look solid and secure, to the benefit of retailers and investors alike.

Today's net lease financing market may not be as energized as it has been in recent years, largely due to rising interest rates, less buying activity from cash-strapped REITs and the credit malfunctions of a major drug chain. Nonetheless, an increasing number of retail corporations have recognized the benefit of capitalizing their real estate to meet a variety of corporate financial objectives.

Long a staple of some corporate real estate, off-balance-sheet treatment of real estate has enabled retailers to better meet investor expectations, speed their own expansion plans and help them be better poised to participate in merger and acquisition activity.

Experts agree that investors get increased stability with less risk and headache than many other forms of real estate investment. Net lease financing eliminates the management problems usually inherent with real estate ownership. Institutional and individual investors alike are looking with favor on the stability of owning commercial properties occupied by national and regional tenants who are usually credit-rated, using the vehicle of a net long-term lease.

This part of the market is particularly appealing to many institutional buyers who want stability instead of surprises, said Sidney Domb, president of United Trust Fund, Miami. "The net lease business has no surprises. You know what the rent is for 20 years, which accounts for lower returns."

With this format, the tenant is obligated under this form of lease to pay for all expenses associated with the operation of the property including property taxes, maintenance, insurance and the like. Leases fall into three main categories:

- **Double net leases**, in which the tenant is responsible for the majority of all expenses, excluding roof and structure. In double net leases, a landlord may also be responsible for other items such as HVAC and parking lot maintenance.
- **Triple net leases**, also known as true net leases, where the landlord has no responsibility for any expenses or maintenance.
- **Bondable leases**, which are even more strongly in the landlord's favor, make tenants responsible for all expenses and maintenance, as well as casualty insurance. The tenant has no termination or abatement rights.

"The cost of doing sale-leaseback transactions is more expensive, but there are still new tenants seeking to do them, although the scene is not as robust as it was in 1998," said Jonathan Molin, president of U.S. Realty Advisors, New York, which works on behalf of pension funds and life insurance companies in this area of sales and financing.

Molin said that while his firm continues to see "a fair amount of business," a variety of factors dating back to a year and a half ago have caused credit tenant lease (CTL) spreads to widen. Another dampening factor has been the significant deterioration of the credit status of the Rite Aid drug chain. "There is no more Rite Aid business being done, and that cast a bit of a shadow over the other drug chains. We are seeing a wider spread for debt in those areas," he said. (Rite Aid Corp.'s credit rating has been lowered to B and then to BB, while other national drug chains are rated Single A.)

Nevertheless, companies always need to raise money to grow their core business, to fund research and development, or to expand. Sale-leaseback transactions will always play a part in corporate fund-raising, Molin said.

"Some developers are selling at higher cap rates, and others are holding on to past cap rates and not seeing the offers they would like to see," said Blair Rinnier, principal at Net-Properties.com, an Internet based net lease financing firm in Salisbury, Md.

Investor interest today is very tenant-specific. "There is money out there, but it depends on how interested the financial community is in a particular tenant," said Keith Sturm, a principal at Upland Real Estate Group Inc., a Minneapolis-based real estate services firm that specializes in selling single-tenant lease properties.

Sturm said buyers are very credit-oriented toward a particular tenant. Sometimes as many as 20 or more lenders may be chasing a Walgreen's deal, but once they get their fill of Walgreen's, that level may drop to five interested lenders.

Retail tenants with less creditworthiness, such as a Hollywood Video, usually have a harder time, and the qualities of the actual real estate factor into the picture more. To be attractive, a Hollywood Video location has to be very well located with market-rate rents, Sturm said. Often, however, rents are higher than market averages, forcing lenders to require additional equity.

There is concern in the market that the technology of Hollywood and Blockbuster is limited. "While they still offer strong tenant credit to some investors, some are worried that these companies might be phased out in the next five to 10 years," Rinnier said.

"Greenspan is affecting the market tremendously," Sturm said. Since the 10-year Treasury bill is the basis for pricing loans in net lease transactions, as it continues to rise, so do financing costs. "Lenders are working on a spread based on the 10-year Treasury bill, which makes it more expensive for investors to purchase properties," he said. Cap rates have not risen and asking prices have not lowered to compensate for the increase in interest rates in the last six months, he said. This has created a large supply of product.

He cited Walgreen properties as an example. "Six months ago ,Walgreen properties were trading in the 8% cap rate range and today are selling for around 8.5%. There is a difference in pricing of 50 basis points, while interest rates have raised 50 to 75 basis points in the same period. Clearly, cap rates have not compensated for the increase in financing costs. Cap rates will have to adjust to continue to attract investors and provide them with the same level of return. Otherwise, investors will look at alternative investments or other more competitive real estate," Sturm said.

"You constantly fight the interest rates in this market. Rates have been moving a lot this year, but with no drastic changes," Domb said. Interest rate fluctuations matter most in to-be-built projects, he said. A deal where a facility will be completed and close in May 2001 is being predicated on today's rates. "You assume rates will be close to this in 12 months, but there is a little too much jumpiness for real comfort

right now," he said. "It's the first time in six months you've had to worry about rates."

Sturm said he looks at net lease transaction underwriting criteria as a triangle, with location, lease and the credit of the tenant being the three sides, all weighing equally in determining investment return. "The cap rate must increase to make up for any weakness in any of these three factors. If anything changes, the cap rate must change," he said.

The differing quality of location, lease and credit can lead to a lot of variations. "But when all of the ingredients are healthy, you can have cap rates in the high 8s and low 9s. Cap rates rise from 9 to 9 1/4, if anything is wrong with either the real estate or the credit," Domb said.

Lenders and buyers scrutinize not only the quality of the real estate but diversification of tenant type and geography. "Rite Aids going south was a wake up call for a lot of people. It has made lenders more hesitant to underwrite too many competitors in certain geographical regions. They have thus upped their spreads in certain situations based on what the market can justify," said Randy Blankstein, president of 1031 Properties.com in Chicago.

"It used to be that all that was necessary was a good location and an investment-grade tenant. But after Rite Aids stock got beaten up fairly bad and considering today's financial markets, everything moves much faster. Therefore, lenders are looking at the real estate more than they used to," said Chris Marabella, owner of Marabella Commercial Finance in Escondido, Calif. Primarily, they look at rent levels to make sure they are equal to or less than surrounding rents. "Lenders want to know if they can re-lease the property. They are getting more conservative and taking more time to look things over carefully, because they don't want to get burned," Marabella said.

Higher-than-market rents come into play more frequently with build-to-suit projects in which a retailer wants a specific location, Sturm said.

Retailer can see many benefits

"The sale and leaseback of corporate real estate has been popular in the past, and I expect it to be a more popular form of capitalizing a company in the future," said Edward V. LaPuma, an executive director at W.P. Carey & Co. Inc., New York. Sale-leaseback financing principles fit in with the trend for corporations to outsource not only human resources but also real estate, LaPuma said.

A major benefit is, of course, cash. "Sale-leasebacks provide the releasing of capital and allow a corporation to realize the full-market value of their real estate and increase their cash and off-balance sheet action. It puts corporations on what is called the efficient frontier of capital. When added into the overall corporate financial mix, the sale-leaseback is attractive to total capitalization. Short-term liabilities are matched up with short-term assets. It provides an additional way of diversifying a company's financial strategy, LaPuma said.

Sale-leasebacks enhance a company's borrowing capacity to fund R&D or acquisition activity, LaPuma said. They also provide benefits in financial reporting, as the off-balance sheet nature of the transaction allows a company to show an improved return on assets and improved return on capital right away. "All of this has helped to increase the number of sale-leaseback transactions," he said.

In terms of expansion, sale-leaseback financing quickens the pace. "The largest asset on the balance sheet was real estate, and traditionally retailers grew on a store-by-store basis. The growth pattern was slower. Now, however, many specialty retailers, start-ups and regional companies are growing their business at a much quicker rate," LaPuma said.

Domb mentioned a simple test for retailers to determine if leased real estate works for them: if they can take the money and earn more, they should lease. "Companies are beginning to understand that they shouldn't carry all of this real estate on their books. They're being advised by their investment bankers of the sense it makes to capitalize."

"A retailer can get 100% financing on a $1 million property, take his $1 million and go get 30% returns rather than 10%. It helps the retailer's stock and benefits the bottom line by helping to increase earnings," Marabella said.

Most drug chains still popular

While net lease financing and sale-leaseback transactions have branched out to encompass a wider variety of retailers, the large national drug chains, excluding Rite Aid, remain a mainstay of the business.

"The freestanding drug store is alive and well," Blankstein said. He mentioned that Walgreen has 490 new freestanding stores, and that the latest change in drug store real estate lately has been the move to add drive-throughs to the facilities. "Drug stores remain the tenant of favor, as many view drug stores as immune to Internet commerce threats," he said.

"There is still a lot of activity in Walgreen. CVS transactions are also very attractive and hard to come by, and they are usually purchased before breaking ground," Rinnier said. Investor perception has shifted negatively toward Eckerd, due to the chain closing some 300 stores, he added.

Blankstein said he is seeing activity not only in the healthy drug chains, whose expansion makes up 20% to 30% of the market, but also in properties of 7 Eleven, Taco Bell, Blockbuster and Staples. While McDonalds remains a holdout, eschewing the net lease route, "clearly everyone else from Wal-Mart on down is doing it or considering sale-leasebacks," Blankstein said.

Blankstein sees a bright future for leased real estate. "I view the trend as moving to all leased real estate instead of owned, as it has been proven that retailers see a 25% to 30% increase in revenue and generating more sales per square foot in freestanding stores as opposed to in-line. As long as the 1031 rules do not change (see accompanying story on 1031 exchanges), it means lower costs to corporations to move real estate off their balance sheets. The trend has been accelerating for the last two to three years, and I see it going in this same direction in the future," he said.

REITs take riskier route

"Real estate investment trusts (REITs) have been priced out of some markets, because they can't get equity as cheap," Blankstein said. "REITs have gone to higher cap rates and non-credit tenants, such as restaurants. They have moved higher on the risk scale and are betting more on the real estate than the tenant as the stock market has changed." This is a positive move for REITs, he said, because it means they are functioning as operating companies and are showing enough diversification in their portfolio to be able to afford to take some tenant risk.

"REITs are also active buyers in the secondary market," he said. They are buying leases that have long terms remaining, seeing this as another place where they can add value.

Anchored Centers Can Take Advantage of Net Lease Financing

Stand-alone retail properties are no longer standing alone in their ability to take advantage of credit tenant financing. Two new programs initiated by New York-based Capital Lease Funding LP, (CLF) are now enabling owners of different types of shopping centers to use net lease structures.

Paul McDowell, senior vice president and a founder and partner at CLF, says that while classic net-lease financing is for a stand-alone property that is 100% net leased to a credit-rated tenant, "we see a lot of properties that have combinations of credit tenants and some percentage of non-credit or less-than-investment-grade tenants as well." An example is a center anchored by a Wal-Mart or Home Depot that contains local tenants such as a pizza parlor, a florist and the like.

This type of center typically has followed a more traditional path to financing, usually obtaining a 10-year

loan with loan-to-value (LTV) ratios of 75% to 80% and a 30-year amortization, McDowell says. The problem with the standard real estate loan for such a center is that the underwriting ignores the 10-year rent stream from the credit tenant because it assumes the risks of the local tenants, figuring that the non-credit local retailers will not be able to pay their percentage of common area charges, taxes and insurance for the life of the loan.

In some cases, owners have isolated the various cash flows, subdivided the property into separate tax parcels or have created a condominium structure to isolate common area charges, taxes and other obligations of non-credit-rated tenants in order to structure credit-tenant financing. But doing so invariably gets complicated or in many cases is prohibitively expensive or impossible to structure due to local regulatory constraints, McDowell says.

CLFs' two new programs, rolled out this year, are meant to fill this niche and make it easier for owners of such centers to maximize proceeds.

The first program is for centers anchored by a credit tenant in which rent from non-credit tenants represent 15% or less of the overall property's net operating income (NOI). With this program, the borrower can finance only the cash flow from the credit tenant, leaving the NOI from the other tenants as free cash flow, with a single mortgage held covering the entire property. Depending on the credit rating of the anchor, lease quality and interest rates, a borrower can fund approximately 85% of property value through a self-liquidating 20-year loan, McDowell says.

"Both programs isolate the risks of the local tenant so that the borrower can in general get more proceeds than from traditional real estate lending," he says. "While we cannot be all things to all people, CLF tries to provide as many programs as possible, and these programs appeal to a segment of the market where borrowers want more leverage, and we can give them full value for their credit tenant lease payments."

The second option applies where the NOI from non-credit tenants is between 15% and 50% of overall property NOI. Here the credit tenant loan is based on the anchor only, with LTV ratios up to 95%. The cash flow from non-credit tenants is financed under a separate conduit loan with traditional real estate loan underwriting, typically with terms of debt service coverage of 1.3x and LTV of 75%. Taken together, this allows the borrower to finance a property with higher leverage. In such a case, "one plus one equals more than two," McDowell says.

Capital Lease Funding is currently reviewing loan submissions for the programs, which are typically from local developers who may own two to three such qualifying properties, McDowell says. The firm has not yet closed any such loans and did not disclose its predicted origination volume for this year.

1031 Exchanges Provide Tax Benefits

As many investors have discovered, it is possible to own real estate without having to worry about property management or capital gains taxes. By meeting the requirements of the Internal Revenue Code 1031 Exchange, owners tired of playing a hands-on role can dispose of a high maintenance property by exchanging it for a net leased property in which the tenant takes responsibility for management. At the same time, the owner defers taxes on the capital gains.

With all of these benefits, it is easy to see why 1031 exchanges drive much of the net lease financing market.

Commonly referred to as "like-kind" exchanges, 1031 tax-deferred property exchanges are exchanges in which capital gains tax deferral is available to real estate owners who sell their investment, rental, business or vacation real estate, and reinvest the net proceeds in other like-kind real estate. Net-Properties.com (http://www.net-properties.com) reports that an investor can trade any type of investment property or property held for trade or business for any other type of investment property, meaning that an investor can trade an apartment building for a retail property or a working farm for an industrial

building. Personal property is not included in the rules.

Many of the real estate owners who participate in 1031 exchanges are older developers who are disposing of their multitenant commercial properties or multifamily apartment buildings and turning to no-management types of real estate, which frequently translate into net-leased retail properties.

"It is the developer who does not want to manage buildings any longer and instead is looking for a coupon-clipping type of real estate," said Randy Blankstein of 1031 Properties.com, one of several firms throughout the United States that specialize in facilitating this type of property transfer.

The desire for so many sellers to avoid capital gains means they are willing to pay higher prices than investors with other investment criteria.

"The 1031 tax-deferred exchanges drive the cap rates," said Keith Sturm of Upland Real Estate Group Inc. "Because of the tax deferral, an investor is willing to pay more." Sturm said that approximately 90% of Upland's sales last year were to buyers taking advantage of the 1031 exchange.

Blair Rinnier of Net-Properties.com said that 1031 buyers "can afford to pay aggressive prices," because if they don't, they are losing considerable equity to the government. "Now that returns are down and rates are up, 1031 investors are looking for higher risks and higher yields," he said. Most of the 1031 buyers are individuals or partnerships, Rinnier said, and the typical size of 1031 exchange deals is from $3 million to $5 million.

The 1031 exchange buyers have led the market since 1995-96, according to Chris Marabella of Marabella Commercial Finance. "As the economy is booming, prices go up on real estate. Apartment owners have made a lot of money and are exchanging out of them for net-leased properties," he said, adding that he is seeing a great number of buyers in Southern California and from Silicon Valley, including many developers who are finding it difficult to find good new land deals.

Besides the clear tax savings, investors can also benefit from improved cash flow; greater leverage into a replacement property; investment diversification; and geographic relocation/consolidation of multiple business or investment properties.

Net-Properties.com says the two most common types of IRC 1031 Tax Deferred Exchanges are:

1. Simultaneous Exchange: This is the less favored method of exchange because it requires both the relinquished property and the property to be acquired to close simultaneously. It is important in this circumstance that each closing is contingent upon the other closing to maintain the integrity of the exchange. Since it is difficult to predict with certainty exactly when a transaction will close, most investors prefer to use a delayed exchange.
2. Delayed Exchange: Delayed exchange rules come from amendments to the tax code as part of the 1984 Tax Reform Act. A. The exchanger has a total of 45 days from the closing of the disposed property to identify up to three potential replacement properties. B. The exchanger can instead identify any number of properties so long as their combined fair market value does not exceed 200% of the value of the property being disposed of. C. The 95% exception rule states that neither of the first two rules apply if 95% of the value of all of the properties identified are actually acquired. D. The exchanger has a total of 180 days from the close of the property sold to purchase and close on a replacement property.

An exchange intermediary should hold the proceeds of the relinquished property in trust for the exchanger, acquire properties for the exchanger and assist in closing of the replacement property. The intermediary should offer a Letter of Credit backed by a financial institution to guarantee the safety of funds held.

"It has been a very vibrant market," said Jonathan Molin of U.S. Realty Advisors. "As the real estate market has had lots of liquidity, people are looking for trades."

Here's how 3 retailers used sale-leasebacks to fund growth

A consumer electronics giant, a fitness center operator and a megaplex movie chain are three examples of the many different retail corporations who have derived benefits from sale-leaseback transactions.

W.P. Carey & Co. Inc., a New York-based asset management firm specializing in the acquisition and management of single-tenanted commercial real estate, cites three case studies to show how specific transactions enabled retailers to use their real estate to help them achieve other financial and corporate strategies.

- Fitness Holdings Worldwide, the Pleasanton, Calif.-based operator of 24-Hour Fitness centers, used a sale-leaseback financing strategy to fund future growth. By freeing up 100% of the value of its real estate assets, the company benefits from substantially more funding than that provided by traditional mortgage financing and can therefore accelerate its expansion program. This applies to any retailer whose operations are real estate intensive and require multiple physical locations. In January 2000, W.P. Carey arranged a $13 million sale-leaseback with a 20-year lease term for two 24-Hour Fitness properties totaling 95,000 sq. ft.
- W.P. Carey arranged $14.7 million in sale-leaseback financing for Consolidated Theaters last year. The agreement was for a 20-year lease term for a build-to-suit 20-screen theater of 88,000 sq. ft. in Richmond, Va. Consolidated is currently building more than 100 screens throughout six locations, and its five-year plan involves expansion to more than 500 screens with more than 200 being in operation by year-end 2000. This transaction allows Consolidated to pursue and capitalize on an aggressive strategy involving solely megaplex, stadium-seating theater construction in the Southeastern United States.
- Best Buy Co. Inc., is one of the nation's leading consumer electronics specialty retailers, based in Eden Prairie, Minn. Early in Best Buy's plans for expansion, in 1993, W.P. Carey structured sale-leasebacks totaling $46.2 million for 17 retail locations totaling 594,748 sq. ft., which enabled Best Buy to realize 100% of its property values, to raise significant capital for reinvestment in its core business and to expand. Best Buy is currently ranked in the top half of the Fortune 500. *

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