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# Striking a balance

**The net lease market has plenty of buyers, but a limited supply of quality properties.**

Jamie Evans Associate Editor



Not long ago, Randy Blankstein witnessed a bidding war break out over a 1-year-old Walgreen's store in Chicago.

In the net lease market, Walgreen Co. is a highly prized tenant with a Standard & Poor's "A+" credit rating and a market capitalization of more than $25 billion.

Six parties submitted an offer for the property and, ultimately, the drugstore sold for $110,000 above the property's listing price of $4.6 million.

Another Chicago-based net lease broker said he has seen several other incidents of multiple potential buyers bidding for a single Walgreen's location--often before the properties were built.

"The buyers are paying premiums for the better properties," says Blankstein, president of Northbrook, Illinois-based The Boulder Group, which worked on $210 million in net lease deals in 2002. "The most desirable properties are ending up in bidding wars."

Blankstein and other net lease specialists are currently seeing a limited supply of quality net lease properties on the market valued at $10 million or less. Buying a property with a non-investment grade tenant can translate into putting more cash down and dealing with a more challenging lending environment and more onerous loan terms.

A net lease property--often referred to as a sale-leaseback property--is a property that has a long-term lease that generates predictable cash flows. And the tenant--not the owner--is responsible for the operating expenses, real estate taxes and insurance in addition to the rent.

For net lease tenants, such as corporations, they maintain operational control of the property while not locking their cash up in real estate. The tenant's money is freed up for operations, paying down debt and other needs.

The current lack of supply in part is a result of companies putting the brakes on growth plans and closing under-performing stores during the current economic malaise. Healthy demand also is reducing the supply of quality net lease properties.

A majority of the buyers are looking for a 1031 exchange opportunity--selling one property and investing in a net lease property of equal or greater value within a 180-day window to defer paying capital gains tax.

More investors also are pulling money out of the sluggish financial markets and placing it in net lease properties. They view their investment in a net lease property as comparable to placing money in a long-term bond. It is particularly attractive with the current low-interest rate environment.

The current market conditions clearly put sellers with quality properties in the driver's seat.

"Either everyone wants your property or no one wants it," Blankstein says. "It is a strong market, but you can't sell anything into it."

**What's available?|**

Michael Houge, CEO and principal of Minneapolis-based Upland Real Estate Group Inc., which specializes in single-tenant net leasing, says he has seen the pool of available properties shrink in recent months.

"Normally, we would have 300 properties on our inventory," he says. "Now we may have 150 of them. Of those, 75 to 100 are extremely attractive compared to the rest."

Net lease properties with investment-grade tenants like Walgreen's are generally being snapped up with lightning speed. Difficulties can remain with locating to buy just below investment grade properties, such as Pier One, Eckerd Corp. and OfficeMax.

Industrial and manufacturing properties generally remain attractive with their stability, flexibility in use and ease in finding a new tenant if one falls through. But they also are not always easy to come by.

"You just have to be there at the right time," says Joe Cosenza, chairman of Inland Real Estate Acquisitions Inc.

Inland recently paid $19 million for a 489,000 square foot Deere & Co. manufacturing facility in Janesville, Wisconsin, one of three Deere facilities on its acquisition list. It also plans to buy Deere facilities in Davenport, Iowa and Jefferson City, Tennessee.

With non-investment grade tenants, more homework must be done to study a property, says Scott Kipp, managing director at Dallas-based Cardinal Capital Partners Inc. That may include investigating the real estate location, looking at the tenant's financials and considering the possible future lease or reuse possibilities.

"If you own a movie theater and you lose the movie theater [company], it's tough on the reuse," says Kipp, whose company completed $600 million in net lease transactions in 2002. "With a warehouse, you have broader use."

But the greater the risk taken on a non-investment grade tenant can often lead to a greater reward, Kipp says.

The most readily available net lease properties seem to be restaurants that have non-investment grade tenants. Barry Bain, senior vice president at Brauvin Real Estate in Chicago, says he regularly sees plenty of listings nationwide for sit-down and fast-food restaurants, such as Jack in the Box, International House of Pancakes (IHOP), Golden Corral, Old Country Buffet, Taco Bell, Arby's and Kentucky Fried Chicken.

Marcus & Millichap Real Estate Brokerage Co. worked on about 150-restaurant property deals nationwide in 2002, including about 12 in Illinois, says Bruce Harris, a director in the company's national retail group in Chicago.

He says the restaurant deals often are attractive because of the prices--typically under $2 million. They can come with leases that increase the rent annually by 1 percent to 2 percent and the restaurant pays rent even if it closes its doors.

Again, Harris agrees that buyers must do their research on a restaurant net lease acquisition, but several factors can mitigate the potential risks of investing in a non-investment grade tenant--such as buying into a good location and making sure the restaurant has strong sales.

"Good store sales are really your security in a restaurant," Harris says.

In the best of all worlds, a buyer would line up the best tenant with the best credit at the best location and get a 10 percent return or better, says Houge at Upland Real Estate. He calls that a "unicorn" and the reality is that they really don't exist. On the flip side, the investor wants to make sure they don't get stuck with a "mule."

"Find a good workhorse," Houge concludes.

**1031 exchange buyers|**

A majority of buyers of net lease properties valued at up to $10 million currently are moving out of one property type and into another. The buyer may own an apartment building, shopping center, office building or strip mall and seek a net lease property that requires less maintenance and upkeep.

"People buy these things for the long-term," says Gary Cornelssen, president of Marcor Investment Properties Inc. in San Diego. "They have no maintenance. All they are going to do is get a check each month. If you get a good tenant like Walgreen's, you have nothing to worry about. People buy these things like they buy a corporate bond. That's why they call it a bond net-lease."

A key economic barometer of a net lease property is its cash on cash return. The calculation determines the before-tax cash income on the cash invested. For example, if a buyer puts $1 million cash down on a $5 million property and your cash flow after debt service is $100,000, the cash on cash return is 10 percent.

Stan Johnson, CEO of Stan Johnson Company, a national net lease brokerage in Tulsa, Oklahoma, says the cash on cash return is not the only thing to watch. Buyers should look at three components when considering a net lease property: the credit of the tenant, the real estate and the overall economics, which includes the lease term and yield. Generally, the buyer is only going to get two of the three, he says.

With 1031 exchange buyers, they generally have a low-risk profile and typically are looking for a good-credit tenant and strong economics, which equals stable cash flow over a 10-year or longer period, Johnson says.

"In general, the leveraged cash on cash return is approximately 7 percent give or take, based upon the credit or financing risk you are taking," Johnson says. "Given the fact that the 10-year Treasury is at less than 4 percent, it makes the net lease attractive."**|MWREN**