The Net-Lease Attraction

by Mike Sheridan

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Even if the heated U.S. economy simmers down, net-lease financing professionals believe that their business will continue to thrive as increasing numbers of corporations see an economic advantage in monetizing assets and more retailers continue aggressive expansion plans.

As more and more corporations look to sell their corporate assets and lease them back, net-lease business will increase, explains Richard Ader, chairman of New York-based U.S. Realty Advisors. "We're now seeing a whole spectrum of CFOs look at their real estate assets and say, 'What is the value of holding it?'

"Typically you get a 10% to 13% rate of return in real estate," continues Ader. "Most corporations try to get a 20% or greater return on their capital. So there is a big difference. Net-lease financing cuts across all credit lines, probably down to the single-B credits, but there has always been interest. Using the asset has always been paramount, whether a retail company needs more locations or headquarters to house its employees."

Future prospects Gary Ralston, president of Orlando, Fla.-based Commercial Net Lease Realty Inc., adds that net-lease opportunities in the future are significant since industry sources estimate that corporations own $1.7 trillion of real estate.

"Corporations will need capital for new infrastructure - technology, processes, facilities, etc.," says Ralston. Traditional corporate capital sources are not enough. Equity issuance may be limited and corporate debt levels are limited by the rating agencies. Thus, companies will need to seek alternative capital sources."

Net-lease properties are attractive to taxpayers seeking replacement properties and tax deferral under Section 1031 "like-kind" exchanges. Thus, 1031 exchange buyers are often part of the equity component of net-lease properties. "We believe that there will be a rationalization of the 1031 exchange market. We expect to emerge as the change agent," says Ralston.

At the same time, Wall Street and other institutions continue to encourage industries and corporations to focus on their core business, says Ethan S. Nessen, executive vice president of Boston-based Corporate Realty Investment Co. (CRIC) LLC. "They're not in the real estate business, so they want to concentrate on making widgets or whatever their product is," he says. "They want to get out of the real estate business and put that money to work elsewhere."

Today, there is a surge of creativity. "We're seeing new industries opening up that are going to be good real estate users," says Nessen. "In retail, for instance, e-commerce is not going to replace the need for retail because we live in a physical world. Retailers will continue to have physical needs. Contrary to what people think, we are not going to be living in a virtual area anytime soon,"declares Nessen. "Even though retail is out of favor in the capital markets, it will come back into favor. The Internet is not going to replace retail."

The period when the real estate boom starts to show signs of weakening will be interesting for the net-lease industry, predicts Nessen. "Net leasing will survive that, and I think we're going to see a broadening of what net- lease buyers do."

Paul McDowell, senior vice president of New York-based Capital Lease Funding LP, a firm that specializes in long-term, fixed-rate financing for properties net leased to investment- grade tenants, concurs that the net- lease financing market is healthy.

"We're a direct lender for properties net leased to investment-grade credit tenants," he says. "We're seeing the market continue its steady growth as credit tenants focus on the benefits of carrying real estate off their balance sheets."

In general, Capital Lease Funding views the market as very positive, he says. "Credit tenants, the major national retailers, show healthy, strong balance sheets and continue to expand," says McDowell. "A slowdown in the economy will have a big impact on regular real estate lending flows, but I don't think it will be as large in the credit-lease market.

"Originations seem to have bottomed out and are starting to trend up," he adds. "Obviously, recent rising interest rates have had an impact on borrowers but a credit-lease loan is different from a typical real estate loan."

Jim Nolan, executive vice president of Miami-based United Trust Fund, a company that invests in single-tenant, net-lease properties, notes that his firm has witnessed an increase in the volume of business recently. "Our business is up a good 20% this month alone," says Nolan. "The positive news on the net-lease front is that business is good, demand by tenants is increasing, and the economic and excellent business climate continues."

Storm clouds on the horizon? Not all the stars are in alignment, however. There are some concerns in the industry, says Nolan. "Rising rates will increase occupancy costs. For the rest of the year, we're forecasting a very stable environment. We've already experienced the volatility with rate hikes by the Fed."

On the equity side of the equation, interest rates are having an effect and more equity is required, says Nolan. "The amount of debt financing has been eroded. I think there are fewer dollars, and part of the reason might be the tremendous amount of financing that was done with Rite Aid and the difficulty that Rite Aid later went through. People are shying away from some retail, particularly institutional lenders," concludes Nolan.

Rich Jacobs, managing director at Baltimore-based Legg Mason Wood Walker Inc., says that after a year of strong growth, the net-lease financing industry could experience a slowdown in some sectors, such as the corporate sale-leaseback arena, due to higher interest rates and wider spreads.

"Currently, we're seeing CFOs sit on the sidelines, reading the economic tea leaves and seeing if they can predict the direction of the market," says Jacobs. "Now the corporate sale-leaseback sector is a little slower than it has been, but that is to be expected. Spreads are wider, and unless a company has to execute a sale-leaseback they're sitting on the fence."

Companies such as Legg Mason remain busy, although many say this year's volume will not reach the heights of 1999, when more than $4 billion in business was reported in the industry. "If CFOs believe the timing is right, they will execute the transactions," says Jacobs.

Industry insiders say September and October may set the tone for the balance of this year, noting that some investors seem to be shying away from some retail deals. The strife at the Rite Aid drug store chain is one reason for the hesitancy, according to industry members. According to Standard & Poor's, the company's credit rating has declined, from BBB in June 1999 to a current non-investment level of single-B because of company problems.

The drug store sector has been a prolific force in the corporate sponsored sale-leaseback arena and some investors note an oversupply of drug store transactions.

Currently, investors are seeking deals involving non-retailers such as industrial tenants and service providers, says Jacobs. "There aren't that many non-retail deals out there, but there is still plenty of capital to fund CTL deals," he says.

Balancing the requirements of the capital market, the lessee and the lessor is key, Corporate Realty Investment's Nessen adds. The capital markets are being less aggressive in terms of debt. "There is less aggressive pricing available than we've had in the past. There is still lot of debt out there to do a lot of deals, but it is not as easy as a year or 18 months ago. You have to structure the deal more carefully," says Nessen.

At the same time, Nessen and others note that more equity is required of the lessor. The equity returns are not nearly as dynamic as corporate bond returns, says Nessen. "It is moving constantly, which drives pricing. However, in the fixed equity side of it, it doesn't have that same sort of dynamic moment.Equity returns don't float up and down as on the corporate bond side."

Nessen believes that there will always be a balance between real estate and cap rates. "Control of the asset is also important. Investors want a long lease that gives control, and companies are willing to lease it back because ownership for them is not important but control of that asset is," says Nessen.

Ader of U.S. Realty Advisors notes that as the industry grows, the debt markets are becoming more selective. "Wall Street is disappearing from the credit-tenant leasing market, and the industry is going back to institutional insurance companies, pension funds and banks."

Emerging trends The net-lease sector continues to attract investors because net leases are a secured corporate obligation based on the credit of tenant, according to Ader. "The obligation to pay the debt service comes from the rent, and that is attractive to lenders. If the tenant is viable, the rent gets paid. The downside is if something happens and the lease is disaffirmed in bankruptcy. So, the key is in the initial underwriting to pick assets that are vital to the corporation."

Synthetic leases are another big issue, adds Ader. "Many corporations have a waning interest in synthetic leases because the economy is entering a higher interest rate environment. That means when the synthetic lease ends, you've got to do it again or enter into a true lease."

Corporations are asking themselves whether they want to take a bet on interest rates in three, five or seven years, or lock in rates now for 20 years. "A strong company is always better off locking in for 30 years," states Ader. "If you're in a period of low interest rates and low inflation, why not lock in interest rates?"

Commercial Net Lease Realty's Ralston also notes that pooling net leases or mortgages from a diversified group of companies provides improved capital access. Several economists believe that there will be an increased demand for high-grade, fixed income in the future, says Ralston, noting that this bodes well for the securitization of credit-tenant lease loans as an efficient capital channel. Execution should be superior to "one-off" individual credit or bond deals, adds Ralston.

"We believe that the future will bring increased standardization of lease forms as well as CTL loan documents," says Ralston. "We also believe we will see more vertical integration of the process."

Brant Bryan, president of Dallas-based Staubach Financial Services, an active buyer of both investment-grade credit-tenant leases as well as sub-investment grade credit-tenant leases, says his company has observed the number of investors that buy non-investment grade product shrink.

"It's more difficult for corporations who do not have investment- grade credit to complete transactions," says Bryan. "And it's a decidedly more difficult market for non-investment-grade single tenants than for investment-grade tenants. There has been an emphasis on credit quality because there is some difficulty in finding liquidity in non-investment grades."

Over the past several months, both underlying Treasury rates and spreads over Treasury have risen. Spreads in the market have widened considerably and in most cases have increased by 50%. CMBS spreads have widened for lesser-grade tenants, so the cost of financing has increased, adds Bryan.

With the Federal Reserve action, spreads should tighten, adds Bryan. "I think there's going to continue to be a lot of people bringing single-tenant, net-lease properties to the marketplace. We're seeing a number of institutional sources decide to enter into the marketplace - pension funds and insurance companies - who are deciding that this is a particular asset class they want to hold."

At the same time, Bryan sees globalization in the marketplace. "Historically there has been lot of international real estate investment, but very little of it has been single-tenant net lease," says Bryan. "We're seeing international interest in single-tenant net-lease properties, both with foreign money in the U. S. and with U. S. money going to other places. It's still a small part of the overall equation, but people have identified net-lease financing on the radar."

Bruce MacDonald, president of Boston-based Net Lease Capital Advisors, says the industry will continue in its expansion mode as more individuals and companies become familiar with the industry.

"Our focus is on the end market and the end market is growing," states MacDonald. "Because our strategies frequently rely on credit-tenant property, we are generating continued demand for this product."

Real-life example Net Lease Capital recently met with a group in New York that owned a 1 million sq. ft. industrial building with no debt. The owners were facing a $12 million tax liability if they sold the property. The owners didn't understand credit-tenant properties or credit-tenant financing, says MacDonald. Their attorney had dissuaded them from opting for a 1031 exchange because he said they could not find a suitable replacement, and the owners didn't want to get involved in the risks and responsibilities of real estate.

"We explained the concept that they could exchange into $40 million worth of credit tenant property and save $12 million in taxes," according to MacDonald. "Since they held the property free and clear, they would have an 8% cash-on-cash return, with zero management responsibilities. It's almost like owning a corporate bond since the tenant would be 100% responsible for the building. They embraced the concept on the spot. Further, if they chose to finance the property based on the credit of the tenant, they could withdraw $36 million and deploy that money elsewhere," explains MacDonald."

There is increased efficiency in creating sale-leasebacks in terms of the debt markets, emphasizes MacDonald. "The lease structures and debt market are becoming more sophisticated, so we're getting more product into the market. Even as interest rates trend upward, I don't yet see a slowdown in sale-leasebacks since demand for product continues to grow."