

Old-fashioned deal is hot again

For a time considered too conservative in the heady days of real estate investing, so-called net-lease deals are gaining ground.

By **DON JACOBSON**, Special to the Star Tribune

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Modest, worry-free property investments once upon a time were the name of the game -- essentially your grandparents' way of making money on real estate.

Investors would derive a steady income by buying small retail or office buildings with ultra-creditworthy single tenants who've signed long-term leases -- tenants like the U. S. Postal Service, McDonald's or Walgreens.

Under these "net-lease" deals, it's up to the tenants to take care of the buildings -- if they need a new roof or a toilet fixed, it's on them to get it done. All your grandparents had to do as property owners was sit back and watch returns roll in. It's nothing fancy or ultra-lucrative, but steady and dependable -- sort of the commercial real estate equivalent of investing in blue-chip stocks for the dividends.

Like many old-fashioned ideas of investing, it fell out of favor in the debt-laden, go-go real estate market of the last decade. But with the collapse of the speculative bubbles and the drying up of the credit markets, net-lease investments -- once scoffed at as too conservative for all but the most unambitious -- are now back in style as investors seeking their relative safety and simplicity are chasing after the best properties.

In fact, investors this year have been so eager to get into net-lease deals that they're branching out from the top-of-the-line "gold standard" tenants with investment-grade debt such as Walgreens and are buying into properties whose tenants are still solid but a bit less creditworthy. These offer higher "cap rates," or returns, because they are a bit more speculative.

This branching out reflects a massive influx of cash into the net-lease sector and a dwindling supply of "A-plus" properties to choose from, according to second-quarter research performed by the Boulder Group, a Chicago-based boutique investment real estate service firm specializing in net-lease properties.

Boulder noted that investors seeking entry into the net-lease market are being aided by

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lenders, who are willing to finance such conservative purchases while remaining leery of other types of commercial real estate deals. At the same time, supply is dwindling significantly because creditworthy retailers such as Walgreens and CVS pharmacies are scaling back their expansion plans in the face of the recession.

The firm said activity in the net-lease market is taking place in two segments. One is in single-tenant properties priced under \$10 million featuring cap rates of 8 percent or less. These are "gold-plated" tenants with long-term leases occupying buildings in core metropolitan areas.

The other area seeing a surge in interest is properties with cap rates of 9 percent and higher, which are being snapped up by investors with shorter-term strategies seeking higher, more opportunistic returns. These buildings are generally in second-tier suburban areas and are occupied by retailers with non-investment-grade bond ratings.

Taken overall, the net-lease market is in the midst of a surge of popularity it hasn't seen in quite awhile, said George Rerat, managing director of acquisitions for St. Paul-based AEI Capital Corp., which offers net-lease property investment funds to wealthy

individuals and institutions.

"It has been the strongest commercial real estate segment out there, and it has rebounded the fastest," Rerat said. "Financing has been available for net-lease deals, even through the worst of the downturn."

Rerat said AEI strictly buys properties that feature investment-grade retailers such as Best Buy, Tractor Supply Co., Staples and Dick's Sporting Goods in all-cash transactions.

"Right now, there's supply-demand imbalance, because the demand for good net-lease properties is way up," he said. "We're seeing investors continuing to put money into funds like ours because they want to own only the safest and most secure properties, with income streams that will remain positive."

"People have realized that high debt on commercial real estate doesn't make sense in all environments."

The upsurge in net-lease deals is providing work at a time when so much commercial real estate activity remains frozen, added Howard Noziska, president of Encompass Inc., a structural engineering firm that vets

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buildings being considered for purchase by net-lease buyers.

"Our business has long been about providing services to developers building new buildings, but since that is down a little bit now, we've picked up business by checking for possible deficiencies in structures being purchased in net-lease transactions," he said. "This is helping us to fill in the low spots."

One of the most active local brokers in the net-lease space is Upland Real Estate Group of Minneapolis. Upland's Keith Sturm agreed that investors seeking easy-to-understand deals after years of complicated, leveraged transactions are crowding into the sector.

A sampling of Upland's current net-lease listings include a Family Dollar store on St. Paul's Payne Avenue; Arby's fast-food outlets in Oak Park Heights and Woodbury; a Walgreens in Willmar; and a Denny's restaurant in Brooklyn Park.

"We've been tracking this a long time and it's not surprising it's popular now," he said. "It's a flight to quality -- the classic real estate 'triangle' strategy of good location, creditworthy tenants and long-term leases without the landlord responsibilities."

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