NET LEASE forum

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INDUSTRY UPDATE

FASB Proposes Modifications To FIN 46

Will Changes Affect Reporting Of Synthetics?

Roughly two months before the deadline to comply with FIN 46, which provides guidance for the reporting of special-purpose, or variable-interest, entities, the **Financial Accounting Standards Board** has proposed a series of modifications to the document. The Norwalk, CT-based FASB is accepting comments on the proposed changes until Dec. 1.

Some real estate industry experts say the changes are, for the most part, wording adjustments and clarifications that are not likely to have any substantive impact on FIN 46's implementation with regards to synthetic leases. Rich Jeanneret, partner and mid-Atlantic real estate industry leader for **Ernst & Young LLP**, says members of his firm "don't expect changes in the application to synthetic leasing.

"I think this is going to be a very fluid standard for quite a while."

Rich Jeanneret
Ernst & Young

"That doesn't mean that something couldn't evolve," Jeanneret adds. "I think this is going to be a very fluid standard for quite a while."

David Silvers, vice chairman of New York-based **U.S. Realty Advisors LLC**, offers a different view. He notes that an appendix of variable-interest examples, including one related to leases, is eliminated from the original document as part of the proposed changes, with the proviso that the FASB will provide guidance on such examples in the future. "Existing and future synthetic lease transactions may now find themselves recharacterized as transactions that are required to be consolidated into the financial statements of the nominal synthetic lessees," Silvers warns.

An attempt to clarify the very technical FIN 46 won't come as a surprise to many in real estate. Since it was first issued in January, affected parties have been busy trying to understand and apply FIN 46. Along the way, many in the business—including accountants, attorneys, corporate CFOs and real estate advisors—have told ***NET LEASE forum*** they found parts of the document hard to decipher.

"There has been no generally accepted view on how to interpret FIN 46," says Mike Rotchford, president of New York-based **Cushman & Wakefield Securities**. "I view FIN 46 as a work in progress."

"The proposal is being issued in response to input received from constituents regarding certain issues arising in implementing Interpretation 46," FASB stated in releasing the draft of proposed changes. The draft itself further states: "Since the issuance of Interpretation 46, the board has learned that certain provi-

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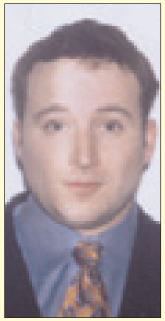
AT DEADLINE

In what is likely to be the Pittsburgh area's biggest office deal of 2003, **Dick's Sporting Goods** signed a 20-year, triple-net lease for a build-to-suit headquarters in Findlay Township, PA.

See details in *GlobeSt.com*'s story: http://www.globest.com/RMISOWPN-MMD.html.

NETLEASE INSIDER



Jeff Rothbart

How does investing in net-leased real estate compare to putting your money on Wall Street? According to Jeff Rothbart, research director for the ***Boulder Group*** *of Northbrook, IL, it is far superior. In this guest column, Rothbart crunches the numbers after contemplating why a credit-tenant, net-leased property may be ideal for a 1031 exchange.*

While 1031 exchange investors have a myriad of options—including but not limited to vacant land, apartment buildings or industrial property—it may seem difficult to sort among these various choices. We believe that the choice is actually very simple. Purchasing net-leased, credit-tenant properties is essentially equivalent to buying corporate bonds. These properties are easily leveraged, extremely secure and liquid investments that provide a management-free cash flow.

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sions of the interpretation are not being consistently interpreted as the board intended. The board decided to address certain technical corrections and implementation issues that have arisen."

The proposed changes come just a few weeks after the FASB deferred the implementation deadline for public companies, essentially extending it to year-end.

Rybarski Launches Specialty Agency For Lease-Enhancement Insurance

Industry veteran Joe Rybarski has founded an insurance agency called **Financial Specialty Risk Management Inc.** to serve the lease-enhancement niche. Rybarski, who has more than a decade of experience in providing insurance products specifically geared to lenders in credit-tenant lease transactions, is the president of the Dallas-based firm.

FSRM works primarily with insurers **American International Group Inc.** and **Chubb Group of Insurance Cos.** to match CTL lenders with casualty and condemnation, environmental and residual-value insurance policies.

"There's a strong demand, and that demand has always been there, but it's changed," Rybarski says of his product. It first came to the fore, he notes, when Wall Street began securitizing the income stream from credit-tenant properties. Then life companies started financing CTL debt; they are still one of the biggest providers of CTL loans and the biggest buyer of lease enhancement insurance products today. "As long as life insurance companies still want to do this, they need this insurance."

What also has changed in his business, he observes, is the base of property types involved in CTL deals. "Now we see many more large buildings, predominantly office buildings and industrial warehouses, as well as retail."

In addition to its current offerings, Rybarski's firm is working with an insurer to develop an appropriations-risk program. That program, should it come to fruition, would provide heretofore unavailable coverage for CTL structures with governmental entity tenants and lease provisions that allow the lease to be terminated if funds sufficient to pay the rent are not appropriated by the pertinent legislature.

Rybarski was most recently with NorthStar Cos. and, prior to that, spent 16 years with Aon Corp. His current two-man shop includes Ben Miner, who has experience in providing insurance for CTL transactions in addition to a background in executive-risk insurance products.

Norseman Adds Mezz Product To Net-Lease Financing Menu

Jersey City-based specialty-finance firm **Norseman Group LLC** has introduced a new mezzanine loan program to its menu

▸▸▸ Continued on page 5

RECENT TRANSACTIONS

▸ **Lehigh Consumer Products Corp.** sold its 270,000-sf headquarters facility in Macungie, PA to **AMC Delancey Group Inc.** Lehigh continues to occupy the building.

▸ **Triple Net Properties** and 20 tenants-in-common bought a 117,339-sf office building in Richardson, TX for $13.9 million. **SBC Communications Inc.** and **Agilent Technologies** are the tenants. Seller **Invesco Realty Advisors** was represented by **CB Richard Ellis**. Financing was provided by **Midfirst Bank** and arranged by Triple Net and **Essex Financial.**

▸ A 523,470-sf facility at Orebro Distribution Center near Stockholm was purchased by **ProLogis European Properties Fund** in a sale-leaseback with **Elektroskandia AB**.

▸ **May Center Advisors** represented **Focused Retail Property I** in the sale of a freestanding **McDonald's** in Oxford, NC to a private investor.

▸ A private investor bought the 245-room **Red Lion River Inn** in Spokane, WA, which will continue to be operated by seller **WestCoast Hospitality Corp.** under a long-term lease.

▸ A 393,000-sf office building in Gaithersburg, MD was the subject of a sale-leaseback between **IBM Corp.** and **Monument Realty LLC**. The purchase also included a 33-acre parcel that can support 1 million sf of office development. **Grubb & Ellis** sat in for the seller, **Holland & Knight** for the buyer.

▸ **U.S. Realty Advisors LLC**, on behalf of **San Diego City Employees' Retirement System**, paid $22 million for a 186,000-sf office building in an unspecified Midwest location. The property was net leased for 17 years back to the seller, a Fortune 100 company.

▸ Recent transactions brokered by the **Boulder Group** include the acquisition of a $583,000 retail property in Monroe, LA, by a St. Louis investor completing a 1031 exchange. **Applebee's** holds a 20-year ground lease to the property. The cap rate was 7.2%.

▸ **McKellips Preschool LP** sold a 10,200-sf facility triple-net leased to **McKellips Tutor Time** for almost $1.9 million. The Mesa, AZ property has 16 years remaining on its lease. **Sperry Van Ness** represented the seller, while **Marcus & Millichap** sat in for buyers **Ping-Wang** and **Theresa Chang**.

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Upon trading into a triple-net lease property, there is no management required. The landlord's sole duty is to deposit the rent check every month, since net leases typically obligate the tenant to pay for expenses including real estate taxes, insurance and building maintenance.

Income from investment-grade tenants generates returns above those of corporate bonds. Most net leases range in duration for 10 to 25 years, with the average lease being contracted for 20 years. In addition to the increased returns, these lengthy durations eliminate the tenant turnover commonly associated with other real estate investments such as apartment or industrial buildings.

Due to this tenant security, net-leased properties are easier to leverage than most other real estate investments. Some net-leased properties can secure financing with as high as a 90% to 95% loan-to-value ratio.

In addition, the lack of required active management and the secure nature of the lease afford easy and frequent transferability of credit-tenant properties. Such liquidity is rare in the real estate market. And while benefits of net-leased properties over other forms of real estate investments are clear, those benefits are increased when combined with the tax-deferral regime of IRC section 1031.

As mentioned, net-lease investments generate greater returns than those of corporate bonds. Surprisingly, credit-tenant net-leased investments actually provide for greater returns than the historical average of most stocks and bonds as well.

According to the Vanguard Group, stocks have a historical return equal to 10% of the initial investment, whereas bonds have historically returned 5.5% annually. Contrast that to, for example, a standard Walgreen's triple-net lease. Assuming that the property was financed on a 10-year term and amortized over 30 years, net-lease landlords can expect a 12.9% average annual rate of return. (This projected rate of return assumes a cash-on-cash return and principal paydown.) Furthermore, this analysis omits any appreciation in the real property's value.

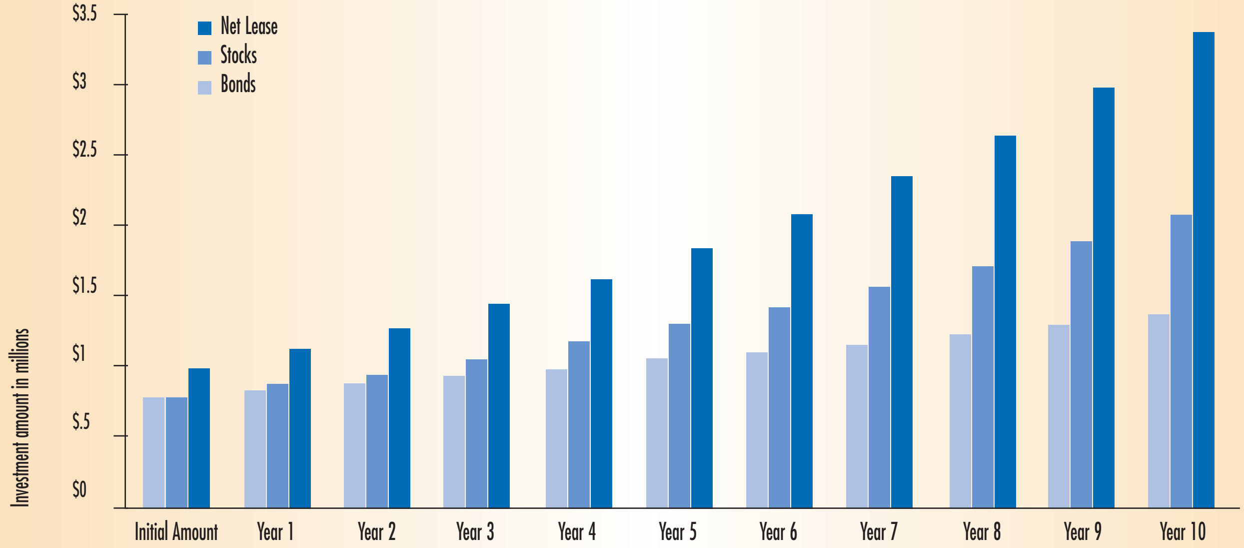
The table below illustrates the expected returns from a net-lease investment over a 10-year period, based on the above-referenced historical rates of return. While the return for net-leased properties may be less than those for other real estate investments, such as apartment and industrial buildings, inherent with those properties is the burden of management, tenant turnover, a volatile market and less liquidity.

Comparing active versus passive investments does not generate comparable analysis. Additionally, more active real estate investments pose risk that is not associated with their passive net-lease counterparts.

When net-lease returns are combined with the ability to defer taxes on the sale of a relinquished property via a 1031 exchange and the freedom from asset management, it is surprising that people choose to invest in anything but net-leased properties.

NET-LEASE INVESTMENT RETURNS VS. STOCK AND BOND RETURNS

This data is based on a $1-million income stream from the sale of a relinquished property and 20% depreciation recapture for the reinvestment into stocks and bonds.



Source: The Boulder Group

RATINGS UPDATE

▸ The outlook for **Safeway Inc.**'s BBB senior unsecured notes was revised to negative from stable by Fitch Ratings following the grocery-store operator's decision to take its **Dominick's** division off the market. Ongoing labor difficulties and increased competition in its industry factored in as well.

▸ Standard & Poor's Ratings Services revised its outlook for **Nextel Communications Inc.** to positive from stable, citing an "improved view of Nextel's business risk profile."

▸ The senior unsecured notes of **Union Pacific Corp.** were upgraded to Baa2 from Baa3 by Moody's Investors Service, which cited reduction of debt, improved financial performance, solid and sustainable railroad operations and strong liquidity.

▸ The senior unsecured debt rating of **General Mills Inc.** was affirmed at BBB+ by Fitch, which noted "management's commitment to debt reduction and stable operating earnings and cash flow." But it also kept the company's outlook at negative, citing "weak credit protection measures for its assigned rating."

▸ Fitch initiated coverage of **Supervalu Inc.** with a BBB rating of its senior unsecured debt and a stable outlook. "The ratings reflect Supervalu's broad geographic presence, stable portfolio of retail and wholesale businesses and improving financial profile," according to Fitch. "Also considered is Supervalu's thin margins, consolidating customer base, mature nature of its business and intensifying competition in both its retail and distribution businesses."

▸ Fitch also initiated coverage of **Dillard's Inc.** with a BB- senior unsecured rating and a negative outlook. "The ratings reflect Dillard's broad market presence in growing areas of the country and significant real estate ownership position offset by negative operating trends and high financial leverage," Fitch said.

▸ The outlook for **Newell Rubbermaid Inc.** was revised to negative from stable by Fitch, which noted that "Newell's planned turnaround and expected improvement in its credit profile is taking longer than anticipated."

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Publisher: Jonathan A. Schein
Editor-in-Chief: Michael G. Desiato
Editor: Michelle Napoli
Managing Editor: Jackie Day
Creative Director: Scott Thompson

For Editorial Feedback & News Leads:
Contact Michelle Napoli at 212.628.9254 or netleaseforum-feedback@remediainc.com

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of net-lease property funding options. The program is being fueled by an unspecified hedge fund. The fund has never done this kind of lending before but invests in a number of different asset classes, including real estate, says Norseman managing director Joseph Yiu. "This is something a bit new for them, although they do asset-based and credit transactions," says Yiu.

Norseman's new product offers mezzanine debt for terms of up to 10 years and allows a residual balloon loan-to-value of up to 80%, combined with the first mortgage, and initial proceeds of up to 95% LTV, again including the senior financing. It can be priced at a fixed rate of 11% at the start or a lower current payout rate with the remainder accrued and payable at maturity—either way, significantly cheaper than traditional mezzanine debt, which can fetch rates of 15% to 20%. The rate can be even lower if the loan is structured as a shorter-term, floating-rate deal, Yiu adds.

"We found that borrowers want a little bit more flexibility," says Yiu. "So we developed a product that doesn't fully amortize and, hence, has more of a real estate underwriting, although of course we're looking to the credit as well. But at the end of the day, when we look at how large of a balloon we can handle, we look to the real estate—the type of property as well as the type of market that particular property is in."

Due to the real estate-focused underwriting, Norseman will consider tenant credits as low as B for the mezzanine product, unlike the Credit Tenant Note product it introduced earlier this year with Cleveland-based **KeyBank Real Estate Capital**, which is focused on tenants with credits of BBB or higher. The two products can complement each other, says Yiu.

O'Charley's Closes $50M Leaseback; Another $35M May Follow

Twenty-three **O'Charley's** restaurant properties were the subject of a recent $50-million sale-leaseback. The owner and operator of its eponymous casual-dining eateries, O'Charley's Inc., did not name the real estate investor involved in the transaction's announcement, nor did its CFO return calls seeking additional information.

The leaseback portion of the transaction provides for 20-year leases with renewal options for up to another 20 years. Minimum average annual lease payments will be $4.2 million during the initial term. Proceeds from the deal were used to pay down debt under the company's senior credit facility.

Nashville-based O'Charley's may use the sale-leaseback structure to unleash even more capital from its real estate. According to the company's announcement, it "intends to enter into additional sale and leaseback transactions pursuant to which the company may sell and lease back up to 20 O'Charley's restaurants, which the company expects will generate gross proceeds of up to approximately $35 million."

The company owns and operates 206 O'Charley's restaurants in 16 states in the Southeast and Midwest. It also operates **Ninety Nine Restaurant & Pub** in 85 locations throughout New England and in New York as well as six **Stoney River Legendary Steaks** restaurants in Georgia, Kentucky, Illinois and Tennessee. The company plans to expand in 2004, as well, with approximately 15 new O'Charley's locations, at least a dozen new Ninety Nine restaurants and up to two new Stoney River restaurants.

EXECUTIVE POSTINGS

Bill Rice

Bill Rice joined **Asset Management Consultants** as director of the company's tenant-in-common division. The Mission Hills, CA-based company specializes in buying properties in the $4-million to $50-million range and has closed on six TIC deals in the last 18 months. Before joining AMC, Rice partnered with the Schroeder Co. in addition to managing his own investment property portfolio.