Net-Lease Transactions Enter 2000 on a High Note

by Beth Mattson-Teig

Shopping Center World, Feb 1, 2000

A surge in freestanding store development coupled with a strong economy are reasons for the net-lease financing industry to celebrate. Just ask Brian Tracy, managing partner at Net Lease Properties LLC in Manhattan Beach, Calif. "1999 was a great year. It's pretty well documented that shoppers are less and less interested in fighting the malls, and Main Street has once again become an attractive shopping environment."

Meanwhile, retailers are expanding during this unprecedented economic wave of prosperity. "So the market has been hot," Tracy says. "We're in good times, and we don't anticipate any changes in 2000."

For Boston-based Net Lease Capital Advisors Inc., 1999 was an exceptional year. "Our transactions went from $125 million in 1998 to $280 million in 1999," says Bruce S. MacDonald, president of Net Lease Capital Advisors.

A variety of factors are driving that activity. The supply is there, and the demand for net-lease properties remains strong, explains MacDonald. Meanwhile, investors ranging from REITs to private investors are chasing deals.

In addition, corporate America is warming up to the idea of the sale-leaseback structure, and innovations in credit-tenant financing are creating new business opportunities, MacDonald adds.

The optimists While several firms report that 1999 was a good year, net-lease finance specialists have mixed projections for 2000. On the positive side, the retail market appears to be in good health for some time to come.

"It won't slow for our business because there is well over a $1 billion in property out there that has financing available or in place where rates are locked in," says MacDonald. "So those rates are not going to be affected by current interest rates."

Ethan Nessen, an executive vice president at Boston-based Corporate Realty Investment Co., says the current economy has demonstrated its resiliency. "We're through our apocalyptic gauntlet. We survived the (CMBS) crash in 1998, survived Y2K, and the economy didn't burst last year," he says. That confidence will bolster retail expansion and the economy in general in 2000, he predicts.

However, the underlying factor in net-lease finance activity in 2000 will be the cost of money, which is tied to the Treasury rates and corporate spreads.

"As long as interest rates and spreads don't go horrendously high, you're going to have a huge amount of activity in 2000," Nessen says. Net-lease transactions will be driven by pent-up demand and strong corporate earnings, as well as retailers' ongoing strategy to keep real estate assets off their balance sheets, he adds.

The critics Meanwhile, other industry experts remain a little more tepid about the prospects for 2000 due in part to more expensive pricing.

"I believe that the higher interest rates and widening spreads on mortgages have had a dampening effect on the net-lease business at the moment," says Gary Ralston, president of Orlando-based Commercial Net Lease Realty Inc.

Another effect on credit-lease deals in 2000 will be a degree of polarization - a growing gap between best-quality credit transactions and border transactions, Ralston says. Not only will there be a larger gap in pricing, but also some of the deals that are on the border will experience difficulty coming to fruition, he adds.

Hurdles ahead A variety of factors could slow net-lease financing activity in the coming months. As of early January, the Federal Reserve Board was debating another interest rate hike as a means to curb inflation. Real estate lending in general slows as interest rates rise. Rising interest rates put more pressure on borrowers, which includes investors and developers, says Paul McDowell, a senior vice president at Capital Lease Funding LP in New York.

Normally, if interest rates increase, the investment value or price tends to dip, according to Tracy. "Even though interest rates have already ticked up (in 1999), values have remained stable," he says.

Overall, interest rates are still reasonable, inflation is low, employment is at an all-time high, and people are continuing to spend money. So from an investment point of view, sale-leasebacks continue to be a highly desirable investment vehicle, Tracy says.

The collapse of the CMBS market in the third quarter of 1998 has altered the flow of debt available to finance net-lease transactions. "You are dealing with a marketplace where the level of debt in terms of loan-to-value ratios is less available today," Nessen says.

However, a conservative shift among the debt community is aimed primarily at non-investment-grade tenants, who have been forced to accept finance terms at 70% to 75% loan-to-value vs. a more favorable 90% loan-to-value ratio not so long ago. In some cases, those loan-to-value ratios are comparable to what traditional bank lenders are offering.

'A bit skittish' over downgrades In addition, a few high-profile slips in retailer credit ratings have made lenders more cautious. The most prominent example is the rapid downgrade of Rite Aid Corp.

The BBB+ rated company dropped to a BB rating by Standard & Poors. Rite Aid's aggressive expansion coupled with internal management problems are responsible for the downgrade.

"My view is that at the end of the day, Rite Aid has a very strong market franchise, the right management team in place, and it will return to investment-grade status," McDowell says. Nevertheless, the precipitous downgrade has made lenders more cautious, and some credit-lease deals have become more difficult to finance.

Ann Arbor, Mich.-based Captec Net Lease Realty Inc. has reined in its Rite Aid development program. The net-lease REIT had planned to finance 15 new Rite Aid developments, but ended up doing five.

"We put it on hold because there is some uncertainty with the company," says Ronald Max, Captec's chief investment officer. Captec specializes in providing financial support to developers that are building the stores for tenants, and then Captec buys the stores following completion.

"Rite Aid was a very big element of a couple of big securitizations. So lenders are a bit skittish," explains Jonathan Molin, president of New York-based U.S. Realty Advisors LLC. The downgrading of Rite Aid has made it more difficult to borrow against credit-lease financing deals.

"I think lenders would be wise to underwrite the real estate, but they're still looking mostly to the credit of the tenant," he says. Even though the bulk of the credit-lease financing market is healthy, slips such as Rite Aid have had an adverse effect.

The downgrades, as well as the CMBS shakeout, have widened spreads. AAA deals are experiencing spreads of 120 to 130 basis points over Treasuries, while BBB properties are in the range of 250 to 260 basis points over Treasuries.

Prior to the collapse of financial markets in August 1998, spreads were much tighter. AAA spreads were at 80 to 90 points over Treasuries, and BBB spreads were at 150 to 160 basis points over Treasuries. "So the market has widened very, very dramatically," Molin says. But those spreads may narrow slightly in 2000, he notes.

Craving their independence Retailers are expected to continue on a growth track in 2000, and freestanding stores appear to be their property of choice. Charlotte, N.C.-based Centurion Development Corp. is one of the nation's top developers of freestanding, triple-net-leased facilities. The firm expects to build more than 100 freestanding stores in 2000.

"A lot of those retailers that have traditionally been in mall locations or shopping center locations are now going to out-parcels and freestanding locations," says Parker W. Neely Jr., a principal of Centurion Development. Some of the retailers that have been successful in their move from in-line locations to freestanding stores include Payless Shoe Source, Blockbuster Video and Kinko's Copy Centers.

Retailers are finding that sales volumes are higher at freestanding locations because of improved visibility and accessibility. "What we're seeing is that revenues run 125% to 150% more than in-line locations," Neely says. "If the economy dips at all, most retailers are going to look to high-producing locations as a way to stay afloat in a declining economy."

Despite the growth in freestanding stores, retailers are less inclined to own those stores. Retailers don't want to tie up capital in real estate.

"If they went into a bank direct, they would have to leave 25% of their equity in that store," says Chris Marabella, president of Marabella Commercial Finance, a boutique loan broker based in Escondido, Calif. The 100% financing of sale-leasebacks allows retailers to expand without diluting the earnings of the company, and it provides more liquidity for expansion, he adds.

Sale-leasebacks also offer some tax benefits for retailers. In some circumstances, it removes the tax obligation or depreciation expense as the tenant's obligation.

Developer's perspective Net-lease finance also is popular among developers. Developers have two options when financing a credit-tenant property for development.

First, the developer can finance the deal based on the real estate. For example, a developer that is building a $20 million Wal-Mart may borrow $10 million to $15 million based on a typical 50% to 75% loan-to-value ratio.

A second option is for the developer to go to the capital markets with credit-tenant financing. One of the big advantages is the higher loan-to-value ratio. A developer may be able to secure a 90% loan-to-value ratio, or $18 million, on the $20 million Wal-Mart project.

Essentially, a developer can finance a project substantially more on a credit-tenant basis compared with the standard real estate-based mortgage, MacDonald says.

Centurion Development relies on net-lease lenders to provide financing for about two-thirds of its projects. Net-lease financing providers are more predictable and have larger amounts to lend, Neely says. In addition, traditional bank lenders typically don't understand the net-lease business as well, and they are not as aggressive in their lending, he says.

New ways of thinking More sophisticated models are emerging amid a growing acceptance of the net-lease financing mechanism. "I think you're seeing some people look at the business and saying there's a maturity factor to the business, and we want to do something a little bit differently," Nessen says.

"What we are seeing is specialized lenders creating new financing programs and structuring techniques that enable us to open the basket wider," agrees McDowell. Capital Lease Funding, for example, is forging ahead with innovative new structures that target double-net vs. the typical triple-net lease deals. "For a long time, Wall Street could not manage those types of leases."

Another new program initiated by Capital Lease Funding is aimed at providing credit-lease financing for shopping centers that encompass mixed-credit tenants. Says McDowell, "The trend is for a few specialized lenders that understand what they're doing to look at how credit tenants own and operate real estate - and then develop products to efficiently finance those credit leases."

The net-lease market is unique in that financing is based almost entirely on tenant credit. Net-lease transactions also are long-term arrangements, typically 15 to 20 years. Net leases are referred to as single net, double net or triple net, depending on whether the owner or tenant pays for taxes, insurance and maintenance.

The most popular net lease among investors is the triple net, because owners avoid the bulk of operating costs and management responsibilities.

Net-lease finance often is referred to as "credit lease," although technically credit-lease transactions are a type of net lease.

Net leases are categorized as either a bond or credit lease. A bond lease requires the tenant to perform all obligations related to the leased property. A credit lease differs from a bond lease in that there may be some degree of landlord responsibility, or risk.

Credit-tenant properties are established in two different ways. The true corporate sale-leaseback might involve a large block of sale-leasebacks initiated at the corporate level. A second opportunity arises on individual development transactions.

"Retailers are the biggest users of a sale-leaseback because they are in constant expansion, whereas an industrial company doesn't build a factory every week," says Sydney Domb, president of Miami-based United Trust Fund. At the end of 1999, United Trust was flooded with business as several retail companies sought to remove real estate assets from their balance sheets prior to year-end.

"We expect that activity to continue, at least for the first quarter," Domb says.

Investors ranging from small private buyers to publicly traded REITs are pursuing a wide range of net-lease acquisitions at a healthy clip.

Private investors, international banks, Wall Street conduits, institutions and REITs are all vying for large and small net-lease or credit-tenant properties.

This heightened competition is forcing net-lease finance firms to be more aggressive in scouting transactions. "You have to really hunt down as many sources of deals as possible," confirms Jonathan Molin, president of New York-based U.S. Realty Advisors LLC.

Although REIT activity has slowed due to capital constraints, demand for net-lease properties remains high. "That slack has been picked up by private players or direct investment by institutions," Molin says.

Factors at work Private investors seeking 1031 exchanges are driving much of the demand for smaller, below-investment-grade transactions. A 1031 exchange involving a net-lease property offers the same benefit as other property types: deferred capital gains taxes.

That in itself is a sizable incentive considering that most sellers are subjected to the highest federal tax rate of 25%, not to mention the state capital gains tax. But net-lease, or credit-tenant, investments also offer advantages that other property types don't.

Low maintenance is one perk of net-lease property ownership, particularly with triple-net-lease properties.

"The advantage of this kind of property - vs., say, an apartment property - is that the tenant takes care of everything," explains Chris Marabella, president of Marabella Commercial Finance, a boutique loan broker based in Escondido, Calif.

An owner that invests in a triple-net-lease property could live in New York and own property in California because the property is relatively low maintenance. That flexibility also opens up more options for investors who are trying to identify properties suitable for a 1031 exchange, Marabella says.

Net-lease investments also offer a solid income-producing return, typically about 8% to 10% per year. Although investors could very well earn more money in the stock market, many will take the lower return because of the ability to defer capital gains taxes.

"Net-lease investments through transactions such as sale-leasebacks have become baby boomers' alternative to the stock and bond market," Marabella says.

Real-life example In addition, net-lease investments offer 1031 investors greater access to capital. For example, a client of Boston-based Net Lease Capital Advisors Inc. recently took advantage of a 1031 exchange after selling a $56 million office portfolio to a REIT. Instead of accepting shares of the REIT as payment, which is a popular method of avoiding capital gains tax, Net Lease Capital worked with the investor to purchase credit-tenant properties.

If the investor had taken the REIT shares, the most he would have been able to borrow is 50% on margin, notes Bruce S. MacDonald, president of Net Lease Capital Advisors.

By putting the $56 million in credit-tenant properties, the investor was able to go to the capital markets and finance the properties by taking 100% of the rent and applying it to the debt service. Essentially, the investor was able to withdraw 90% of his cash or $51 million, while still avoiding capital gains tax, MacDonald says.

REITs also have discovered the advantages of specializing in net-lease properties. While the retail REIT sector struggled throughout 1999 with returns below (11%), the majority of net-lease REITs are in the black with returns upwards of 8% to 10%.

One reason for this positive performance is that net-lease deals provide a very predictable income stream. Most net-lease deals are written with 15- to 20-year lease terms.

"In the case of our portfolio, most of the leases expire well past 2000 and toward 2005," says Ronald Max, chief investment officer at Ann Arbor, Mich.-based Captec Net Lease Realty Inc. Captec was reporting a yield of 18.4% as of Jan. 7.

Despite the positive returns, net-lease REITs struggle with the same capital constraints that the entire REIT industry faces. As a result, net-lease REITs are searching for more creative ways to finance additional acquisitions.

"We've been fortunate in that we have been able to access capital to do new deals," Max says.

Captec has initiated off-balance-sheet joint ventures rather than return to the stock market. Captec participated in two separate joint ventures in 1999, including a venture with Boston-based Fidelity Management Trust Co. that raised $100 million.

"We will continue to look for those types of ventures in the future," Max says. Captec also plans to raise additional capital in 2000 by selling off some of its existing properties. Captec completed about $100 million in transactions in 1999, including net-lease-financing deals with Office Depot, Blockbuster Video and Best Buy.

Orlando-based Commercial Net Lease Realty Inc. is another REIT that avoided equity issuing in 1999.

"We're a company that has sustained adequate critical mass to finance our business with different capital access points," says Gary Ralston, president of the firm. The REIT has been emphasizing other capital sources such as debt financing and off-balance-sheet ventures.

Making the grade The most widely sought-after deals among REITs and other institutional investors are investment-grade properties - those retail corporations that are rated at BBB- and above. The stiff competition for investment-grade deals has prompted some lenders and investors to target opportunities among non-investment-grade deals.

Marabella Commercial Finance specializes in arranging permanent financing for triple- and double-net properties with loan amounts upwards of $350,000, and store sizes averaging 7,000 sq. ft.

Much of the demand for small- and mid-size credit-tenant deals comes from private investors, who typically have less money to invest compared with larger institutions. "There's more money chasing these properties than available properties," Marabella says. "If your buyers aren't making a quick move, they're wasting time because the stores disappear."