Value approach

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National Real Estate Investor, May 1, 2000

Retailers were among the first to embrace the benefits of net-lease financing. Now a new wave of corporations is discovering the advantages of property sale-leasebacks structured as single, double or triple net-lease deals.

"I think a lot of companies over the last five to seven years that haven't traditionally been users of sale-leasebacks are seeing the merits," says Joe Owen, director of acquisitions at Dallas-based NLP-Net Lease Properties.

"We're seeing a lot of transactions in the market from restaurants and hotels to utilities and healthcare that are accessing sale-leasebacks more than ever before. It really crosses over industry boundaries," according to Owen.

Retail activity hasn't slowed down, but corporations are beginning to recognize the value of sale-leasebacks, says Scott Tracy, executive managing director at CB Richard Ellis Investors LLC, Los Angeles, the investment management arm of CB Richard Ellis "We definitely are seeing more office and industrial [sale-leasebacks] than we have seen in the past," says Tracy.

Over the past nine months, CB Richard Ellis Investors acquired about $350 million in single-tenant net-lease properties.

Some sizable corporate portfolios are still on the market, for example, Houston-based Baker Hughes Inc.'s four-property portfolio in Houston valued at about $120 million.

"I think Corporate America is recognizing the tax and accounting benefits that have always been there," says Paul Domb, vice president/asset manager at Miami-based United Trust Fund, which works with both public and private companies in all property sectors, including investment- and sub-investment-grade firms. "Over the past five years, our business has increased, on an annualized basis, fourfold," says Domb.

Pressure on earnings The need to improve corporate earnings is the primary driver behind sale-leasebacks. Companies are searching for innovative structures to get real estate off their balance sheets, and net-lease financing is an increasingly popular choice.

"In the CFO suite, real estate-based financing has become a more important issue," says John Winer, a partner at E&Y Kenneth Leventhal Real Estate Group in New York."The business that we're seeing from sale-leasebacks is largely driven by the desire to get off-balance-sheet financing, which helps operating ratios and public companies' stock prices," says George Baldwin, a real estate investment analyst at Dallas-based Dana Commercial Credit Corp.

Corporations also favor sale-leasebacks because they believe they can achieve the higher rates of return on their capital demanded by equity markets. Instead of making 8% on real estate assets, companies are betting that they will make more money by putting that capital back into the business, Baldwin says.

Corporate interest has increased significantly in the past 12 months, Tracy says. "There is this growing awareness of resource and capital allocation, and its impact to stockholders."

"My view is that sale-leasebacks and the efforts of corporations to get real estate off their books is growing and will continue to grow," according to Paul McDowell, a senior vice president at Capital Lease Funding LP in New York. Last year, Capital Lease Funding issued $900 million in bonds backed by credit-tenant leases.

The pressure from Wall Street to grow earnings has prompted companies to review all assets, including real estate. "This is one asset that companies have not been enhancing to its fullest extent," says Owen.

By liquidating a non-core asset, real estate, firms can use the money to grow their businesses. One public company recently came to the market with a significant sale-leaseback of its real estate holdings in order to repurchase company stock. "In this case, the company was redeploying capital back into the core asset to add value," says Owen.

Exploring options Companies that want to get real estate off their books are discovering a variety of choices that include traditional mortgage financing, joint ventures, sale-leasebacks and synthetic leases. The key to finding the best real estate-based financing method depends on a company's motivation. Each firm has its own unique goals and needs. "Doing something like this is very goal-dependent," says Winer. "You could have two identical companies, and what might be right for one might be wrong for the other."

One situation where sale-leasebacks often make sense is when companies have a credit rating that hovers at or slightly below investment-grade. "Generally, those firms have somewhat limited capital options," he says.

"If you're a company that has lots of capital-raising opportunities, ready access to debt, or maybe can issue equity, then doing some sort of real estate-based financing generally won't make sense to you," Winer explains. Companies that have limited access to debt and equity markets are typically the firms opting for real estate-based financing.

The competition Companies frequently end up deliberating over two financing options - sale-leasebacks and synthetic leases. One big advantage of a sale-leaseback is the off-balance-sheet financing. The sale-leaseback transaction allows the seller to realize the full value of that real estate, while still being able to control the property on a long-term basis through lease provisions.

Companies can build flexibility into the lease terms that allow them to maintain significant operating control. In addition, they receive tax deductions on the rental payments. "The big disadvantage is that you don't own the property at the end of your lease term," says Tracy.

The synthetic lease is treated as an operating lease for general accounting purposes. However, for tax purposes the company is still considered the owner of the asset. The firm can still take appreciation, which helps shelter income for the company.

"The advantage to the synthetic lease is off-balance-sheet treatment for accounting purposes, but you're

treated as an owner for tax purposes," says Winer. Synthetic leases also provide low-cost financing because it is a relatively short-term vehicle - often with a seven-year term.

Some industry observers believe that synthetic lease financing has been attracting more companies compared to sale-leasebacks. "There are companies that feel that they just want absolute control of their assets, and some feel that the synthetic lease is more akin to that," says Winer.

Meanwhile, other industry experts believe that the demand for synthetic leases is beginning to shift to sale-leasebacks. Companies are becoming more aware of the risks associated with synthetic leases, Domb notes. The IRS is scrutinizing synthetic lease structure more carefully, and some bankruptcy courts have rejected synthetic leases as valid operating leases. Another risk of the synthetic lease is the potential rate increase at the end of the term, which is typically five to seven years, Domb notes.

"Synthetic leases are falling out of favor because it's really a form of corporate debt," says McDowell, since such leases don't take real estate off company balance sheets.

Net-lease players, such as Capital Lease Funding, are developing programs that combine the benefits of sale-leasebacks with the benefits of other financing vehicles such as the synthetic lease or even outright ownership. If a company wants to expand or relocate, it is bound by the lease. Once the lease expires, the tenant loses control of the property.

Capital Lease Funding has launched a new flex-lease program aimed at the corporate market and designed to provide the benefits of sale-leasebacks, while still retaining a tenant's right for the ultimate disposition of property. Because the flex-lease program is a debt-financing-driven structure, compared with the typical equity financing of a sale-leaseback, investors are generally satisfied with lower levels of return, McDowell says. The debt financing structure also allows for added benefits that provide flexibility to the corporate tenant, he says.

Conservative environment Companies seeking net-lease financing are discovering that capital is both more expensive and more difficult to obtain due to both rising interest rates and widening spreads. "It has gotten considerably more expensive over the last couple of years to do a transaction," says Owen.

NLP-Net Lease Properties invests about $150 million per year in sale-leasebacks and single-tenant transactions, primarily in the sub-investment-grade niche. Such deals are among the most difficult to finance. Typically, a lender will create a piece of paper, bundle it and sell it to the CMBS market. But B-piece buyers in the CMBS market have become scarce due to the higher risk, concerns about lax underwriting, increased pricing and concerns about liquidity, Owen notes.

The shakeout in the CMBS market in late 1998 also created a greater sense of caution where below-investment-grade net-lease deals are concerned.

Some lenders and investors have reevaluated the market, and realized that if a company can't raise 20-year debt financing, why should they be financing a 20-year stream of payments.

"The difficulty for net-lease lenders is that we originate product, we sell it in secondary markets or securitize it, so there is a lag from when we originate to when we sell," according to McDowell. Also, spread volatility is more pronounced in below-investment-grade markets.

High-risk tenants In many cases, it is difficult to project the viability of companies 10 to 20 years into the future.

"The weaker the credit, the more focused we are on the property type," says McDowell.

Capital Lease Funding specializes in financing properties that are net leased, primarily by investment-grade credit tenants. Movie theaters, for example, are experiencing weak credit ratings, so those transactions have become more difficult to finance.

"We primarily focus on investment-grade, although on occasion we will dip below for companies that we feel are financially strong, but have not yet reached investment-grade," according to Richard J. Rouse, co-CEO of New York-based Lexington Corporate Properties Trust, a publicly traded REIT that specializes in office and industrial net-lease properties. For example, Lexington recently purchased two Nextel call centers in Hampton, Va. Nextel currently has a BB rating.

High-tech is another sector finding it difficult to complete net-lease transactions. Many of the fledgling tech and dot.com companies either don't carry a long-term debt rating, or if they do, it's below investment-grade, McDowell says. In addition, those firms often are reluctant to write 10-year leases. The unique aspect of writing net-lease deals is the long-term predictability of the leases. "For us, we generally don't finance companies that don't have long-term debt ratings," he says.

The high-tech firms and start-ups are perceived as having a high default risk. "There are a lot of tech companies and start-ups interested in getting real estate off the balance sheet, and they just can't get it done," says Owen. "Lenders aren't willing to take that risk."

NLP focuses on sub-investment-grade deals because there are greater inefficiencies in the marketplace, fewer providers and higher yields. "With those higher yields comes higher risk as well, but we mitigate the risk through due diligence," says Owen. NLP focuses on factors such as price per square foot, location and market conditions. NLP also looks at the strategic assets of a company. "We want the best of both worlds - a good tenant and good real estate," he says.

E&Y Kenneth Leventhal works with a number of high-tech and dot.com clients. While these deals are among the most difficult to finance, they also face the highest expectations for growth. Those companies can't afford to be spending money on real estate, Winer says. "In that sort of environment, you should always go off balance sheet."

One structure that has been effective for such high-risk firms is the use of equity or warrants as a security deposit to sway the landlord or investor. "In that marketplace, more landlords and investors are looking for more equity to take the associated risks," says Winer.

Industry outlook Despite some of the challenges in obtaining net-lease financing, the market remains active. About $1 billion worth of transactions are out in the market right now for long-term sale-leasebacks, Owen notes. "It's a pretty hearty market right now," he says. " It's just not as easy to get deals done as it once was."

"Capital constraints on the REITs, and certainly on Lexington, precludes us from being more active and growing at an even more rapid pace," says Rouse. Lexington Corporate Properties Trust completed $160 million in transactions in 1999, and the firm anticipates investing about $200 million to $250 million in net-lease properties in 2000.

Although some life insurance companies have become more selective on net-lease transactions, there is still strong demand for net-lease product among conduit lenders, Rouse notes. "I think activity will continue to be as strong or stronger than last year, primarily as a function of the economy," says Rouse.

"Companies are still growing, and with that they have growing demands for space," he says.

The good news for borrowers is that capital markets remain competitive. Lenders are simply becoming more selective in the deals they are financing. "That has to do in some areas with a degree of uncertainty as to new supply and the impact that could have on future vacancy and rental rates," says Tracy.

The year 2000 may be one of transition as investors sit back and examine where the market is headed. "Right now the net-lease market is a little bit of a rocky market," says McDowell. The market has been negatively affected by credit downgrades such as that of Camp Hill, Pa.-based Rite Aid Corp.

"Those issues are transitory," says McDowell. "I think the market will continue to expand, and capital markets will be even more involved in the net-lease market, particularly on the debt side."

A number of large players, predominantly REITs, have been active on the equity end of the sale-leaseback market. But there has been little activity on the debt side. That could soon change as more debt players such as banks become interested in the market, he notes.

Ultimately, net-lease finance transactions are some of the strongest fixed-income investments available. "The market isn't recognizing that now," says McDowell, "but it is inevitable that markets will recognize the value of collateral net-lease debt provides, so [investors] will come back to the market as purchasers."

The need for prime real estate is hotter than ever as retailers continue to expand their businesses. To conserve time, money and manpower, many retailers are looking beyond traditional growth methods and focusing instead on strategic alternatives, such as combining sale-leaseback financing with build-to-suit development.

"With the vertically integrated sale-leaseback, build-to-suit combination, you have fewer moving parts," says Gary Ralston, president and COO of Orlando, Fla.-based Commercial Net Lease Realty Inc. The company focuses on long-term, net-leased freestanding retail real estate. "You have more cost savings and less brain damage because you have half as much to do," he adds.

An analysis of leasing issues Ralston says that creditworthy companies choose to lease for three key reasons: First, a net lease can provide a company with the ability to match a long-term real estate asset with a long-term liability. "This is important for less mature companies - those without an investment-grade credit rating - and companies that are expanding and rapidly opening new stores," says Ralston.

Second, a net lease is treated as an off-balance-sheet financing transaction if it is structured as an operating lease - reported in financial statement notes as a contingent liability rather than reflected on the balance sheet. A company thus achieves a lower debt-to-equity ratio, which may favorably affect its cost of debt and equity for its core business.

Third, a net lease allows a company to use its capital for more profitable investments. "Typically, a company would expect to pay net-lease rent equivalent to 10% to 12% of the cost of the property," observes Ralston. "Normal return on investment targets for growth companies range from 15% to 20%. A net lease should allow a company to net a 5% to 10% gain on the capital that is now available for more profitable investments, such as the company's core business."

Leveraging people too By outsourcing both sale/leaseback financing and build-to-suit development,

retailers can leverage not only their financial but also their personnel resources.

Dennis Tracy, senior vice president of services and program business for Commercial Net Lease Realty, says this is important when a retailer is competing for a prime site. "Recently, we assembled as much as 22 parcels in order to put together a 1.75-acre site," says Tracy. "This required relocating 15 of those 22 parcels. The timing of all the contracts had to be synchronized because we had about 14 hearings for rezoning. A retailer could have employed one person for an entire year just to handle the contractual side of this one project."

For Tracy, the advantages of combining sale-leaseback financing with build-to-suit development are many:

* The landlord handles all due diligence issues such as easements, title, environmental, etc.

* The tenant is not in chain of title.

* Both the tenant and the landlord save money because of one closing vs. multiple closings.

* Property taxes are reduced.

* The procurement is strategic because of few vendors, lower costs and increased predictability of performance. Tenants can operate their businesses without being caught up in red tape and details.

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