NET LEASE forum
From the editors of Real Estate Forum and GlobeSt.com

April 3, 2007
By Michelle Napoli

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*NET LEASE forum spoke with Sean O'Shea, who recently joined Los Angeles-based **BRC Advisors** as managing director of the net lease investment group. He was previously EVP at **Triple Net Equities Inc**. and has more than 30 years' experience in real estate investment. BRC is about to embark on a modest expansion, O'Shea tells us, with offices planned in Houston, Las Vegas, Scottsdale, AZ and Tampa, FL.*

Q: What can you tell us about BRC Advisors' activity in the net lease property market?

A: Our net lease investment group has three people. We've come over here in the past six months. The deals we do are 80% to 90% 1031 generated transactions. They are coming quite organically from the client base of BRC Advisors, whose principal core business is multifamily investment advisory. Over the years they've represented a number of Southern California investors who, like many people around the country, are transitioning from multifamily assets, and have been able to sell at the high end of the market, to less management intensive properties like our net lease offerings.

Quite literally the first day we showed up for work, we were given $50 million worth of assignments. They were all shapes and sizes. One was a $27-million assignment, one was a $1-million assignment, so we cover a much broader spectrum of net lease properties than we did before. Our training under Bob Arbor (at Triple Net Equities) was credit tenant properties, and we stuck to a very precise criteria. And what we found in the past couple of years is that people have been chasing yield and they haven't really been putting a big value on risk. So we found ourselves in a little bit of a straightjacket trying to make a pitch for credit tenant properties, even when we were able to assert that with credit tenants, the default rate on their bonds--and the bond is not their lease, but the suggestion we would make to folks is as your considering replacement properties--is estimated to be roughly 3.8% for investment grade. If it is not investment grade, during a 20-year term, the default rate is upward of 38%. So again, we would say to folks, 'What's your risk tolerance?' And they would say, 'I still want the higher cap rate.' So we found ourselves, in a very natural way, tired of trying to sell people something that they essentially don't seem to value properly. Of course, this may all change shortly. Credit properties that have less risk are going to have more appeal, we believe, as a trend.

Q: Could you expand on that last point?

A: We see a couple of things going on in the market. I spoke to several people yesterday who had been at the recent CCIM conference, and a number of the panelists there were projecting that interest rates are going to come down again. We are not of that school. We can't even imagine a set of facts under which, over the next three to five years, interest rates are going to come down. The timing of when they are going to go up is the question, but a 'when' question, not an 'if' question, in our judgment. As it relates to our net lease market, we think that the level of risk that people have been willing to assume and the spreads that we see on responsible financing have made a very tough market in which to function. The cap rates have ratcheted down--the national cap rates are somewhere in the mid-6s, and here in California were dealing with mid-5s. So what we've seen for a couple of years now is your California folks want to sell at California prices and then buy around the country. Part of the reason we affiliated ourselves with BRC Advisors was that they had a pipeline of ongoing business. Quite literally, every month we have transactions that people have requirements for, and so while BRC Advisors has been a very localized organization, our practice is really a national practice.

What we've all seen during the past couple of years is that people start talking, they begin the conversation often with 'I want a credit tenant with a stable income stream' and then they say 'unacceptable cap rates.' Cap rates and returns have been what are generating a lot of decisions recently. I think there's going to be a little bit of a pullback over the next year. It's very presumptuous to try to estimate these things, but all indications would be that the interest rates are going to be relatively stable for the balance of the year. I think that for this year things will be relatively stable. There will be an ongoing flow--it may be something less than previous years--of 1031 transactions. I think as the year unfolds and some of the investors' fears begin to evidence themselves, I think we'll be able to make a stronger case for the credit tenant properties, frankly.

Q: Are there any other trends you've been keeping an eye on in recent quarters?

A: We're seeing a pickup in M&A activity. Take something like the **KKR** deal for **Dollar General**, where they're paying a roughly 31% premium to buy that organization. Essentially, somebody's going to have to pay that debt they're going to load up on, and we think a lot of these M&A folks are thinking as part of their M&A strategy, 'How can we squeeze the value out of our real estate? Is there any hidden value in our real estate?' So we think as a result there will be a lot of new sale-Leasebacks over the next couple of years simply because of the M&A activity we're going to see between now and the end of the year.

Also, even though cap rates are holding pretty tight, because of the 10-year--it is still relatively stable and relatively low--you can finance things. But if you're going to finance something at a plus or minus 6% rate, you can't be paying sub-6 caps for these properties as a net lease buyer, and that's the dilemma for many California investors. So what we are seeing is there is not an adequate spread, because the cap rates are so aggressive in California, so we have clients who say they'll go to Arizona or Nevada, and some that are more adventuresome will go to Texas and the Chicago markets, which have been very active for us recently.

If you're willing to be a disciplined investor, we think that the same properties we're looking at today at 6 and 6.5 caps will be 7.5 and approaching 8 caps in a little while. A lot of these folks we deal with have never had a bad cycle, and so without sounding negatively grounded, we try to give a cautionary message. Our message right now is, if you're reaching for cap rates, you will find yourself buying assets that may or may not withstand the holding period.

Q: Given that your client base is in Southern California, do you see any let up in demand from 1031 exchange requirements?

A: We do. We see some slowing, but something that we have to remind ourselves of is that 2004, 2005, 2006 have been wild years, probably the best years in people's professional careers in the net lease business. So if there's some diminution in the flow, it's still not a bad business. There's still business to be transacted, and we're blessed by being in Southern California.

Because some of the credit tenant offerings have flat lease income streams and people have resisted that of course, we are developing what we're calling a credit tenant hybrid. We're saying to folks, if you're resisting the lower cap rates of these credit tenants but you want the security of the income stream, we think you should consider a product in the market that we're beginning to seek out around the country: between 15,000-sf and 30,000-sf strip centers where the center might have a **CVS** or a **Walgreens** or some other credit tenant as one of the anchors, if you will, and then you might have a number of other tenants that are perfectly good local or maybe national tenants. My colleague came across an offering this morning that is a Walgreens and **Starbucks** anchored center. We think these hybrids are really the best of both worlds in the sense that the management issue is handled because they're all on net leases, you've got the creditworthiness of the main tenant and then you've got some bumps and a little more aggressive lease negotiating with the smaller tenants. We're seeing there is real market acceptance to buying that, and that's a very different business from the credit tenant business that we started in, but it's an attempt to be responsive to the marketplace and investors' objectives.

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