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Net Lease: Recap and Forecast

Net leased properties are among the hottest sectors of commercial real estate. With 2010 ending on a high note, all signs are pointing to a positive 2011.

Randall Shearin

One of the healthiest sectors in commercial real estate remains triple-net leased retail properties. Drug stores, banks, auto parts stores, discount retail stores and restaurants built and leased on a triple-net basis remain popular with private investors and funds, and both groups are keeping demand incredibly strong in the sector.

Build-to-suit developers, investment funds, corporate sale-leasebacks and franchise sale-leasebacks continue to feed buyers' appetites, says Barry Silver, principal of San Rafael, California-based The Silver Group. During the second half of 2011, and especially so in the fourth quarter as fears loomed about future tax issues, buyers came on strong, compressing cap rates on triple-net properties. In December 2010, Marcus & Millichap's Mark Theil acquired a Walgreens under construction in Hollywood, California, on behalf of a client who paid $10.71 million for the 7,830-square-foot property, making it the highest priced per square foot deal for a single tenant net leased drugstore in 2010. That year-end sale is a good milestone for a quarter that has been good to the net lease sector.

Marcus & Millichap brokered the sale of a 7,830-square-foot Walgreens location in Hollywood, California, in December. The sales price of $10.71 million equated to $1,368 per square foot, the highest price paid per square foot for a single-tenant net leased drugstore in the U.S. in 2010, according to CoStar and Real Capital Analytics.

Volume And Pricing Up

One common thread that we received from all of our sources is that investment sales volume was up for the single-tenant net lease sector in 2010 over 2009. The market was slow until the beginning of the third quarter of 2010, when activity began ramping up.

"Money started flowing back into the market and transaction volume has significantly picked up from June and July through the end of the year," says Jon Hipp, president of Calkain Companies.

As with Hipp, many saw activity increase in the last quarter.

"The market has been up over the last 4 months of the year," says Gil Warner, managing director of Tulsa, Oklahoma-based Stan Johnson Company. "There is a lot of demand for A product. The B product gets a little attention, but on an all-cash basis, A product sees a lot of activity."

Many experts we spoke to said that they saw cap rate compression in the final months of the year. There were a few causes of this, report sources. The first was the impending expiration of the Bush-era tax cuts that would have hiked the capital gains tax rate. Since their tax situation was unclear, many investors chose to market their properties for sale or were seeking replacement properties in time to avoid possible increases in the capital gains tax. Second, a number of fund-based companies are in the sector chasing Class A, well-located, strong credit properties in top markets. This competition is pushing up prices. Lastly, there was not a lot of product on the market, creating a market for premium pricing.

"A lot of people were spooked with the capital gains tax increase," says Warner. "Sellers were a lot more motivated with the uncertainty of not knowing what would happen. Many lenders want investors more liquid and that has forced some people who were upside down in deals to sell. They need to sell that product and move on."

"There's a limited amount of product on the market," says Hipp. "The good product is being chased by a lot of players, both institutional and individual."

For many individual sellers, the feeling is that they have held onto properties past the point they should have, says Ricky Novak, president of Atlanta-based Strategic 1031 Exchange Advisors.

"Sale prices are back to where they were in late 2006 or early 2007," he says. "If they didn't get out then, they feel like they better get out now. Developers, meanwhile, are looking at this market as a good opportunity to sell assets they've held and use the proceeds to build something new. We are seeing a good amount of construction exchanges and construction lease-hold exchanges."

While the investment sales market has always been dependent on demand, Sean O'Shea, managing director of Los Angeles-based BRC Properties, reminded SCB that the market is a change from what experts told us 2010 would be at the beginning of last year.

"We've seen cap rates fall 50 to 100 basis points over the last year," he says. "When the year began, people were looking at how much higher cap rates would go. It has been quite shocking to see the cap rate compression we've witnessed."

Cap rates started the year between 7.5 and 8.5 for well located quality credit assets. At the end of 2010, cap rates for the same quality assets were around 6 percent. [See charts accompanying this article].

Looking For A Good Investment

With yields low in most property sectors and in nearly every cash investment strategy, many new buyers have turned to net-lease properties to get returns. These new investors have fueled demand, while existing demand from those already active in the sector remained strong.

"Investors are chasing yields," says Hipp. "They're not getting yields in other [sectors]. There was a ton of money sitting on the sidelines and there were good, quality assets on the market. There was an opportunity for buyers with terms that they couldn't get anywhere else, including bonds, stocks, CDs, and money markets."

"It's been striking to us to see what kinds of yields and current cash flows investors have been willing to chase," says O'Shea.

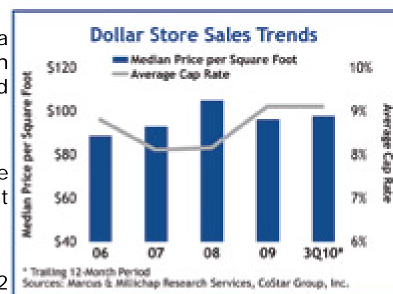
Yields are one of the main attraction to the net-leased market. With the net lease guaranteeing set returns every year, there is little risk for buyers. While yields in the sector were at a high in 2009 — due to higher cap rates — more deals are now getting done because debt has become more available to buyers.

"Yields for single-tenant properties spiked in 2009 and carried through the beginning of 2010," says Silver. "With the high demand for management free investment property with safe, reliable cash flow, and a decreasing supply of quality property, yields have begun to compress."

Silver cites Walgreens, one of the top drugstore retailers in demand by buyers. Cap rates on Walgreens, he says, traded at 7.75 or greater cap rates when credit was tight; now, Walgreens are often trading at cap rates below 7 percent. Matthew May, president of Sherman Oaks, California-based May Realty Advisors, sees aggressive rates on McDonald's properties, which he says are trading around 5.5 percent cap rates, and Chick-fil-A properties, which are selling in the high 5s. Lower credit tenants, he says, are trading at slightly higher cap rates.

"As an investor, for a nominal difference in return you are taking on a greater credit risk," says May. "The weaker tenants are getting the benefit of the marketplace. There is a compression of cap rates across all product types."

"During the better part of 2009 and early 2010, the single-tenant net-lease sector was one of the only spots of liquidity because the marketplace had gravitated completely to anything that offered stability and security," says Al Pontius, senior vice president and managing director at Marcus & Millichap. "This is real estate's version of a bond. In many cases, [single-tenant net-leased properties] are superior to a bond because of the inflation catch of rental escalations."



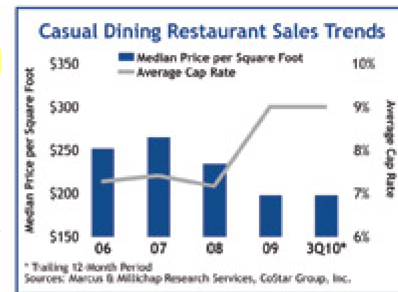
Demand is also strong because of a feeling among buyers that there is a shortness of product. This is due to the slowdown in retail expansion combining with a return of capital available to finance net-leased properties.

"A lot of our clients have felt that there is a lack of inventory in the marketplace," says Novak. "There are dollars ready to be spent, but not enough people willing to sell."

The demand at times gets heated. May says most Walgreens sell within 2 weeks of being brought to market, and other well-located, quality assets do not last long.

"At times in the last 6 months, we have found ourselves being in a series of auction environments for investment grade, better located properties," says O'Shea.

On the sell side, Warner is seeing a lot more new sellers listing properties on the market.



"You see a lot of developers who may not have been sellers in the past who are sellers now," he says. "The market has changed in that aspect."

"For the most part, net leased offerings that come to market are coming from developers, merchant builders and private investors," says Pontius.

Many of the investment sales specialists we talked to also see a lot of new buyers entering the sector. As in the past, those buyers are looking for the long term stability and low management that triple-net properties offer.

Corporate Sale-Leasebacks

On the sale-leaseback side, many corporations are attracted to the fact that real estate holdings will no longer be on their books and that cash is freed up to invest in the company's core business. Corporate sale-leasebacks still feed some of the acquisition activity in the industry. With funds willing to buy multiple properties and pay premiums, as well as offer ease of execution, they are the obvious buyers for many corporations. Supply from the corporate side is lower than in years past, of course, because banks, restaurants and retailers haven't been opening as many locations. For steady buyers of net-leased properties, this has made acquisition difficult. Miami-based United Trust Fund, who has been a buyer of net leased properties for 40 years, has seen development slow.

"There has been a deterioration of credit quality of those companies who want to do sale-leasebacks," says Paul Domb, vice president of UTF, of one cause.

UTF has been in the business so long the company has a steady stream of corporations who continue to offer properties. While the company is always sourcing new properties, most of its steady client base has been in place for 10 to 15 years. While funds and private investors may have heated the competition for properties, Domb says corporations like to do repeat business with a buyer that they know can close the deal.

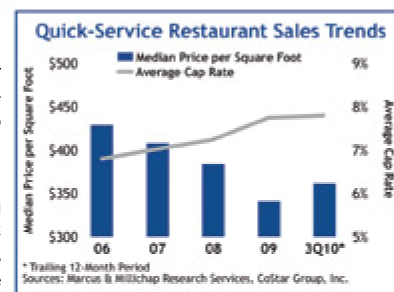
"Because we are not institutional in nature, we can make decisions quickly," says Domb. "We have in-place companies who rely on us, and we have some large projects that are under contract with us that will come to fruition in 2011."

On the merchant developer side — the middleman in the sale-leaseback — debt has returned to finance the development of net-leased properties. Regional banks are the predominant source for developers seeking short-term loan instruments to finance construction.

Some merchant developers have held properties from the market and are now bringing them to market while demand is high.

"The nice thing about a long-term net lease is that you can time your exit strategy," says Michael Maffia, senior managing director of Newmark Knight Frank/Cornish & Carey Commercial in San Francisco. "You don't have to sell it in a down market because if you have the net lease, your income stream is uninterrupted, irrespective of the economy."

Who Are The Buyers?

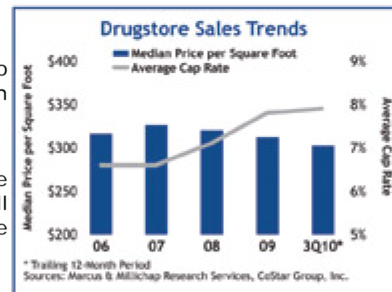


"By far the dominant single party is the private individual investor or the family investment firm," says Pontius. "The stronger net lease funds, formed either as non-traded REITs or private equity funds, who are in the business of acquiring net leased offerings."

Several of the largest players on the institutional side who are buying are Cole Real Estate, Agree Realty Corp., Brauvin Real Estate and ARC Properties. Most of the institutional players are buying the properties on an all-cash basis. Many have also more or less taken advance options on properties by providing acquisition and construction financing to developers of credit tenant deals.

"The funds provided financing when credit was hard to come by," says O'Shea. "It was a brilliant strategy."

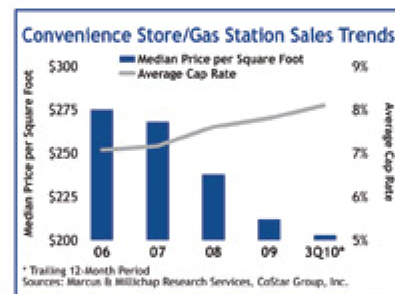
The institutional net lease funds have also benefited from the downturn in the tenant-in-common (TIC) investment market. A number of investors have moved away from TICs after the downturn. Many see net lease funds — or direct investment in net lease properties — as a strong alternative to place their money.



"A lot of the capital that was going into the TIC market has to go somewhere," says Matthew May. "This money is now investing with the net lease funds or directly investing in net lease properties."

For buyers, permanent financing has returned to the market. Life insurance companies, Wall Street players and regional banks are all financing net leased properties. The loan-to-value ratio depends on the individual deal structure.

Also in the mix of buyers are international investors, who see the value of investing in U.S. real estate today.



"We've seen a fair amount of international buyers coming to the market," says Hipp. "In the $1 million to $15 million space, there are a lot of international individual buyers, high net worth buyers, and 1031 or 1033 buyers."

Exchanging

All our experts reported seeing an increase in the number of buyers using 1031 exchanges. This is due to the up-tick in the investment sales market in general, since 1031 exchangers are selling other investment properties. Many investment brokers reported a lot of activity among 1033 exchange buyers as well [the 1033 exchange allows those whose land has been condemned or assumed by a government entity to exchange using the proceeds]. One unique characteristic to either of these buyers is that they are often willing to pay a little more to get the property they want.

"If a 1031 or 1033 buyer has a low basis — or large capital gain — you don't mind paying an extra 50 basis points if you really want a property," says Hipp. "You'll still probably come out ahead on the tax side."

Novak, whose firm specializes in 1031 exchanges, says that the ease or difficulty of finding a replacement property after a sale in today's market depends on two issues.

"What you are looking for in a replacement property and your ability to use all-cash versus debt financing are instrumental in quickly locating a replacement," he says. "A lot of sellers today are more open to looking at alternatives on the replacement property side. Historically, those who sold a triple-net leased product would build if they were a developer and private sellers would look for a similar investment with some upside. Over the last few months, the trend has been to sell stabilized net leased assets and look for properties with a lot of upside opportunities, like distressed assets or distressed sellers."

What Investors Want

Bank ground leases and drugstores still top buyers' wish lists, say our experts.

"Bank ground leases generally have increases every 5 years, so they are attractive," says Warner.

As well, buyers still have a preference for primary markets first, then strong credit properties in secondary markets. Tertiary markets are generally cherry-picked for top credit properties, like drugstores and banks.

"If it's the right tenant in the right market, buyers will go to a tertiary market," says Hipp. "The best cap rate compression is driven by good credit in core markets."

Pontius says that while strong credit and the length of the lease term are still major factors for a buyer, debt availability has returned for some weaker credit properties.

"Liquidity is returning to the lower credits," he says. "During the bulk of 2009, lower credits would not be liquid or they would command a real premium in the cap rate. There has been an acceptance for the shorter [lease] term as well. In 2009, 15 years was the benchmark for a long-term lease; 10 years wasn't considered long-term. There was a pretty meaningful difference as to how an investor would look at a 15-year lease versus a 10-year lease with comparable credit. There is still a premium today for the 15-year lease, but the margin has tightened. The 10-year lease is now the standard."

Still, says Newmark Knight Frank's Maffia, "the longer the lease, the better." Maffia also says buyers want fixed rental income growth. "A lot of retailers do not have any rent increases [built into the lease]. That is an attribute of a property that is attractive."

Buyers are also paying more attention to where the asset is and what exactly they are buying, than they did when times were better.

"A few years ago, buyers were rushing to get something because they didn't want to be the last to the party," says Hipp. "Underwriting wasn't as diligent as it is today; lenders looked at credit versus non-credit. Today, buyers know that they will sometimes have to pay all cash for a property. If they do get a lender involved, they need to do their own due diligence up front because the lender is going to underwrite it much harder than it ever would have a few years ago."

"Brokers who truly understand both retail and finance are able to provide better value for their clients in this market," says May. "When we do a deal now, we fly around and look at the properties. We don't base decisions on what is printed on a one-page flyer. As a broker, you want to have other brokers on the ground who can help you understand the dynamics of the market."

May uses his affiliation with Retail Brokers Network, while others, like Marcus & Millichap, rely on regional teams.

Debt financing has become available to many buyers of net leased properties, and that has helped bolster demand. O'Shea reports that, depending on the tenant and the property, loan-to-value can be up to 70 percent, with 50 to 60 percent LTV more common.

Pontius also reports that some buyers are looking beyond the next 12 months and looking more long-term for their investment goals.

"As confidence continues to comeback into the picture, it does create an new environment," says Pontius. "Typical of a recovery cycle, you see investors willing to stretch and start to accept lower credits and accept the quality of the tenant. They are making some overall projections that business is improving and that the tenant, if it is doing well now, will do better in the future."

The Climate in 2011

Many of our sources agree that 2010 has set 2011 up to be a good year for the net lease business. Increased demand and new buyers coming to the table, as well as a slowdown in the number of properties being built are drivers to the market. This is rekindling old flames, like pre-development exchanges.

"The volume of construction exchanges we are starting to see is increasing," says Novak. "The demand for new construction is starting to grow and developers are starting to turn dirt again. With the inventory in the market being so limited, it starts to make sense why we are seeing an up tick in development."

In addition to construction exchanges, investors are looking beyond the traditional retailers and banks with public books and strong credit ratings to strong privately-held retailers who are doing their own sale-leasebacks.

"Because retailers slowed down their development over the last few years, there is less product out there," says May. "That has helped demand for locations held by private retailers like QuikTrip and Wawa."

Construction and development on the whole is expected to continued to be slow in 2011, but this will help keep prices strong in the net lease market.

"There is probably going to be a lack of product on the market in 2011 because retailers have pulled in their horns on developing new sites over the last 18 months," says Hipp. "While the ICSC New York Dealmaking was somewhat positive that retailers are looking at opening new locations, that pipeline won't start to fill out for at least 12 months, but most likely 18 to 24 months."

One swing factor in this equation could be a stronger surge in the debt markets. If there is more debt available for construction, development will return more quickly to the sector.

"Most people are saying we won't see any new development until 2012 or 2013, but in the triple-net lease world I think there is going to be a lot of development in 2011, assuming that the debt markets continue to fall," says Novak.

Overall, factors are strong for the net lease sector. With mostly newer and healthy properties on the market, net lease players expect a strong year.

"We expect 2011 to be a year of transition," says O'Shea. "Debt will be available [for buyers] and the excess inventory from the recession has been purchased in 2010."