

Triple-Net-Leases Regain Investors' Trust

By Steve McLinden

As with all retail real estate investment sales, deal volume in the triple-net-lease market slipped drastically in 2009. Yet the triple-nets — so named because tenants pay the three “nets”: estate taxes, building insurance and maintenance — have been considered the one relatively bright spot on retail investors' radar screens.

Some buyers are even looking to ‘B’ and ‘C’ markets to find safe, single-tenant properties that house certain fast-food tenants, auto parts stores or the handful of other economically resilient leaseholders that are in favor.

“McDonald’s are flying off the shelf and will sell in about the 5-cap territory — if you can find one,” said Jon Adamo, vice president of dispositions for Orlando, Fla.–based National Retail Properties, a REIT specializing in freestanding single-tenant assets. “McDonald’s are right in the [investor] sweet spot.” That sweet spot is an equity-heavy or cash triple-net purchase of about \$1 million, with 15-to-20-year terms and rent bumps of about 15 percent every five years, Adamo says.

Apart from the low cap rates that McDonald’s buildings typically offer, these restaurants have also become the gold standard in the net-lease investment world because of high investment-grade credit ratings by both Moody’s and S&P and their stability during the recession. Other select food and drugstore chains are similarly in investor favor.

Many such purchases require far more cash than a few years ago, however, because financing remains difficult. Adamo notes that the industry saw only a handful of triple-net deals in excess of \$5 million last year, owing to such capital constraints.

Strong fundamentals have again become top priority for investors, sources say. “Two to three years ago you would buy properties with shorter-term leases, but now investors want the security of a longer-term lease with only the best credit tenants,” said Ken Hedrick, a senior associate

at Stan Johnson Co., a Tulsa, Okla.–based net-lease brokerage.

Triple-net deals are attractive to some because they are less complex. In a triple-net, single-tenant building investment, investors are acquiring a bond-type lease with investment-grade credit and little or no operational requirements, particularly compared to multitenant properties, Hedrick says. “A lot of investors are tired of management responsibilities,” he said. “They are willing to take an 8 percent to 8.5 percent return on money right now in these deals, as compared to having it in the stock market.” Additionally, buyers of triple-net properties often pay no commissions or other fees, Hedrick says, because those are typically paid by sellers. “Ground leases are the lowest risk factor.”

Though most investors still prefer major-market properties, small-market banks are beginning to “loosen and lend,” enabling more triple-net investment in secondary and tertiary markets, Hedrick says. “We are starting to see regional and local banks willing to lend again and are seeing more interest in the \$2 million to \$2.5 million range for investors who can put 40 percent of their own equity into [smaller] deals,” he said.

“The larger deals, on the other hand, require much more of an equity hit.” Added Adamo: “If the credit is there and the price point is \$1 million to \$2 million or so, and there’s still a good lease term remaining, then [smaller-market deals] can get done.”

Hedrick says he has seen individuals who felt 6 percent returns were inadequate starting to come off the sidelines over the past few years for slightly higher income streams. In recent months, the market has started to see more high-net-worth individuals and syndicators return to the game, he says.

Despite their status as safer plays, U.S. single-tenant

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net-lease retail sales in the \$1 million to \$20 million range slipped from 6,003 in 2007 to 4,990 in 2008, before falling more precipitously last year to an estimated 2,830, according to Marcus & Millichap. The two-year window between the fourth-quarter 2007 total of 1,723 sales and the fourth-quarter 2009 total of just 382 may be the starkest picture of the drop.

Though stand-alone drugstores remain a staple of triple-net owners, the buying terms can be challenging at present. "In 2005 through 2007, we saw a huge volume of Walgreens and CVS sales with the national credit net-lease deals being chased at very low cap rates of 6 points," Adamo said. "They are now 200 basis points higher."

More of those properties are likely to come to market in the next few years. In a real-life example that National Retail Properties cited online last year, the would-be seller of an 'A' credit drugstore it bought at a 9 percent cap rate in 2000, at 80 percent loan-to-value with a balloon payment coming in 2010 at \$2.5 million is in a challenging position. To refinance and pay off the original lender, the seller would have to write a check at closing for \$225,000. This is why the owner opted to sell instead, the firm says.

Triple-net specialists are seeing far fewer 1031 exchanges of late. Adamo says it is because there are no capital gains to shield.

Net-lease buyers are not interested in buying triple-net buildings with short-term-lease tenants these days because even the most creditworthy tenants are doing all they can to ratchet down rents at renewal, sources say. "It used to be that as leases would expire, they would just exercise options [for the same terms]," said Kenneth Katz, a partner at Houston-based Baker Katz, a commercial real estate brokerage firm. "But not now."

Most of the deals being done are for cash or for 60 to 65 percent loan-to-value, as opposed to 80 percent loan-to-value a few years ago, says Adamo. "There is some debt available out there, but it's at terms that are just out of reach," he said. "In the meantime, I don't see banks taking

more risks. They are still trying to figure out pending commercial refinances before taking any more risks."

Katz says multitenant retail buildings are likely to start returning to investment favor later this year, despite their complexity and management needs. "We widely expect we are going to see more opportunities shift to shopping center investment," he said. "Yields are more attractive, even if they require more management. The majority of these buyers are waiting on the sidelines, content to wait for prices to adjust." The rest of the year should see an increase in retail real estate investment volume across the board, Katz says. "People on the sidelines are going to start jumping into the game in 2010. It's just matter of time."

For now, though, soft retail sales, the gap between asking and bidding prices, and the shortage of debt financing all remain stumbling blocks in the higher-price segments. This leaves McDonald's and other plum, triple-net, sweet-spot properties as a failsafe, says Katz. "They're long-term, less management-intensive historically, and a little more liquid," he said. "Right now they are the strongest of the components out there."