



Triple-Net Triple

by Sara Drummond

Threat

Investors vie for the safety, convenience, and ROI of top net-leased deals.



Looking for a rock-solid investment in a shifting economy?

Look no further than single-tenant net-leased properties. In markets where shopping centers sit empty and office buildings are dark, the lights are on (usually 24 hours) at the corner drugstore — provided it's a Walgreens or a CVS. With their investment-grade credit ratings and penchant for long-term leases, these drugstore triple net-leased deals attract top dollar in almost every market.

But drugstores are only one of a stable of creditworthy tenants for net-leased deals, according to a recent anecdotal survey of CCIMs. Other tenants are also attracting buyers. CCIMs report that everyone from all-cash individual buyers in small towns to big-city real estate investment trusts are looking to add one, two, or 20 of these stable investments to their portfolios.

Supply/Demand

From every U.S. region, CCIMs report that the NNN supply is tight and the demand is high. “The entire state of California has more money than product,” says

George L. Renz, CCIM, of Renz & Renz in Gilroy, Calif. He has the investors: His biggest challenge is finding deals with good intrinsic value that “truly reflect safety and truly reflect investor’s goals — most of which involve risk avoidance.”

In Atlanta, “I am seeing more out-of-town buyers from everywhere in the country and even international,” says Virginia I. Wright, CCIM, vice president of net-leased investments for Bull Realty. “With a strong lease, tenant, and location, they are satisfied without having to visit the property and just enjoy the rent checks. Many buyers would love portfolios of properties; however, these are more difficult to come by.”

Many of those portfolios are going to institutional investors that have turned their attention to net-leased product in the past few years. REITs, insurance companies, and pension funds have contacted CCIM brokers in smaller markets this year, looking for portfolio deals.

Money Is Available

One reason for the interest in net-leased deals is that financing is available at all

TODAY'S NNN MARKET

The net-leased market is a \$25 billion segment of the real estate industry. Structured like a bond and usually backed by investment-grade tenants, net leases have proven to be among commercial real estate’s most resilient and popular sectors. In the first half of 2011 alone, single-tenant property sales accounted for nearly 20 percent of all retail, industrial, and office sales.

Net lease capitalization rates averaged 7.75 percent for the first half of 2011, down from 7.88 percent in 2010. This change can be attributed to the lack of high-quality, investment-grade tenants on the market. The recession generally halted new construction, leading to a shortage of new product on the market. At the same time, demand for the stability offered by high-quality net leases steadily rose, and as a result, prices have risen as demand outstrips supply.

The most popular net-leased segments in the market today are dollar stores, banks, drugstores, and quick-service restaurants. The demand has pushed down average cap rates for all segments. — **Winston Orzechowski** is research director for Calkain Cos. Contact him at worzechowski@calkain.com.

NNN Cap Rate Movement

Segment	1H2011 cap rates (%)	2010 cap rates (%)
Dollar stores	8.63	9.29
Banks	6.47	6.82
Drugstores	7.56	7.69
Quick-service restaurants	7.42	7.65

INCREASING NNN YIELD

We all are aware of the negligible yields that investors have been earning from traditional financial instruments, as well as the capitalization rate compression that has occurred in primary real estate markets for credit-tenant NNN investment properties. However, now may be the time for sophisticated investors to pursue NNN investments located in secondary markets with tenants that are non-investment-grade rated. Three potential investment candidates are reviewed below.

Rite Aid

The third largest drugstore chain in the country, Rite Aid currently has a Standard & Poor's debt rating of B-. The company's financial situation has stabilized and management is focused on boosting front-end sales and eventual profitability.

The investment sales activity for Rite Aids began picking up in 2010 and has continued into 2011. Well-located Rite Aids with strong sales in the eastern U.S. have been selling at cap rates in the 9 percent range and are yielding an approximate 2 percent premium to comparable CVS and Walgreens. Cap rates in California reflect a similar 2 percent cap rate premium.

Of course, understanding the local market that the store is located in is critical. Now is probably not the time to buy a non-credit investment property in a section of the country not known by the buyer or his broker. Properly underwriting the specific location should reduce the investor's reliance on the company's credit position.

Dollar Stores

Dollar stores are another viable NNN option. Popular retailers such as Family Dollar and Dollar General continue to open new stores and S&P raised Dollar General's credit rating to BB+ in late July. The current cap rates for dollar store net leases are in the 8 percent to 9 percent range, depending on location, specific lease terms, and creditworthiness of the tenant.

Net-leased real estate investors are currently paying lower cap rates for Dollar Generals than Family Dollar assets. On average, new Dollar General stores are trading at 8.0 percent to 8.5 percent cap rates, while Family Dollar stores are often 25 basis points to 50 basis points higher. Given Dollar General's improving credit rating and that both companies operate out of similar locations, the difference in value is predominantly driven by slight variations in the corporate leases.

Chick-fil-A

Although Chick-fil-A is a private company, there is great demand for its free-standing stores as net-leased investments. Chick-fil-A assets typically have 15- to 20-year primary term NNN ground leases with 10 percent increases every five years throughout the lease and option periods. The properties are well located near major shopping centers, university and college campuses, and business centers. More than half of Chick-fil-A's 1,500-plus locations are stand-alone restaurants, which meet customer demand for convenience and access in high-traffic areas.

Chick-fil-A is known for having strong franchised restaurant operators. The company maintains a franchisee turnover rate of less than 5 percent per year.

For NNN investors, it is reassuring to know that Chick-fil-A triple-net leases have a corporate guarantee. Many investors are becoming more comfortable with this top quick-service brand and recognize that it carries a certain implied creditworthiness. Recently Chick-fil-A assets have traded at cap rates averaging around 6.35 percent.

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levels. With most net-leased properties priced under \$5 million, many single-asset purchasers buy with cash, according to the CCIM market round-up. "We have been doing transactions almost always with knowledgeable all-cash buyers who want to close swiftly," says Rob Murdocca, CCIM, of Pre-scient Property Group in Wayne, Pa.

Len S. Jarrott, CCIM, of Jarrott & Co. in Santa Barbara, Calif., has completed three portfolio deals ranging in price from \$9 million to \$32 million — all 1031 deals that closed with cash. "When I do use debt, I go to life companies," he says.

Wright adds that a variety of financing sources are available for investors who want leverage, and CCIMs in most markets confirm this.

"Smaller investment deals are getting financed through smaller, extremely well-capitalized rural banks flush with farmers' cash," says Shad J. Phipps, CCIM, a senior associate with CB Richard Ellis in Columbus, Ohio.

"Very desirable rates, usually in the 60 percent loan-to-value range, can be found for qualified buyers with qualified properties," says Chris Schreiber, CCIM, an associate broker with Kiemle & Hagood Co. in Coeur d'Alene, Idaho.

NNN Challenges

Despite the availability of money for NNN properties, financing is still a concern, given that most local banks require pre-existing relationships. "All of the smaller community banks require that a borrower has an established track record of working with them," says Casey Weiss, CCIM, of Access Commercial Real Estate in LaCrosse, Wis. They also often limit their loans to the local area, he adds.

Another problem is conflicting buyer and seller timelines, Murdocca says. "Sellers need to be prepared to meet buyers' need for due diligence. Triple-net deals sell well, but buyers still want a feasibility period."

While lack of supply is a problem in almost every market, a hidden niche may be older

CCIM Snapshot: NNN Activity

MARKET	CAP RATE RANGE	TENANTS	FINANCING
Wisconsin	9% multitenant, 8%–8.75%	Industrial; high visibility office; Plato's Closet, Big Lots, Texas Roadhouse	Local banks, 75%–80% LTV
Washington State	7%–8%	Medical, government services	Cash, life cos., local banks, 60% LTV
Georgia	7%–9%	Small box retailers, larger banks	Cash, life cos., local banks, 70% LTV
California	6.75%–7.5%	Walgreens, Autozone	Cash, local banks
Pennsylvania	7%–8%	Medical	1031 exchanges, cash, local banks
Florida	7.5%–9%	Dollar stores, drugstores	Cash

Source: CCIM survey, Sept. 2011

net-leased properties, Weiss says. “Investors seem to be more interested in NNN properties that have some age, versus brand-new NNN properties,” he says. “Older NNN properties have a lower per-square-foot price, which means that they don’t require as high of lease rates if they are forced to re-lease.”

In today’s market, he adds, “Investors are putting more emphasis on their back-up plans. They realize that losing a tenant is a real possibility, and buying older properties can help them prepare.”

Even with newly developed NNN properties, investors are not taking as many chances, says Gregg H. Thompson, CCIM, general manager of Ratcliff Facilities, in Alexandria, La. Ratcliff specializes in developing NNN properties, recently for Dollar General. “Since there is no such thing as ‘too big to fail’ anymore, investors are exploring options and worst-case scenarios with their properties,” he says. “We are seeing this hedging early in the negotiating phase of our completed development projects.”

Thompson is also concerned about upcoming FASB changes. “As a developer, we feel that these proposed changes will decimate the design-build net-leased market by forcing tenants into shorter lease terms or to revert back to fee-simple ownership of properties. This will dramatically decrease the attractiveness of commercial real estate as an investment due to increased management and risk associated with properties.”

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FASB AND THE NNN MARKET

In recent years, the Financial Accounting Standards Board, in conjunction with the International Accounting Standards Board, has caused concern in the financial community with its proposal to significantly change generally accepted accounting principles for leases, effectively requiring lease capitalization by both the lessor and lessee.

With the recent decision by FASB/IASB to re-expose their draft of the new standard and therefore delay implementation of the changes, a lot of the concerns in the real estate sector have subsided, at least temporarily.

FASB/IASB’s current timetable is to issue a revised exposure draft for additional public comment in the fourth quarter. Analysis of the feedback will probably delay issuance of the new standard until at least mid-2012. The FASB/IASB had previously set a standard implementation date of January 1, 2015, with retroactive presentation for 2013 and 2014 financial statements. Based upon delays experienced to date, additional delays may well occur.

The proposed standard has not had a significant impact on the NNN market to date either in deal terms or in transaction velocity. Sale-leaseback activity continues to be governed by the economics of the transaction; a lower cost of capital versus the company’s alternative sources will result in the deal going forward. Companies that understand the benefit of utilizing sale-leaseback transactions as a financing source will continue to do so. Investors will continue to purchase NNN properties.

Eventually there may be pressure to shorten lease terms in order to reduce the new balance sheet liability created by the lease. Ultimately this will be decided in the marketplace, as it is now; lessees will still have to balance their desire to minimize the lease term against the lessor’s ability to amortize improvements over a longer lease term.

Should lease capitalization be adopted, a company’s historical financial metrics/ratios will change and debt covenants may have to be renegotiated, but the company’s financial solvency will not be affected. However, recording the impact of these proposed changes will be a monumental task for both lessors and lessees, and the cost to companies and their consultants will be substantial.

Although the proposed changes will be significant to the way companies report their leasing transactions, economics should govern the NNN market, as it always has.

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