Net Leases: Who, When and Why

Net-lease financing can bring your investor clients a world of possibilities

By **Christopher P. Campbell** and **Carl W. Christensen,** managing directors, Net Lease Capital Advisors

Net-lease property, already prized as a safe real-property asset, offers strategic opportunities to investors.

A net lease is an agreement in which the tenant has financial and management responsibilities usually associated with property-ownership. In a double net lease, the tenant pays capital expenses, typically including roof and structure. A triple net lease holds tenants responsible for all expenses, including taxes, insurance and capital expenses. The term "net-lease property" refers generally to classes of property occupied by a single tenant under a double or triple net lease.

How they work

Net-lease assets trade in different markets, depending on their financing. Individual net-lease properties usually are originated by the developer and financed based on their real estate fundamentals at as much as 80-percent loan to value (LTV). Like traditional real estate, these trade based on return on equity.

Net-lease property with an investment-grade tenant and a long-term bond lease also can be financed based on the credit of the tenant's corporation, rather than on the underlying property — if the corporation has a solid credit rating. This financing can result from a corporate sale-leaseback in which a corporation gains liquidity by selling real property and promising rent payments to cover debt service.

Based on the corporate guarantee of debt payment, credit-based financing can reach as much as 95-percent LTV. This high-leverage financing results in a debt-coverage ratio of 1, in which all rent covers debt service.

Because of this credit-based financing and because rent covers the debt service, pricing for high-leverage net-lease property is not determined by cap rate or cash-on-cash return. It is expressed as a percentage of equity over the debt.

Properties with tenants who have high credit ratings trade for a higher percentage of equity. Analyzing these properties by focusing more on the tenant's credit, lease structure and loan terms than on the underlying real estate can be efficient.

What to watch for

The market for these properties can be complex. Cautious investors turn to niche advisers rather than wading in on their own.

Some investors use net-lease portfolios to take advantage of the spreads between low interest rates and investment yield. By borrowing against existing holdings at low rates, investors can turn a profit by purchasing sound, conservative investments of net-lease property with the refinancing proceeds gaining higher returns, sometimes more than 8 percent.

In this overheated market, though, the challenge can be in the acquisition. One investor, eager to place borrowed monies rapidly, found the market was too fast-moving to properly analyze. Specialized niche advisers helped the investor surface 30 net-lease properties in 10 days.

The board approved the investments knowing that even if the high-grade corporate tenants failed, there would still be value in the long-term leases and the underlying real estate could be repositioned. If market rents improved, a repositioning could even result in superior rent returns.

Tax-deferred property exchange with credit-based financing allows sellers to pull out more cash after the exchange than would have been possible with a taxed sale. Investors can purchase replacement property for less equity than they would otherwise pay as capital-gains tax.

For property with a low tax basis or a large appreciation, capital-gains tax can reduce a sale's proceeds. Taxes are due on the full amount of the difference between the property's sale price and its tax basis (its value after annual depreciation expenses).

> "The market for these properties can be complex. Cautious investors turn to niche advisers rather than wading in on their own."

Through a 1031 exchange, capital gains from the sale of property can be deferred with the purchase of replacement property. All equity from the sale of the relinquished property must be used to acquire the replacement property.

Once the exchange is complete, however, debt levels may be raised. With credit-based financing, leverage is available to as much as 85-percent to 95-percent LTV based on the tenant's corporate guarantee. Rent covers the debt service, and the seller takes away cash from the refinancing.

Christopher P. Campbell and **Carl W. Christensen** are managing directors of Net Lease Capital Advisors, a Boston-based investment and advisory firm focused in the nationwide net-lease arena. The firm has closed more than $3 billion through its advisory programs. For information about strategic tax solutions or about the net-lease market, contact Campbell at ccampbell@netleasecapital.com or (603) 598-8560, or Christensen at cchristensen@netleasecapital.com or (603) 598-1144. Their address is 1 Tara Blvd., Suite 403, Nashua, NH 03062.

Reprinted From *Scotsman Guide* Commercial Edition, March 2006