Counting ON Credit

Know the basics of credit-tenant-lease loans for your investment-grade clients

By **Barry P. Reiner,** president, CEO and co-founder, Bond Street Capital Corp.

Credit-tenant-lease (CTL) loans are hybrid loans that meld two different types of financing together to create an innovative product. They join the elements of corporate finance and real estate finance, resulting in a long-term, highly leveraged, quasi real estate loan.

Typical commercial real estate loans are underwritten and sized based on the property value and the cash flow generated by that property. CTL loans, however, are sized based on the tenant's credit rating, lease structure and rental payments.

CTL loans are backed by the rental stream under a long-term lease to an investment-grade tenant (a corporation with a high investment-grade credit rating) on virtually any type of property. Loan terms offered by CTL lenders typically boast a 100-percent loan to value and a 1.0 debt-service-coverage ratio (DSCR) with no reserves and no phantom underwriting deductions. This is a dramatic departure from standard real estate underwriting. It boosts loan proceeds significantly.

Moreover, any rent increases contained in the credit lease that are calculable at closing will be given credit and underwritten prospectively. This further maximizes loan proceeds and represents yet another departure from traditional underwriting. While the CTL loan may in fact sound too good to be true, it is not. These terms are attainable and common within the CTL-financing arena.

What lenders seek

CTL lenders primarily focus on the creditworthiness of the tenant and strength of the lease. Triple net leases are most desirable, but most lenders have developed structures to accommodate double and single net leases as well. As a secondary consideration, CTL lenders look to traditional real estate considerations such as property type, location, age and condition, submarket, competition and quality of the asset.

First and foremost for the CTL lender, however, is the credit of the tenant. Strong credit has the ability to overcome many sins at the property level. Technically, the collateral for the credit-lease loan is indeed the real estate. From the lender's point of view, however, the primary source of repayment will come from cash flow under the credit lease. This will essentially be the rental payments made by the credit tenant.

Loan pricing

Pricing for these loans is predicated on the tenant's credit rating. Lenders also look at the general perception of the tenant in the mortgage market and in the tenant's industry. In other words, all credits are not created equal. One single A-credit in a hot industry sector will likely trade more tightly than a similarly rated credit in a negatively viewed industry. This results in more-favorable pricing for the corporation in the hot industry sector, notwithstanding otherwise identical credits.

Investment-grade tenants are rated from AAA down to BBB-minus. Credit ratings of BB-plus or lower represent subinvestment-grade ratings. Under most CTL programs, these tenants will not be eligible for financing.

Loan structure

The property type is secondary to the pricing consideration. Loan term and amortization will be coterminous with the remaining lease term, so these credit-tenant loans are usually long-term by conventional real estate standards. For example, a 22-year

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lease executed two years ago would yield a 20-year loan term with a 20-year amortization schedule so as to run alongside the lease and be fully amortized at maturity.

In some cases, a CTL structure may permit a balloon to exist at maturity. Because the entire transaction is based on credit, though, a creditworthy balloon-risk insurer must insure the balloon with residual value insurance (RVI). Without the RVI policy, the credit nature of the financing transaction would be compromised and hence ineligible for CTL treatment.

The long-term, fixed-rate nature of a CTL loan is an additional feature that is likely to pleasantly surprise borrowers. The typical loan will have a fixed rate with no reset and no floating period for the life of the loan. The loan will be rate-locked at closing for its duration and priced over a U.S. Treasury-based index. That means that if your clients have a 25-year lease, they have a guaranteed fixed rate for the 25 years on a single-tenant, income-producing property.

This ability to lock in a long-term fixed rate is rare in the commercial sector. In addition, CTL loans offer the added feature of being nonrecourse. This combination of loan attributes is also rare and favorable to borrowers.

One thing to note about a credit-tenant loan is that because proceeds are fully maximized by writing the loan down to a 1.0 DSCR, 100 percent of the monthly cash flow is used to service the debt. This leaves the borrower with no excess cash flow. The trade-off, of course, is that the borrower takes out the most proceeds possible upfront and will own the property unencumbered at maturity.

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CTL loans are not for everyone, but they should be considered by any owner of a property that is net leased to a credit tenant. They offer features that cannot be matched in the conventional real estate lending market.

Glossary:

Net lease: A property lease in which the lessee agrees to pay all expenses that are normally associated with ownership, such as utilities, repairs, insurance and taxes. Also called a closed-end lease.

Credit-tenant lease: The premium net lease in which the high caliber of the tenant's credit provides assurance about rent-payment reliability. The tenant must have an investment-grade credit rating of AAA to BBB-minus as determined by a recognized credit-rating agency.

Triple net lease: A lease in which the lessee pays rent to the lessor, as well as all taxes, insurance and maintenance expenses that arise from the the use of the property.

Double net lease: Like a triple net lease, only the lessor pays maintenance expenses.

Sources: www.investorwords.com and *Northeast Real Estate Business* magazine

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