Feature Article, January 2009

Triple-Net Leased Properties See Opportunity in 2009

There may be a silver lining for opportunistic buyers as sellers are forced to bring properties to market.

Randall Shearin

The market for triple-net leased, single-tenant properties, like the rest of the retail business, is having its woes. During 2008, market activity slowed as the year went on. The marketplace for 1031 exchange intermediaries and TIC sponsors has thinned as well, with the most notable milestones the unfortunate bankruptcies of LandAmerica and DBSI. However, the sales of triple-net properties did not slow as much as the sales of shopping center properties, according to brokers who are involved in both property types.

Jon Hipp

“There is a lot of apprehension in the marketplace,” says Jon Hipp, president of Calkain Companies in Reston, Virginia. “There is a disconnect between buyers and sellers. Anyone who is buying in this market is pretty sophisticated and has the ability to put down 50 percent or pay all cash. If someone is selling, they have a need to sell.”

“While nothing fundamentally has changed about who the sellers are, the buyers today are the few people who want to put their money in because the timing is right for them,” says Lori Schneider, senior vice president, investments, in Marcus & Millichap’s Fort Lauderdale office. “They are making offers at their comfort levels. We’re seeing a lot more astute buyers.”

“The marketplace is in the process of recalibrating and making a profound adjustment,” says Sean O’Shea with BRC Advisors in Los Angeles, whose company did about $80 million in transactions in 2008. “That will take some time. There is about a 100 or 150 basis point difference between what buyers want to pay and where sellers want to sell. We do see on a daily basis that this gap is beginning to close.”

The adjustment comes as markets use to trading at 5.5 cap rates become markets trading at a 9 cap rate.

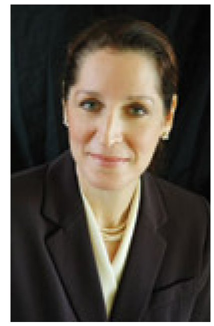
“We predict the recession for the industry will last about 8 quarters,” says O’Shea. “During that time, a lot of really good people are going to fall by the wayside.”

Changing Market

To show how the market has moved over the last year, in June 2008 Calkain Companies put under contact a Walgreens in Virginia at a 6.375 percent cap rate, which closed in September 2008. In December 2008, Walgreens were selling from 6.75 to 7.25 percent cap rates. Says Hipp, “While you may see a Walgreens for sale today occasionally at a 6.5 percent cap rate, it is more common for you to see them on the market at cap rates of 7 percent or above.”

Rob James, managing director of Kimco Realty's Kimco Exchange Place, also reports he's seen pricing change at least 100 basis points over the last 12 to 18 months.

"There's no doubt that prices have gone down and cap rates have increased," says James. "The spread between what the seller wants and what the buyer wants to offer has closed. It did take a while for the sellers to react to the lower values of their properties, but we feel like they've gotten the message now. They are much more willing to take less for their building than they were 6 months ago."



Lori Schneider

"There is no activity on the overpriced deals," says Schneider. "It is very much in the seller's hands how they want to react on deals that are otherwise marketable."

What caused this change? Sellers are anticipating higher capital gains under the new Obama administration, so a number of sellers were motivated to get properties to closed by the end of 2008. A second factor, according to James, is that many sellers realize the bottom of the market hasn't hit yet, so their properties may continue to lose value. Many are taking lower prices than they want because they believe that value will continue to decline.

Some owners, like AEI Fund Management, who buys net-leased properties via investment funds, are continuing to buy. The company's funds purchased over $100 million in net leased properties in 2008.

George Rerat

"We only invested in very strong balance sheet tenants that are the leader in their respective vertical [market]," says George Rerat, vice president of acquisitions for St. Paul, Minnesota-based AEI Fund Management. "Throughout 2008, many investors sold out positions in stocks, bonds and oil. This investable cash is now in short-term cash and cash equivalent investments, earning close to a zero percent return. That money will start to look for yield, having been burned badly in both the stock and bond markets. We should see a return to a suggested 15 to 20 percent investment portfolio allocation to real estate."

Miami-based United Trust Fund is another buyer who sees opportunity in this market. Because UTF is an all cash buyer, it is unaffected by the credit markets. The company specializes in sale-leasebacks with large corporations, including retailers. For UTF, the real estate comes first and the credit of the tenant comes second.

"It used to be that companies would come to us with all these terms; they would insist on a 7-year leaseback with flat rents," says Paul Domb, asset manager at UTF. "Now, they just want to know how quickly we can close. It's the polar opposite of how it used to be."

Inventory

As you might expect, there are a lot of properties on the market. Most of the brokers SCB spoke to reported a backlog of properties; quite a change from a few years ago when we reported that a number of 1031 exchanges couldn't be completed because traders couldn't locate a property in time.

"A few years ago, you would see five buyers for every property," says Gill Warner, senior director of Stan Johnson Company in Tulsa, Oklahoma. "Today, that's reversed, and the buyers are looking carefully."

"Activity has slowed, causing a backlog of inventory," says Barry Silver, president of San Rafael, California-based The Silver Group. "There are more than 180 new Walgreens currently on the market. Cap rates hit their lowest point at the beginning of 2008 and have jumped above 7 percent. There are also scores of Advance Auto, Dollar General and Family Dollar deals on the market. Some sellers are being pressured to retire construction loans or add equity. Those unable to secure debt will become aggressive sellers."

While inventory may be out there, bringing buyer and seller closer together may still be part of the problem. Looking to do a 1031 exchange in 2008, Paul Souza, principal of San Francisco-based Sansome Pacific Properties, Inc., looked at over 200 available net leased properties and came up empty handed at the end of the search.

"The basic fundamental intrinsics we need weren't there," he says. "We made offers on 10 properties and ended up not buying anything. We paid our taxes."

Souza sees a flood of properties entering the market in 2009 as financially strapped developers are forced to sell properties in an environment with rising cap rates. For retail, especially, he sees a hard year ahead with financial pressures on consumers keeping them away from stores.

What is selling in the net leased market?

"Deals with a story," says Hipp. "Properties that are fundamentally real estate plays and not credit plays. In a market like this, there is a flight to quality. Other properties that are selling include those that may have a B credit rating, but the rent is well below the market or the sales are high for the location."

"It used to be we would package properties from the same seller into a portfolio to get a premium," says Schneider. "Now, it's quite the opposite: the smaller a deal is, the easier it is to get done."

"Foreclosure, pre-foreclosure and other distressed properties are selling because they can be obtained for a fraction of their value," says James Miller, vice president and Southwest regional manager for Investment Property Exchange Services, Inc., in Phoenix. "The buyers are purchasing with cash or huge amounts of equity down payment so they are less affected by the credit markets."

All cash deals and deals that require small loans are what many brokers report selling.

"The majority of deals are in the $1 million to $2 million range," says Warner. "Institutional deals greater than $5 million are virtually non-existent."

Geographically, none of the brokers SCB spoke to saw much difference in activity between one part of the country versus another. However, nearly all pointed to the size of market as a differentiating factor in both deal pricing and popularity of properties.

“People pull away from tertiary markets in a time like this,” says Hipp. “That also goes for leasing today. If there is any leasing going on, it is happening in urban and high growth suburban markets.”

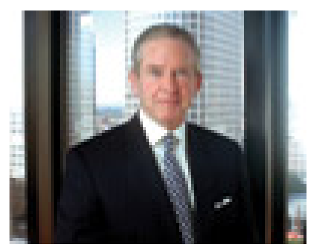
Most buyers are still looking to place a little debt into new acquisitions, which can complicate deals. Buyers are finding this debt with regional banks.

“Net leased property owners have suffered along with the owners of other commercial property when seeking debt,” says Silver. “If we can get some liquidity into the market, I believe we can work our way through this low point.”

1031 Market

1031 exchange buyers have been troubled by the economy as well. With lending more difficult to get, those doing 1031 exchanges have a more difficult time trading up to properties with higher values.

“We had a number of would-be 1031 buyers this year opt to pay their taxes because they didn’t like the way the economy was going or couldn’t get financing,” says O’Shea. “In the economy that we are in, with the psychology that exists today, nobody wants to buy anything right now. Sales will come from smart investors who see value in today’s market. Some sales will also come from investors who are buying for tax planning reasons rather than real estate reasons.”



Sean O’Shea

“We see a lot of demand for 1031s,” says Hipp. “The reality is the pace of the market isn’t what it was. People are not just trading everything and moving up.”

Some intermediaries are even seeing buyers leave the table with deals they no longer see as advantageous. Stan Johnson Company’s Warner estimates that the number of 1031 buyers is down by about 75 percent in 2008.

“We are seeing deals where the buyers are walking away from substantial deposits they made a year ago and not buying the property, which is now being appraised 30 to 40 percent less than the year-old contract price,” says Marie Flavin, vice president and Northeast regional manager for Investment Property Exchange Services, Inc.

Kimco Realty, which sells triple-net properties for Kimco Realty Trust and other clients into the 1031 market through Kimco Exchange, has seen activity remain robust in its intermediary business.

“1031 buyers still have to buy something to avoid paying capital gains taxes,” says Rob James. “The market is busy with properties valued at $3 million or less. Once you get into the larger, institutional size deals, the buyer pool is thinning considerably. The institutional investors are on the sidelines. We are mainly seeing private individuals and wealthy families as our buyers right now."

Kimco's average deal size is $5 million. The company currently has 70 properties listed, the majority of which are triple-net ground leases and triple-net buildings like banks, grocery stores, drug stores and restaurants.

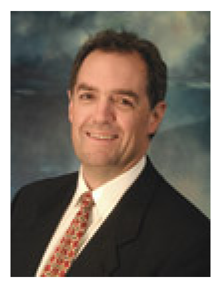
Schneider, of Marcus & Millichap, anticipates that multifamily apartment sales will be impacting the sale of single-tenant retail properties through 1031 exchanges. With financing more difficult for homebuyers, demand for apartment rentals is up, which creates more of a premium on apartment complexes. Sellers of these properties often opt for 1031 exchanges into less management intensive properties like triple-net lease, single-tenant retail properties.

"We may also see an up tick from investors who are looking for an alternative to the stock market," says Schneider. "Even small shopping centers have also been increasingly difficult to underwrite, so there may be an increase in demand for single-tenant properties from buyers who would otherwise have purchased a multi-tenant shopping center."

"Buyers are slowly starting to come back," says IPX's Miller. "However, there are a lot of people still sitting on the fence. When credit markets thaw, I think we will see a considerable amount of activity, quickly. At the present, most of the activity seems to be coming from investors or investor groups buying all property types at discounted values. This doesn't translate into exchanges yet, but it is the first important step. Most of the exchanges we are seeing are from the clients we have been working with for a number of years and who are always in the real estate market to one extent or another doing deals."

Some brokers see 2009 opening up new opportunities because of the number of distressed assets expected to hit the market.

"The last few years have been marked mostly by what we call the 'good problem' — high capital gains resulting from high sales prices in a seller's market," says Carl Christensen, managing director of Nashua, New Hampshire-based Net Lease Capital Advisors. "We think in 2009 we will be seeing more of what we call the 'bad problem" — workouts and foreclosures that produce capital gains tax problems for sellers. It's tough to watch. While it's tough to see clients go through the pain in this part of the cycle, we are often able to help them with strategies addressing the tax problems resulting from forced sales."



Carl Christensen

Buyers also see changes in 2009.

"I see a thaw happening in the second half of 2009," says AEI's Rerat. "Some buyers, like AEI, will continue to invest in high quality deals in early 2009. The future for transactions with little or no credit and poor cash flow is dark. Those deals will no longer be sold, except for land value."

Some in the business see a silver lining in the clouds.

“At the end of the day, real estate is a hard asset,” says Hipp. “Good real estate will always trade in the market. With the amount of loans coming due over the next year, there will be a lot of property hitting the street. There’s also a lot of cash sitting on the sidelines with private owners as well as institutions. I’m cautiously optimistic that it could be a better market in 2009 than most people think.”