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Connecting Real Estate in the West

In Orange County, Calif., HIG NNN is under contract to sell a single-tenant, triple-net-leased drive-thru Carl's Jr. Built in 2013 with a brand, new 20-year corporate lease, Carl's Jr. has 70,000 cars per day passing by at the intersection of Harbor Boulevard and Edinger Avenue.

NET LEASE KNOW-HOW

Two of the West's leading net lease experts explore the intricacies of these deals to reveal how and where investors can capitalize in the new economy.

TOP 3 ATTRIBUTES TO LOOK FOR IN A NET-LEASE INVESTMENT

By Eric P. Wohl

Single-tenant, net-leased (STNL) properties remain one of the hottest sectors in commercial real estate today. Many owners of other product types like multifamily and multi-tenant commercial are looking to simplify their lives by completing a 1031 exchange into net-lease retail properties. With all the new capital flowing into retail-net lease properties, I am constantly being asked, "Is this a good deal?"

Current values are far exceeding "bubble" pricing of 2005 to 2007, so it is increasingly important for investors to pay attention to the core fundamentals of each property.

With that in mind, here are the top three attributes to look for in a net-lease investment:

Location, Location, Location

Regardless of which type of retail net-lease property you are looking to buy (fast food, bank, drug store, convenience store, etc.), the first attribute you should consider before purchasing is the location.

Important location characteristics include:

• Visibility: Is the property located on a signalized intersection or within an anchored shopping center? These types of locations will usually outperform "mid-block" locations

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HAS YOUR CENTER HAD WORK DONE?

A facelift can breathe new life into tired, old, rundown malls. But a simple renovation may fall flat if it doesn't take these five strategies into account.

By Stan Braden

Photo credit: John Bare Photography

Redesigned entrance by KTGY Group, Inc. at the Bellis Fair Mall in Bellingham, WA, captures the feel of the Pacific Northwest architecture.

With more consumers shopping online than ever before, mall owners and managers are looking for ways to revitalize a tired or dated shopping center. Now more than ever, older shopping centers are undergoing everything from a quick cosmetic facelift to a major redesign. Many renovations also take place when vacant space needs to be reconfigured to accommodate new tenants.

Below are five aspects of a renovation you should consider before putting any renovation into place.

The Plan

Design a retail-built environment that attracts the type of tenants you want in your mall. The type of shopping environment required by a Bloomindale's is not the same kind of environment that may be requested for a sporting goods store. The right tenant drives traffic to your center, which is why it's so important to focus on the image your targeted tenants will want to project. This image should be influenced by the type of renovation design plan you have in mind. Adding a pedestrian-friendly

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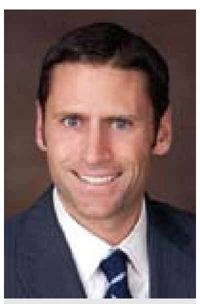
and will be easier to re-lease down the line.

• Demographics: How many people live in a 1-, 5-, and 10-mile radius, and do their income levels match up to the tenant's target audience? This is very important to understand so you can be sure your tenant will be there for the long haul.

• Traffic counts: How many cars are driving past the site every day? The more cars, the better. Many tenants have minimum traffic counts that they look for before moving to a new site.

• Access: Does the property have easy in/out access from both sides of the street? Customers don't like to make U-turns to access a property. Instead, they want to easily exit in either direction when leaving.

• Parking: Is there plenty of parking for the tenant's customers? Parking is a major commodity, especially in denser infill markets.



Wohl

In Orange County, Calif., HIG NNN is under contract to sell a single-tenant NNN drive-thru Carl's Jr. at 16101 Harbor Blvd. in Fountain Valley. Built in 2013 with a brand new 20-year corporate lease, Carl's Jr. has 70,000 cars per day passing by at the intersection of Harbor Boulevard and Edinger Avenue, making it a strategic location for Carl's Jr. for years to come.

Market Rents

It is very important to understand the leasing market in a specific trade area prior to purchasing a property. While it's great to have a credit tenant paying you rent on a long-term basis, it is important to ensure their rent is replaceable, should you need to re-lease the space in the future.

Important rent characteristics to consider are:

• Current vs. Market Rent: Is the current tenant paying above, at or below market rent? Find out the past couple comparable leases that have been executed in the trade area. This information is extremely valuable to better understand if your tenant's rent is above or below market.

• Rent-to-Sales Ratio: Does the tenant's annual store sales support the rent they are paying? This ratio is calculated by dividing the annual store sales by the annual rent. The lower the number, the more sustainable the tenant's current rent is. Most tenants prefer this ratio to be less than 10 percent.

In December 2013, HIG NNN represented the seller in the sale of a single-tenant NNN Smart & Final in Fresno, Calif., for $6.3 million.

HIG NNN represented the seller in the sale of a NNN corporate ground lease to Union Bank in San Bernardino, Calif., for $1.85 million in October 2013. Located on a corner pad to a well-trafficked Food 4 Less and Ross Dress For Less-anchored shopping center, the property sits adjacent to San Bernardino City Hall and Superior Court. The investment has strong upside potential due to Union Bank's rent being well below market with nine years remaining on the lease. The buyer was comfortable paying an aggressive capitalization rate on the current income because he knew market rent was at least 30 percent more than what Union Bank was paying.

HIG NNN represented the seller in the sale of a 50-year, triple-net corporate ground lease to Union Bank in San Bernardino, Calif., for $1.85 million in October 2013.

Tenant Financials

When underwriting a net-lease deal, understanding the financial stability of the lease guarantor and the profitability of that particular location is imperative, as those are the main drivers behind the asking cap rate of the property.

Here are a few aspects of the tenant's financials to request, if available:

• Current Profit/Loss Statement and Balance Sheet: What type of liquidity does the guarantor have on hand versus their current debt? These statements will give you a financial snapshot of the guarantor, which will allow you to determine how likely they are to uphold their lease obligations.

• Annual Store Sales: What are the past three years of store sales at this particular location? Understanding how this store's sales stack up to other locations in the chain is important to ensure the store will remain profitable for years to come. It is optimal to find a location showing increases in store sales over the past few years.

• Tenant Credit Rating: Is the tenant rated on Standard & Poors (S&P) or Moody's? If so, what is their rating? Investors can sign up for a free account with either or both to review the rating of any tenant. It is important to track if the tenant's rating has had a positive or negative trend in the past 12 months to better help you understand the credit risk associated with the tenant.

In Fresno, Calif., HIG NNN negotiated the sale of a single-tenant NNN Smart & Final at 631 H. Street in December 2013. The purchase price was $6.3 million and included both the 17,164-square-foot building on one-acre of land, in addition to the NNN lease. The investment featured a brand new 25-year corporate NNN lease with multiple options to extend. The transaction's cap rate of 5.85 percent is a record low cap rate for a single-tenant Smart & Final. The single-tenant NNN Smart & Final investment provided an outstanding hedge against inflation due to strong rent increases during the initial lease term and throughout the option periods. The reason the buyer was comfortable paying a record price was because the annual store sales were in the top 5 percent of all Smart & Finals chain-wide.

With so many different retail net lease options available, it is imperative to thoroughly understand the property's location, how the rent compares to market and the tenant's financials. If you stick to these guidelines, there is a strong likelihood you will buy a well-located property with a successful tenant that will operate there for many years to come.

Eric Wohl, president of HIG NNN, a division of Hanley Investment Group in Irvine, Calif.

THE NET LEASED OFFICE SECTOR

By Sean O'Shea

O'Shea

The net leased office market has largely been affected by three recent trends: the divide caused by the Great Recession, the variety of capital sources taking part in net-leased office investments and the success of healthcare real estate. At the core of these trends is the fact that these properties are considered very attractive due to their risk-averse structure, with the role of building operations shifting to the tenant(s).

After the Great Recession, a large divide rose between office sales in primary and secondary markets. According to Real Capital Analytics' (RCA) Office 2013 Year in Review, while CBD prices are now slightly higher than peak levels, suburban prices have just recovered within 25 percent peak levels and with yields averaging 7.2 percent. Primary markets are typically preferred by REITs and institutional investors when it comes to net-leased properties because these markets offer a more secure position after such an uneven recovery. Investors seeking a higher return will be more attracted to secondary markets. These investors typically tend to be savvier than passive investors, who will pay a premium to own in a primary market.

Corporations began looking at their real estate portfolios with much more care following the great shock to the economic nervous system from the past recession. The questions became which holdings are mission critical, which assets no longer fit the revised strategic facilities' plan and which properties are good candidates for long-term sale/leasebacks to monetize real estate assets.

This began a new round of corporate sale/leaseback transactions. These corporations are often willing to dispose of their ownership of a property at pricing metrics that exploit the compressed cap rate environment, as long as that disposition price secures a lease structure and occupancy costs at that same building for the next 10 to 15 years. In September 2013, acute-care owner and operator IASIS Healthcare LLC sold three hospitals, including one in Arizona, to Medical Properties Trust Inc. for $283.3 million. The acquisition included a 15-year lease, as well as right-of-first refusal should the REIT decide to sell. Further supporting these strategic moves is the anticipation of new federal regulations that essentially say corporations like banks should be primarily banks and not real estate investors. Nearly every major financial institution, such as Citibank, Bank of America and Wells Fargo, have quietly disposed of many of their real estate assets, including trophy office buildings and retail branches, and have benefited from these transactions due to the impact of the historically low interest rate environment we've experienced in recent years.

The variety of capital sources in net-leased office properties has had a large impact on the market. Private investors have always been in the marketplace, but now institutional investors, real estate investment trusts and global investors are all significant players, too. Publicly traded and non-traded REITs have both had a much greater role than ever before in the net-leased office market, primarily because their cost of capital is much less than that of private investors. They have the ability to purchase the properties and pay a more attractive capitalization rate for better properties. In San Francisco, a capitalization rate for high-quality office properties backed by credit tenants might range between 3 percent and 4 percent.

In addition to REITs, the global economy has also begun to play a part in net-leased office. Instead of the traditional American real estate market, where an investor may compete against other local or national investors, there is increasing competition from foreign investors and even Sovereign Funds. Each of these investors considers different risk factors. For American investors seeking yield, they may be chased out of primary markets and into secondary markets in search of potentially better returns on their investments.

Another significant differentiator among net-leased office space is simply the type of office space in question. The most attractive is healthcare real estate in the form of medical office buildings, such as the 37,000-square-foot Highlands Ranch Medical Pavilion in Highlands Ranch, Colo., or the nearly 75,000-square-foot Centre Medical Plaza in Chula Vista, Calif., both owned by Griffin-American Healthcare REIT II. Healthcare is already the nation's single largest industry, and is also the fastest growing segment of the economy as a result of the aging American populace and the impact of Affordable Care Act. REITs are especially active in the healthcare space, acquiring billions of dollars' worth of new acquisitions annually. New space is also being developed or remodeled, as facilities that support newer technology and a higher quality of space are what these long-term tenants are looking for.

In addition to this, hospitals and physician practices rarely change locations, resulting in a more stable tenancy — a particularly attractive draw for risk-averse investors. Medical office vacancy rates typically tend to hover around 7 percent or 8 percent nationally. This is in comparison to the 17 percent average among traditional office space in the U.S. RCA also found that sales of medical office properties totaled $7.09 billion last year — the second-highest total the firm has seen in the 13 years it has been tracking the healthcare sector.

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