

Introduction to:

SEEKING PREDICTABLE CASH FLOW

THOMASCOMPANY
NET LEASE CAPITAL MARKETS



Evaluating Net Leased Properties

Investors that acquire net leased properties choose them for the promise of predictable cash flow. Predictable cash flow, however, is determined by two specific elements—a long lease term, and strong tenant credit—that must coexist. These elements, together, influence a property’s value proposition to an investor and also determine how that property is priced in the marketplace. That’s why it’s vital that investors researching the sector develop fluency regarding lease terms and credit thresholds that both play an important role in the value of any particular net leased investment.

Term without Credit

Those new to the single-tenant marketplace sometimes learn about an available property with a long lease term and a single tenant and assume the building offers the predictable cash flow associated with a sought-after net leased property. The long lease term may suggest this. However, there’s a missing piece: How’s the tenant’s credit? If the tenant at the property isn’t sufficiently creditworthy, the single-tenant property with the long lease doesn’t fit the value proposition of a net leased property.

Consider this example: A building with a long lease to a video store whose parent company is expected to enter bankruptcy reorganization and thus has bad credit (and a potentially short lifespan) is not the same kind of long-term bet as a property

leased to a coffee shop run by a publicly traded company with investment-grade credit. Indeed, professionals refer to the former sort of listing as one that offers “term without credit” – meaning that the investment offers the kind of long lease term typically sought out within the net leased sector, but that the tenant lacks the top-tier credit rating that guarantees longevity. There is no value in a long lease term if the tenant is expected to go bankrupt before the lease term expires.

Long lease terms command a premium in the net leased sector. However, a “term without credit” property doesn’t often command this premium because the tenant’s sub-optimal credit means its business isn’t secure enough to guarantee predictable cash flow for the life of the lease term. Indeed, a tenant with sub-optimal credit may face trouble upholding its lease obligations, meaning that the landlord/investor who owns the property will encounter market risks associated with this uncertainty and must assume that they’ll need to re-tenant the building sooner than would be expected given the lease term. Therefore, while the building presents as a traditional net leased property—one tenant, a long lease—it offers a different kind of opportunity, one appealing to an investor that wants to actively derive value from re-tenanting or gaming the risks that the tenant presents within a dynamic local real estate market. What this means for prospective buyers is that the property’s long-term lease would not play a determining role in its value.



Credit without Term

Opposite from the above, investors may run across a property occupied by a single tenant that possesses top-tier credit, but where the remaining lease term is relatively short—which in the net leased sector, means a term less than ten years. The investor may assume that such a property offers the cash flow and value proposition typical of the net leased sector. However, this isn't entirely correct. Such a property more or less offers "credit without term," meaning that while the tenant is creditworthy, the property's short lease term means that the landlord faces near-term risks that impede the kind of reliable cash flow that a lease to an investment grade tenant usually provides.

This time, the risks aren't related to the tenant's business fundamentals (as in "term without credit") but instead to the length of the lease term: If the remaining lease term on a property is short, the buyer enters the transaction knowing that a lease renegotiation or tenant replacement is imminent, meaning that rental income variations are likely forthcoming as well as costs associated with repositioning or remodeling the building. While cash flow may be reliable for the duration of the lease and the tenant may be creditworthy, cash flow won't be reliable for long enough to make this property really offer the promise that favorable credit usually provides.

Investment Type

If a property doesn't include the two most sought-after components in the net leased sector—strong credit and a long lease—it needs to be evaluated not as a net leased property but as conventional "real estate." Most net leased investors aren't opportunistic, looking to capitalize on the local real estate market and actively drive value at their properties by re-tenanting them or repositioning them for their local marketplace. Instead, they're strategic, looking for a property already occupied by a solid tenant on a long lease term, a tenant that delivers predictable cash flow. That's why buildings that seem like favorable net leased investments generally require a different investment and purchase approach, and careful price diligence.

Some investors in the net leased space will, of course, seek properties that don't fit the classic net leased criteria, for various reasons. But buyers, regardless, need to understand that lease length and credit rating will function differently in traditional "real estate" investments than they do in traditional net leased scenarios. If a property's tenant doesn't have a healthy credit rating, or a long lease, then the investor needs to look at the property according to the lens applied to a traditional multi-tenant or other commercial purchase. Factors such as current rent versus market rent, anticipated vacancy expenses, price per square foot, and building condition or anticipated landlord-funded repairs must all be evaluated alongside the sale price, even if the property has been positioned by its seller as a net leased building. For investment purposes, it's a building exposed to market fundamentals.

Experienced professionals in the net leased sector can help identify properties appropriate for all investment objectives, and also help with valuation to make sure that building pricing reflects that particular property's value proposition—whether it's traditional "real estate" or a true net leased opportunity with all the benefits such properties offer.

Thomas Company is a boutique commercial real estate brokerage firm providing single tenant, net leased investment brokerage and capital markets advisory nationwide. The firm serves individual and institutional investors, private equity funds, REITs, and developers throughout the United States, helping execute transactions in the complex and growing single tenant, net leased marketplace. Founder Jeffrey Thomas has sold over \$5 billion of net leased real estate since 1997.