



Real Estate & Title Insurance Trends

Credit Tenant Lease Market Likely to Grow

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ONE OF THE MOST common types of commercial real estate ownership in the United States today is the ownership of real property improved with one or more buildings subject to a credit tenant lease. A credit tenant lease (CTL) is a lease where the lessee is an entity whose long-term debt has received a credit rating from one or more nationally recognized rating agencies. Typically, a CTL is long-term, at least 10 years or more, with renewal rights. The annual rental is fixed, with, in some cases, bumps in five- or 10-year increments, and/or percentage rent. The lessee will lease the property for its own use in connection with the operation of its business. The property will be custom built to plans and specifications of the lessee.

Because the property is integral to the lessee's business in many cases, a CTL may contain a right to purchase the property at fair market value or at a fixed price during the term, or in the event that the lessor receives a bona fide offer from a third party to purchase the property.

What makes these properties so popular is that the CTL structure increases the liquidity with which properties trade, increases the proceeds in connection with the financing of such properties, creates a real estate investment product that is attractive to tax-sensitive investors, produces a reliable income stream and involves less intensive management than comparable multi-tenanted properties.

The market for CTL properties is likely to grow as more companies continue their drive toward profitability in these uncertain times. By shedding non-core

assets such as real estate, companies improve current cash flow and earnings per share. Purchasers looking for a reliable income stream or a tax-free exchange to defer capital gain from a real estate sale snap up such properties.

For public companies, the lease of an asset, instead of a purchase, can allow the lessee to exclude the related financing from its balance sheet, and prevents the incurrence of non-cash charges such as depreciation, thereby decreasing leverage and increasing reported earnings per share. Rent payments are typically fully deductible as an ordinary expense. The other side of the depreciation coin benefits the purchaser/lessor, serving to increase its equalized after-tax return and creating an additional incentive for these transactions between public companies and private investors. This increase in after-tax return helps to offset the phantom income created by the non-deductibility of mortgage principal amortization, which affects all property owners alike.

From the purchaser/lessor perspective, CTLs provide a secure income stream from a tenant with quality credit. The day-to-day responsibilities of operating and maintaining the property typically belong to the lessee, with capital items including roof and structure, blacktop and casualty apportioned between the lessor and the lessee. The potential for income loss due to vacancy is often minimized or deferred until the expiration of the lease. The secure income stream provides the real estate investor with an ability to compute, with confidence, its projected internal rate of return (IRR) and to determine whether the transaction meets its investment criteria.

Valuation

The value of a property leased pursuant to a CTL is based upon a number of quantifiable, as well as subjective, factors. Factors that are readily quantifiable are reflected in the current IRR established by the market with respect to leases with a particular lessee, and the net present value of the future income stream discounted by an interest rate that coincides with the lessee's current credit rating. However, the interest rate used may in fact be higher than the interest rate currently being offered on equivalent corporate bonds issued by the lessee. This anomaly presents itself when the debt used to purchase a property leased pursuant to a CTL trades at an interest yield higher than the equivalent corporate bond yield of bonds issued by the lessee. Because the rental stream paid by the lessee secures the debt, a natural presumption is for the corporate debt of the lessee and the debt secured by a rental stream paid by the lessee to trade at equivalent yields. However, this is rarely the case.

After analyzing a CTL property from a quantitative viewpoint, the first qualitative range of issues that requires exploration is the respective obligations imposed on the lessor and the lessee. The allocation of responsibilities between the parties directly affects the valuation of a CTL property. After all, it is the amount of net income that may be applied to the interest and principal payments on the lessor's financing that determines value.

Toward this end, a thorough review of the lease by the purchaser/lessor is required to properly evaluate the CTL property. For instance, the lease may allocate day-to-day maintenance and

repair obligations and the payment of real estate taxes and insurance to the lessee, but require the lessor to pay for capital repairs such as roof and structure and resurfacing the blacktop. Relatively minor omissions in the lessee's repair clause can cause a lessor to incur substantial capital costs. The failure to state that the lessee is responsible for not only the repair of a particular item but the replacement as well may impose a significant hidden cost. If there are offset rights under a CTL, then they should be clearly spelled out rather than a mere generalized statement that except as set forth herein there are no offsets.

Lease review is full of subjective considerations, and each CTL purchaser's sensitivities vary in this regard. Not surprisingly, these sensitivities can also vary depending upon the viability of the underlying real estate for alternative uses. In all events, however, the failure to clearly allocate the maintenance and repair obligations or offset rights under a given CTL will significantly reduce its attractiveness to a lender and the resulting value of the property. Unfortunately, except at the initial structuring of a sale/leaseback with the end user or as part of the negotiations during the building and development stage, purchasers rarely get the opportunity to negotiate the terms of a CTL. Rather, due to the liquid nature of CTLs, as discussed above, they are often traded in a secondary market where the lease terms are already fixed.

The second qualitative range of issues relative to determining the valuation to be placed on a CTL relate to the projected appreciation of the underlying real estate. Generally, appreciation can be achieved in two forms. The first results if the real estate selected by purchaser/lessor appreciates over time. The second results if the concomitant rental payments under the lease are used to pay the interest and principal on the financing. If the loan is self-amortizing over the term of the lease, then each rental payment reduces the principal balance of the loan, resulting in a zero balance at the end of the term.

The purchaser/lessor needs to be aware, however, that how a loan is structured, whether self-amortizing, balloon payment or a combination of both, is dependent

on its ability to digest phantom income or to offset the same with adequate rental income or depreciation in order that the property does not produce a cash deficit on an after tax basis. This range of issues is the most subjective of all because it requires an understanding of each particular investor's projection of future appreciation potential and existing income tax parameters.

'Net' Lease

Real estate professionals throw around terms such as net, double-net, triple net, bond lease and the like, but what do they really mean? Clearly, the degree of netness is a major factor when determining the value of a CTL property. The terms are routinely misused.

In broad terms and at the risk of oversimplifying: (i) a single net lease imposes legal compliance solely with respect to the lessee's use, and the payment of taxes and insurance on the lessee, and imposes on the lessor everything else; (ii) a double net lease imposes the lessee obligations set forth in item (i) above plus repair and replacement of plate glass and signage, and day-to-day maintenance, while roof, structure and other items of a capital nature, restoration of fire damage, condemnation and replacement of mechanical systems and legal compliance due to defects in construction are imposed on the lessor; (iii) a triple net lease imposes the obligations set forth in item (ii) above on the lessee plus roof and structure and other items of a capital nature, while restoration of fire damage and condemnation may be imposed on the lessor; and (iv) a bond lease imposes all responsibilities for the property on the lessee and may either obligate the lessee to restore the property in the event of casualty or condemnation or obligate the lessee to make a rejectable offer to the lessor to purchase the property at a defined termination value, generally pegged at some percentage value over the outstanding principal balance of the loan plus a yield maintenance premium.

In a purchase of a CTL property certain risks, such as liability for roof and structure, can be reduced by availability of builder and suppliers' warranties. Toward

this end, investigation should be made as to the availability and the scope of applicable warranties covering elevators, HVAC, roof, blacktop and other service warranties. Upon expiration of these warranties, the obligation to replace these items is usually imposed on the lessor. As such, appropriate reserves for replacement will need to be built into the cash flow projections and may in fact be mandated by lenders.

Damage caused by fire or other casualty should largely be covered by insurance, but certain issues nevertheless arise in the event damage occurs. The fire insurance will generally be carried by the lessee on a full-replacement basis. The proceeds may be held by the lender and applied as the work progresses. The lessor and the lessee must be careful not to allow the lender to apply the same to the reduction of the debt. The lease may contain a termination right if the property is significantly damaged particularly towards the end of the term, generally during the last two years. Typically, the lessee is obligated to purchase rent insurance. The lease should provide for adequate rent insurance to cover this shortfall. However, rent insurance will not release the purchaser/lessor from its obligation to rebuild the building or pay off a balloon payment.

In the present climate, close attention is required to the particulars of many insurance policies including exclusions for terrorist acts and toxic substances. As insurance premiums escalate, many lessees attempt to include self-insurance options in their leases, and careful consideration must be given to the ramifications of these self-insurance clauses. Lenders often require the lessee to satisfy certain net worth and/or credit tests in connection with the right to self-insure.

Contamination of the property by hazardous materials creates certain issues that are generally readily resolved. If the lessee causes contamination, the lease will allocate responsibility to the lessee. If the condition is pre-existing, then purchaser's due diligence should reveal such a condition. The allocation of responsibility may also include broad indemnification by the lessee against claims and the removal by the lessee of the objectionable material particularly in

the triple net and bond lease contexts.

It is axiomatic that the greater the liabilities of the lessor for the maintenance of the CTL property, the higher the IRR will be on the property where the credit ratings and value of the underlying real estate are comparable. What does this mean? Depending on interest rates and the purchase price for the property, the purchaser/lessor's cash-on-cash return will be higher on a double net property than on a triple net property. In exchange for the assumption of greater risk, the prudent purchaser/lessor will need to set aside greater reserves for the property.

Financing

Typically, a purchaser/lessor will finance a portion of the purchase price of a CTL property. In arriving at its underwriting decision, the lender will request and consider copies of the lease, and engineering, environmental, appraisal and title reports concerning the property. In broad terms, based on the appraisal, the lender will examine the loan-to-value ratio (LTV) sought by the purchaser/lessor (which can be as high as 100 percent), the loan to dark or as vacant value of the property, the debt service coverage ratio, the net present value (NPV) of the future rental stream payable under the lease, the credit rating of the lessee and the allocation of responsibilities between the lessor and the lessee pursuant to the lease. For instance, the lender may decide to lend \$4 million based upon an 80 percent LTV, with an NPV of \$5 million and a credit rating of A- on a double net lease. The lender will address factors such as allocation of responsibilities under the lease, and building and environmental condition of the property separately.

Lenders commonly use lock-box arrangements when funding the loan for the receipt of rental proceeds. Under such an arrangement, the rents are applied in cascading fashion to various purchaser/lessor obligations in a priority established by the lender. These obligations may include reserve accounts established for taxes and insurance (even if reimbursable by the lessee to the lessor) or for the purchaser/lessor's responsibilities under the lease, repair of existing conditions disclosed in the engineering and environmental reports, and monthly debt service, with remaining amounts

remitted to the purchaser/lessor. By the time the reserve accounts are funded, the funds available for distribution to the purchaser/lessor can be significantly less than originally anticipated.

The purchaser/lessor's cash flow projections will need to take into account the reduced amount of funds available for distribution. To the extent that the obligations reserved for by lender are the lessee's obligations, the purchaser/lessor needs to verify that the lease requires such amounts to be paid in the manner required under the mortgage or that the lender will waive such reserve requirements.

With the exception of certain limited circumstances, the loan documents will generally be nonrecourse against the purchaser/lessor. Such limited circumstances are referred to as nonrecourse carveouts. Nonrecourse carveouts generally impose full recourse liability on the purchaser/lessor and a principal with a specified net worth to the extent of losses incurred by the lender as a result of fraud, waste, misappropriation of insurance, condemnation proceeds or rents, bankruptcy, and defaults under the lease that give rise to lessee set-off, abatement or termination rights.

In some cases, the lender may impose full recourse liability on the purchaser/lessor and the principal for losses due to the default of the purchaser/lessor under the lease that gives rise to a lessee termination or a transfer or encumbrance of the property without the lender's consent. The purchaser/lessor should obviously endeavor to delete or scale back these particular carveouts. At the very least, the purchaser/lessor needs to be certain that it is not personally liable for lease defaults that are not the result of its willful acts.

Depending on the structure of the loan, whether it is self-amortizing, a balloon payment or a combination of both, the lender may purchase residual value insurance (RVI). RVI protects the lender against the risk of an unforeseen decline in the market value of the property. The insurance guarantees a specific dollar amount for a property at the termination of a lease or balloon note. This is useful if on the maturity date of the loan, the purchaser/lessor is unable to pay off the remaining balance of the loan and the proceeds from the sale of the property are insufficient to cover the shortfall.

Conclusion

CTL properties continue to be increasingly sought after commercial properties. Quantitative factors such as a reliable rental stream, a defined credit rating and the availability of rental market comparisons offer the transparency and consistency required to meet the expectations of many real estate investors. Subjective factors such as potential for appreciation and accelerated after-tax returns metamorphoses an investment with fixed income characteristics into one with unlimited upside potential. Companies seeking to remove non-core business assets or to avoid the depressing effects of non-cash charges against earnings view CTL as an essential tool. The higher yields afforded above equivalently rated corporate securities also provide lenders with an attractive investment alternative to the traditional bond and treasury markets.

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