**SPECIAL TO: *Real Estate Issues***
**(The Counselors of Real Estate)**
**ATTN: Faye Porter, Editor**

# Elusive Sources of Capital Forcing Corporations to Re-Focus On Benefits of Sale-Leaseback Deals, Triple-Net Leases

*Uneasy stock market also propels investors toward sale-leaseback opportunities.*

*By Jonathan S. Horn, President*
*Horn Capital Realty, Dallas*

For nearly four decades, "Turn concrete into cash" has been the heraldic cry of America's leading lessors of net-leased corporate property. Now, more than ever, the declaration seems *en vogue* across the land.

Of course, few observers would argue with the authoritative statement by the *National Real Estate Investor*: "The sale-leaseback industry has restructured the ownership of trillions of dollars worth of the nation's corporate real estate assets." Even fewer critics would dispute *The CPA Journal* comment that the "National franchise and chain businesses have led the way in using sale/leaseback to benefit business owners, but the system can work for any business -- small or large."

Fact is, funds from sale-leaseback transactions have fueled leveraged buyouts, mergers and acquisitions; underwritten the maintenance and technology to remain competitive, and erased obligations from countless corporate balance sheets nationwide.

Recent developments in the corridors of capital, up and down Wall Street and inside the Internet scene, however, seem to have conspired to further restrict access to traditional cash resources by mainstream companies. Subsequently, firms finding it increasingly difficult to attract cash for bricks-and-mortar growth, geographical expansion or competitive marketing

campaigns appear to be seriously revisiting the concept of sale-leaseback transactions and the benefits they afford.

An interesting recent example is **Carmike Cinemas, Inc**. (NYSE-CKE) of Columbus, GA. In mid-April, the 18-year-old firm, which had 458 theaters (2,848 screens) in 36 states at Dec. 31, 1999, completed the sale and leaseback of $23.5 million in three properties – 41 screens in three states – to an undisclosed investor The Carmike complexes included a 10-screen operation in Missoula, MT; a 15-screen facility in Raleigh, NC, and a 16-screen unit in Johnston, IA.

Carmike Cinemas (**www.carmike.com**), dedicated to maintaining its position as one of the strongest theatre circuits in the industry, had to change its growth strategy in recent years. It moved from the selective acquisition of theatres and circuits located in small to mid-sized communities to constructing new theatres and expanding its existing complexes. That includes retrofitting some of its older properties with stadium seating and digital stereo surround sound.

Obviously, cash is the key to completing the competitive retrofits and to opening five additional theatres (88 screens) in Alabama, Florida, Minnesota, North Carolina and Tennessee by mid-2000. A comment by Martin A. Durant, SVP and Chief Financial Officer of Carmike Cinemas, to the Dow Jones Newswire, reflects the importance of sale-leaseback as a capital resource:

"The ability to turn high-performing assets into cash when so much investment capital is flowing into other industries offers us fresh resources to maintain our steady pattern of growth and to improve existing properties,"

There is no question that the theater industry, with its specialized, single-tenant facilities is ideal for triple-net (NNN) deals. It's also one of the last frontiers to be discovered by investors

seeking conservative types of passive investments. But Durant's point is applicable to many industries and numerous corporations challenged to turn non-performing as well as high-performing assets into available capital for additional growth.

**The Current Money Chase**

Let's first examine some of the reasons many traditional corporations, "old economy," if you prefer, are finding it increasingly more expensive to borrow money in 2000:

- Telecom, wireless, biotech, and dot-com (Internet and e-commerce) operations – both ongoing entities and aspiring initial public offerings -- have literally sucked billions of dollars into perhaps the longest sustained bull market in Wall Street history. Until last spring technology issues were the darlings of investment bankers and hungry investors, venture capital firms and "angels" couldn't wait to crown the next dot-com entrepreneur with a garland of greenbacks – large denominations, primarily. The Nasdaq or "new economy" looked glandular, unstoppable.
- The surge in 401k and other savings plans across the employer-employee landscape pushed more funds into mutual funds, stocks and bonds and away from low-paying savings accounts and dull certificates of deposit.
- Then, in mid-May, the Federal Reserve Board raised the key short-term interest rate a half percent – its sixth increase since June 1999 – and set off a chain reaction as banks ratcheted upward their own interest charges to reflect their new costs. The lingering uncertainty of additional rate increases, possibly before the Nov. 7 elections, is expected to further slow consumer spending and economic growth, as well as trigger some heart-stopping corrections in the market.

Not only have traditional borrowing sources been displaced as funds feverishly pursued new, promising opportunities proffered by the Information Age, but some nervous investors are now moving their money to the conservative sidelines . . . or saying goodbye to it all together as dot-com ventures consolidate, retrench and evaporate entirely.

## Basic Tenets of Sale-Leaseback and NNN

Net-leased projects most commonly involve a company selling one or more single-tenant properties to an investor (individual, company, pension fund or group), usually for *fair market value.* The investor/landlord provides the seller with a triple-net lease for a negotiated period of 10 to 25 years. The seller/tenant usually pays the investor a negotiated annual rent equal to 8% to 15% of the contracted sale price. Most often, the lease rate is credit-driven and constant. If agreed to, there may be scheduled rent increases.

Net-net-net refers to the payment of property taxes, maintenance and insurance. In a NNN lease, the single tenant agrees to pay all the expenses associated with the property use and occupancy, including the cost of insurance, real estate taxes, improvements, on-site property management and maintenance, in exchange for control of the property and a favorable long-term lease.

NNN investments are available for all types of existing or build-to-suit real estate, including service centers, fast food establishments, industrial and health care facilities, office and educational buildings, distribution warehouses and retail stores.

**Corporation/Tenant Viewpoint:**

Most companies require real estate to conduct their businesses, however few firms profit from owning those properties. The cash and credit they have tied-up in facilities and land represent assets that could be employed much more productively in the corporation's core

business operations. Directors and officers are constantly faced with the question of how the company will pay for or finance the cost of the properties without tying up operating dollars, without severely impacting its credit facility and loading up their balance sheet with debt.

The question is fraught with a variety of uncertain variables, including the present and future costs of money, projected tax benefits, maintenance and rental costs, and the accounting treatment. Then there is the guessing game on the expected future value of the real estate in 10, 20 or 30 years.

A triple-net leasehold obligation that qualifies as an operating lease under the criteria set by the Financial Accounting Standards Board, however, will not appear on the tenant's balance sheet as either debt or long-term obligation. The corporation pays off the mortgage obligations and receives the unlocked cash from the sale of its depreciated real estate.

The improved debt-to-equity ratio and current ratio can make a seller/tenant much more attractive to banks and other traditional lenders, as well as to shareholders, prospective investors and potential acquisition partners. Short-term borrowing can be avoided and a need for credit lines possibly eliminated.

In addition to expense reduction and the conversion of the seller/tenant's illiquid real estate assets to capital, a sale –leaseback with a properly structured operating lease can provide the seller/tenant company with the following business advantages:

- 100% financing based on the assessed value of the property, in contrast to the 50% to 85% usually provided by mortgage financing;
- Full operating control of the real estate under the tenant's lease provisions;
- Operating leases that do not appear on the corporate balance sheet as debt or as a long-term lease obligation;

- Tax deductible lease payments, that is a lower after-tax cost;
- Effective land depreciation; (*NOTE:* Since the value of the land acquired is factored into the rent, the tenant can effectively depreciate the land by deducting the rent under the lease attributable to the land.)
- A fixed rent structure with no inflation adjustments provides inflation protection
- Cash realized from the sale-leaseback transactions that can be used to enhance liquidity, expand operations, acquire other businesses, reduce debt, invest in 1031 exchanges, etc.

In the area of acquisitions and leveraged buy-outs (LBOs), a sale-leaseback can be Utilized as part o the overall transaction. A corporation planning to acquire another firm – or even their own companies through an LBO – can use the assets of the acquired company to reduce total acquisition cost. The need for higher-cost debt and lengthening the maturities o the overall financing is reduced.

Taking a long view, many executives express concern about their tenant options when the lease expires. Three choices emerge: a) the tenant can renew the lease at a new negotiate rate, or b) if the tenant had a renewal clause in its initial lease, it could exercise its option and re-lease the property from the landlord at the rate specified in the clause. And c) the tenant can also move to a new location.

**Investor/Landlord Viewpoint:**

Commercial property ownership under a NNN lease agreement has emerged as a highly popular and effective strategy in real estate investing in the past decade. *Business Week* has called triple-net lease real estate "a smart idea…for risk-averse investors seeking a steady source of income."

Banks, trusts, pension funds, REITs and other conservative investors are probably the best candidates for these types of investments. They share homogeneous objectives: safe, passive real estate investments designed to provide predictable, advantageous annual cash income, tax reduction benefits and the opportunity for significant long-term gain.

A sale-leaseback investment with a triple-net lease (NNN) provides that unique investment opportunity to individuals or institutions interested in owning real estate without the hassles of management and leasing typically found in conventional real estate investments. Such transactions generally require a long-term investment of $1 million to $100 million.

As noted previously, the cash-on-cash rate of return varies, depending on the tenant's financial strength. For example, a new franchisee might be considered the highest risk. A multibillion-dollar, profitable corporation with good management, one that has always fulfilled its lease obligations, would be the lowest risk and earn the lowest rate for the investor.

A NNN lease is considered a *passive* investment, since minimal or no landlord responsibility is required. The single tenant agrees to pay all costs associated with the property use and occupancy, including real estate taxes, insurance, improvements, on-site property management and maintenance. As a result, the investor has the ability to invest in geographic markets beyond his own immediate location, without day-to-day involvement required of a multi-tenant lease.

From another view, commercial tenants can be equated to "positive renters." Unlike apartment renters, for example, they are less likely to abuse the property and then relocate, saddling the owner to refurbish and to find new renter. Commercial tenants have a vested business interest in seeing that a location is well maintained and attractive to customers

A NNN property is effectively a long-term bond of a corporation in the form of a lease document encompassed by real estate. The investment appears to be a bond-type investment due to the "coupon-clipper" type of returns; however, they also provide the added benefits of tax and appreciation found in conventional real estate.

Strictly defined, the *bond-type* transaction usually involves a 20- to 25-year net lease, while a *real estate* net lease transaction typically has a term of 10 to 15 years.

The property types of net-leased investment are usually categorized in one of three ways:

1. **Retail** refers to *big-box* users (i.e. discount variety stores, department stores, or home improvement stores) as well as *small-box* users (i.e. restaurants or drug stores).
2. **Industrial** includes facilities used for distribution, manufacturing, or research and development.
3. **Office** refers to any single user such as an oil company or pharmaceutical company occupying a facility as the sole tenant.

Pricing on net-leased projects is based *primarily* on the tenant's a) credit, b) the lease, and c) the location. Although each of these variables has an important role in the pricing of net-leased projects, it is the culmination of all *three* that determine a true purchase price.

*A) Tenant's Credit*

- Many net-leased projects are based solely on tenant's credit. Therefore, it is important that investors evaluate the financial strength of a prospective tenant on its own merit and as a competitor in its industry. Consider the long-term stability of the tenant and that industry during good economic times as well as recessionary periods. Industries that provide basic products and services are usually recession-proof.

- Tenants considered "investment grade" by a recognized rating agency usually trade at a premium (i.e. Wal-Mart, Walgreen's, General Motors).
- Tenants with *junk bond* (non-investment grade) ratings or minimal net worth typically trade for a higher return (i.e. BJ's [Waban], SportsTown, Dairy Mart).

*B) Lease*

- *Length* of a lease is a primary factor in determining the sales price. Primary terms of 15+ years are preferred, but 10 years are sufficient in 1031 tax-deferred exchanges and similar cases.
- "Absolute" triple-net leases -- tenant responsible for roof, structure, and parking -- trade at a premium.
- "Double-net (NN)" leases—landlord responsible for roof and structure—trade at a higher yield and usually include a reserve taken for any potential repairs.
- Leases with built-in "bumps," or rental rate increases, trade at a premium with the exception of flat leases with investment grade credit

*C) Location*

- NNN leases are credit-driven, causing location to be the least important factor.
- Investors often pay an added premium for the residual benefit of the location.

The combination of credit, lease and location can lead to paying a higher premium (i.e. Wal-Mart: 20-year absolute NNN, flat) or receiving a higher yield (i.e. CSK Auto: 15-year NN, bumps).

Yield on a triple-net lease property is composed of three components, beginning with the cash-on-cash return, which is the total annual lease payment as a percentage of the total cash invested in the property.

The second component is the dollars sheltered from federal income taxes. A portion of the cost of the property is allocated to the building and the balance is allocated to the land. For tax purposes the owner may depreciate the cost of the building over a designated period of time. Thus, the portion of the annual cash-on-cash return, which is no greater than the annual depreciation, is sheltered from the long arm of Uncle Sam.

The final component is the compounded annual appreciation rate as a percentage of property cost, since well-maintained real estate traditionally will appreciate substantially in value during a long period of time.

On the positive side, a lease also can be written to provide the opportunity for rent increases as a hedge against inflation. Another hedge may be in establishing a minimum lease payment plus a reasonable percentage of the tenant's gross sales above an established annual base.

## Investor Prudence and Risks

An over-riding concern of most investors new to sale-leaseback deals is the amount of management required. Although the tenant maintains and manages the property, insures the real estate, pays property maintenance expenses, and remits taxes directly to taxing entities, the prudent landlord will take some protective steps.

Investors should always review a lease agreement with competent legal and tax advisors to avoid unexpected expenses. For example, unless specified as a tenant's obligation, intermittent, additional tax assessments during the term of the lease may be determined to be the owner's responsibility. Unless properly detailed as a tenant responsibility in the lease document, all types of structural repairs (roof leaks, foundation problems) may become the owner's responsibility.

To further reduce risk, he investor/landlord will arrange periodically check with the taxing authorities to verify timely receipt and payment of all tax obligations. The investor also should periodically search the title to the property to make sure no liens or other encumbrances have been negligently filed against the property. The lease agreement also should require the tenant to pay any *property taxes under protest* to avoid the (investor's) loss of the property through nonpayment, or the investor having to pay the property taxes

The investor/landlord also must receive current endorsement certificates from the tenant's property and liability insurance carrier indicating that the policies are in force and that the limits of the policies are sufficient to cover risk, the current market value of the property, and that the investor/owner is named as the additionally insured.

The major risk for investors in a sale-leaseback, triple-net lease investment is tenant default – bankruptcy, reorganization, etc. Before a tenant becomes a total default, it usually becomes a slow pay or communicates problems to the landlord. The investor's options include defaulting the tenant, canceling the lease and re-leasing the property to a new, creditworthy tenant at an equal or higher rate. Or, the investor might sell the property for a profit and reinvest the gain in other real estate.

Obviously the investor/landlord wants to act quickly at any signs of financial difficulty to avoid limiting his options. If the tenant is forced into an involuntary bankruptcy, the investor could be drawn into the litigation, and the monthly income stream (rent) would be interrupted. The investor might decrease risk by including a security clause in the lease in which the tenants' equipment is pledged as additional lease collateral. A default would then allow the landlord to seize the equipment.

On the cautious side, investors should be wary of "recapture clauses," which permit the tenant to subtract increases in property taxes, maintenance expenses and/or insurance premiums out of any percentage rent that might otherwise be paid.

**Overview of Investor Benefits**

Any "Sale-Leaseback 101" discourse would be incomplete without a snapshot of the primary benefits of NNN investments to the Investor/Landlord. Here's our top 10 list:

- Security of both the tenant and real estate
- Hassle-free transaction with minimal costs
- Annual high interest cash return on a passive investment
- Property depreciation tax-shelters a portion of the annual cash return
- The value of the real estate frequently appreciates during the lease term
- Minimal risk occurs with investment grade tenants
- The opportunity exists for higher cash returns from less-than-investment-grade tenants
- The investor does not pay for property insurance, maintenance, improvements or taxes.
- The investor can cash-out at any time, often with a profit, by selling the property, or hold the property, allow it to further appreciate in market value, and lease it again at a higher rate to the original tenant or a new tenant when the lease term expires.

The market for net-leased real estate investments is strong currently. The availability of attractive financing coupled with minimal landlord responsibilities creates highly desirable commodities, especially for investors desiring a property for an IRS Section 1031 tax-deferred exchange.

In such a case, the corporate seller becomes an investor itself for a good reason – to avoid significant taxes on the income from the sale. By reinvesting the income in a timely manner into single tenant NNN real estate, the corporate seller can save 100% of its tax obligation. IRS Section 1031 permits this maneuver, which can ultimately provide its shareholders with revenue from a relatively secure investment vehicle with little or no management responsibility.

*(But, as they say in Texas, "That's a whole nuther story.")*

**Conclusion:**

Corporations facing critical crunches in credit and capital, as well as wary (and weary) investors looking for more conservative, long-term opportunities should seek the common ground of well-conceived NNN sale-leaseback transactions. Whether an individual or institution is in need of a smart depreciation vehicle or a relatively safe "coupon-clipper," net-leased properties provide great investments in both credit and real estate markets. The longtime popularity of net lease transactions appears to be in for an extended run, thanks to recent stock market gyrations and the Fed's unflagging resolve to cool the economy.

**About the Author:**

*Jonathan S. Horn is founder and President of Horn Capital Realty, Inc. of Dallas, (www.horncapital.com),which specializes in Strategic Conversion of Real Estate to Capital ™. Horn has personally handled more than $400 million in sale/leaseback deals, net-leased sales and debt-and-equity placements, and Triple-Net (NNN) investments in U.S. markets. Corporations involved include such large national tenants as Blockbuster Entertainment, Eckerd Drug, Kmart, Home Depot, Wild Oats Markets, Taco Bell, Wal-Mart and Walgreen Drug Stores. Horn, who earned a B.A. degree in Economics from the University of Texas at Austin, has been in the commercial real estate business since 1990. The former Vice President-Retail Division at Henry S. Miller Commercial, Texas' largest independent real estate services firm, started his own company in 1996.*