

# Triple-Net Sale/Leasebacks

by  
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## Overview

In leaseback transactions, the owners of triple-net properties sell their building that they fully occupy, and then lease the space back from the buyer. The sale/leaseback unlocks the corporate capital trapped in under-performing real estate, and provides a cash infusion to be used in expansion or other related areas of the company’s core competencies. The higher the credit rating, the less reliance is placed on the quality of the real estate.

Today’s low interest rates have driven capitalization rates down and real estate values up. Now is the perfect time for companies to sell and lease back their real estate facilities. When interest and cap rates rise (and they will rise), the window of opportunity could close.

Many property buyers offer companies a simplified real estate sale/leaseback program. The buyer purchases a company’s facilities at 100 percent of fair market value and leases them back for as long as the tenant company needs them, whether it is 15, 20, 25 years, or longer. The parties create a “bond” or “bondable” net lease whereby the tenant is responsible for 100 percent of the property’s expenses and the property is customized to fit the tenant’s needs. Rents can be fixed, stepped, or periodically reset to best meet financial or tax goals and to take advantage of new financial conditions and contingencies. The tenant frees up valuable capital

and retains full operational control of the property with an off-balance-sheet transaction that can also enhance the company’s financial statements.

The credit net leaseback is a cost-effective alternative to investing in corporate real estate. It is also a capital management tool that allows corporations to use and control essential real estate and commercial property without employing vast sums of debt and equity in a non-liquid, poorly perceived asset class.

The properties can be:

- retail stores of a large chain store
- industrial facilities
- corporate headquarter buildings
- power generating plants
- large office complexes
- toll roads and bridges
- hospitals
- water treatment facilities
- airports
- large manufacturing plants
- refineries, and more

A sale/leaseback provides a company with access to up to 100 percent of the value of those fixed assets, generating funds that can be used for other corporate initiatives or liquidity, while providing the company control of its facilities.

**Analysis and Creation Criteria for Triple-Net Sale/Leasebacks**—In 1999, the California

Public Employee's Retirement Systems issued a "Statement of Investment Policy for Real Estate Sale/Leaseback," Copyright © 1999 by CalPERS

That statement provides an excellent analysis and guide for structuring sale/leasebacks from the buyer's (landlord's) point of view. In pertinent part, the statement defines:

#### IV. INVESTMENT APPROACHES AND PARAMETERS

##### A. Risks

Primary risks associated with the Program are two-fold:

1. Tenant credit risk
2. Real estate risk

Tenant credit risks include risks associated with relying on the business success of usually one tenant and that tenant's ability to pay rent, other property expenses, and maintenance obligations of the property. Comprehensive evaluation of the credit-worthiness of the lessee and proper structuring of the lease includes financial covenants and event risk clauses. The continuous monitoring of the financial health of the lessee throughout the lease term can significantly minimize exposure to tenant credit risks. The structure of leases to corporations ensure a priority position to unsecured, general obligation bonds, which mitigates the risk of loss in bankruptcy.

The Program is also subject to the general risks associated with the ownership of real estate. Those risks include adverse changes in economic conditions, property supply and demand, as well as tax and environmental laws. In particular, functional and economic obsolescence, locational demise, environmental problems, and extensive specialized tenant improvements are all factors that potentially diminish the marketability of a sale/leaseback property in the future. Of particular concern are factors such as a tenant's space needs, which impact the tenant's long-term commitment to a property. Real estate risks can be mitigated by comprehensive due diligence, real estate underwriting, and continuous monitoring of the real estate investments....

Additionally, the following tenant, lease, and property characteristics are critical to the success of real estate sale/leaseback investments. In general, they shall be contained in the negotiated agreements. When agreements differ from these terms, the advisors or management firms shall identify the differences to the System.

**(1) High Quality Credit Tenants** - Tenants shall generally possess the following: an investment grade rating (generally BBB and above, or the equivalent); favorable positioning in a stable or growing market or business niche; strong financial performance; favorable business prospects or outlook; and shall not be subject to excessive leverage. High quality tenants are critical to low re-leasing risk, which is important in investments in single-tenant buildings.

**(2) Long-term Lease** - The lease terms shall generally range from 10 to 20 years. Leases of this length allow for the sale of the investment in years five to 10, with a marketable lease term remaining. Consideration of shorter leases may occur under special circumstances such as when properties possess below market rents, strong tenant demand, superior location, and/or expansion potential.

**(3) Triple-net Leases** - Leases shall obligate the tenant to pay for all or substantially all operating expenses and capital expenditures.

**(4) Rent Increases** - Additionally, the structure of leases shall include periodic rent escalations tied to the Consumer Price Index (CPI) or based on negotiated fixed increases. During periods of low to moderate inflation, these rent increases generally provide adequate inflation protection.

**(5) Financial Covenants and Event Risk Language** - Leases shall contain financial disclosure and event risk clauses such as anti-dilution provisions and net worth tests for protection against loss of value because of a financial event that could diminish the credit-worthiness of the tenant. The structure of leases shall ensure that the tenant is required to pay rent under all circumstances. The lease structure shall protect the System from unexpected financial obligations in the normal course of operations as well as under troubled circumstances.

**(6) Competitively Located Properties in Strong Markets** - Properties shall be well located in markets with favorable supply and demand characteristics.

The above CalPERS' guideline is a good start to the creation of a secure sale/leaseback product for investment and/or resale into the market.