CRIC2 FUNDS

Tough Times Call for Net Leasing

by Ethan Nessen

As a real estate finance professional, it is wonderful to see that the mistakes made by the real estate industry in the late 1980s can be replicated with devastating accuracy by other industries. In the late '90s, the telecommunications industry has proven that any industry combining meteoric growth and computer spreadsheets can do themselves in.

In the 1980s, if a city needed two hotels, like the sun rising in the morning, you could depend on eight developers to come in and build eight. Of course, this phenomenon was not limited to hotels. We can travel the country and view, in all their splendor, an endless supply of industrial, suburban office, urban office, and retail facilities. For a long time I was convinced that laser tag was the ultimate solution for overbuilding, but the rest of the real estate industry did not share my vision. The good news is that eventually we did grow into the additional capacity. It took time, some people lost a lot of money and some people made fortunes, but eventually the real estate industry and the economy emerged stronger than ever.

The economic boom of the '90s has been hailed as the greatest economic cycle in the history of our country. It was fueled, of course, by a technological revolution that has radically changed how we process and deliver information. It was a sustained period of growth that economists had never seen before, and almost every industry type came along for the ride. The net lease industry was no exception, except that it rode on the coattails of the economic boom, picking up the scraps off the table of prosperity.

The truth of the matter is that net leasing does not always prosper during prosperous times. The reason for this is simple. During boom times, public money is cheap and plentiful. Wall Street stands in line to issue billion-dollar bond offerings and IPOs, and companies can focus on growth without worrying about capitalization. But when the gravy train stops, it can get ugly.

During boom times, public money is cheap and plentiful.

Some of us in the real estate community genuinely feel badly for the casualties of the telecom world. We have been where they are and for many of the same reasons. For instance, more than $240 billion of high yield debt has been issued to aid telecom companies in the construction of the information superhighway. To put this in perspective, that is more than all of the junk bonds raised in the '80s.

Unfortunately, we are currently using only 3 percent of all the fiber optic line that has been installed. Furthermore, the cost of actually activating the additional line is $500 billion. Many people ask, "how could this happen?" The casualties of real estate can answer this question easily— assumptions of unlimited growth. While "if you build it they will come" works in the movies, it often fails in the business world. During the dot-com heyday, annual growth estimates of Internet use ranged from 200% to 800%. Just as in real estate, a spreadsheet proforma showing perpetual growth creates tantalizing results. The problem is that a spreadsheet is only a spreadsheet, and we often forget that assumptions do not automatically become reality once they are put into a spreadsheet. As seductive as these models appear, they have led to the same disastrous conclusions that the real estate community went through in the '80s. Eventually, we will grow into the surplus fiber optic capacity. The only question is when? This was the same question that was asked about excess real estate in the '80s (can anyone say RTC?).

Fortunately, the impact of the telecom decline has not led to the widespread recession experienced in the late '80s. The economy has slowed down significantly, but for now it seems to be keeping its head above water. Capital has again become a more important and concerning subject to Corporate America. These factors create an ideal atmosphere for the net lease business. As companies adjust to the reality

that growth is a cycle and not a permanent state, they need to focus on how they capitalize their operations.

Off-balance sheet financing options, which help maintain flexibility with other capital providers, are again becoming a vital part of companies' capitalization strategies. Companies are questioning more and more the virtue of owning illiquid assets. In the past, many companies never had a philosophy against net leasing, but with abundant access to debt and equity, never felt the need to monetize their assets. A common theme was "what would we do with the money?" Today many companies need diversified sources of capital, and net leasing often fits their corporate capitalization objectives.

How long this environment will last is difficult to say. Eventually, Wall Street will be lining up again to lend money. My guess is that it will last until the telecom bloodbath is resolved and the survivors are determined. But like assumptions in a spreadsheet, it's only a guess. ●

Ethan Nessen, Principal of Boston-based CRIC$_2$ Funds, oversees the structuring and financing of net leases and sale-leasebacks.