

# Trends in Real Estate Net Leasing

by Robert L. Nessen

*Net leasing has weathered  
the times, and continues to be  
a valuable financing vehicle*

Net leasing is the Old Man River of real estate finance. It just keeps rolling along. Since I'm almost as old as that River – having spent more than the last 40 years as a witness to the ups and downs of this business – I can speak with authority when I say that leasing has never been more popular than it is today.

With the current economic slowdown, net leasing is proving to be a solid way of raising capital with a cost of funds that is usually much lower than direct borrowing costs. But where is it going to be when the economy improves?

My opinion: net leasing will continue to prosper, but at a more moderate rate, while other areas of real estate begin their periodic (every 10 years) decline. Although I'm the guy who predicted an Adlai Stevenson landslide in 1952, a blowout by Sonny Liston of Mohammad Ali in the early 1960s and a Fred Harris presidency beginning in 1976, here's why I'm right this time.

Real estate professionals never cease to be amazed at how resistant net leasing is to the enormous swings in the real estate industry. While almost every other form of real estate seems to add proof to the big bang theory of the universe – with pulsating booms and busts – net leasing never goes to these extremes. Investors in net lease transactions may not make fortunes, but they don't lose them either, and for good reason.

Net lease transactions may look like real estate investments, but, when you scratch them, you find they are really credit investments – based upon the credit of the lessee and not the real estate. The rents are based upon the lessee's bond rate and not real estate market rates. At the end of the lease term, usually between 15 and 20 years, the investor will own a residual interest in the property. But unless there is a remarkable burst in values over the lease term, the investor's return will be tied closely to the return it would get from investing in a bond of the corporate lessee. Accordingly, the investment is in essence a bond with a residual kicker.

*Corporations are striving for liquidity; and the ownership of real estate does not meet that objective.*

Although net leasing could be characterized as a “moderate” investment, the spurt in its growth over the past few years has been anything but moderate. There is one reason: the corporate need for liquidity.

I have learned when hiking that when you get a sore back you don't just dump your unnecessary gear. Rather, you lighten your load from the beginning and then you will never get a sore back. Corporations are catching on to this principal, and to the fact that it is harder for them to raise capital. Corporations are striving for liquidity, and the ownership of real estate does not meet that objective. Few assets on a corporate balance sheet are as illiquid as real estate. Companies are realizing that net leasing is not just a reaction when you need to raise capital. It is a sound business financing strategy. Net leasing allows companies to use the cash in their businesses where it can earn a significant multiple of what it can earn by being tied up in land and bricks. Consequently, more and more companies are disgorging themselves of their properties and leasing them back. And, when they expand, they are doing it through leasing rather than owning.

This push for liquidity is reinforced by the other standard reasons for choosing leasing over ownership, including off-balance sheet treatment, the below-market cost of occupancy and 100% funding of the value of the real estate.



Moreover, the tax laws allow a corporate lessee to benefit from a remarkably low after-tax cost of funds. Since 100% of the rents are deductible, the after-tax cost of leasing is well below comparable term Treasury rates.

Guessing economic cycles has become a national sport that has more participants and patrons than baseball, football and basketball combined. But as a friend reminded me recently, economic cycles are man-made. They are not laws of nature. It's possible that, instead of being in a cycle, we will continue to move upwards in a straight line.

It cannot be emphasized enough that net leasing is fundamentally a credit investment. Therefore, what we foresee for real estate generically has no necessary relevance to this area. As a result, the value of net lease investments previously made will not be dramatically affected by a real estate turndown.

As to future investing, real estate funds may dry up but not net lease funds. The capital markets may be more selective when investing in corporate lessees, and they may impose tighter terms upon the lessee and require shorter maturities. And the cost of funds will go up. But the markets will continue to invest. The problem is not, as with many other types of real estate, the unavailability of funds at any price.

Net leasing has been labeled dull and unimaginative, and I can accept that. Like many other dull and unimaginative things, it is steady. Steady in good times may not sound too appealing. But in bad times, it's the brass ring? ●

*Robert L. Nessen, the Chairman of CRIC<sub>2</sub> Funds, LLC, has specialized in corporate and net lease financing since beginning his career in 1958. He is nationally-recognized for the work he has done in creating and implementing new financing techniques for real estate.*