Chapter 1

Economics of Net Leases and Sale-Leasebacks

§ 1:1 What Is a Net Lease?

A net lease is a lease of property to a single tenant under which the tenant is responsible for substantially all of the expenses and obligations relating to the ownership, maintenance and use of the property during the term of the lease. In other words, in a net lease, the tenant retains substantially all of the exposure to the risks and costs associated with the property, other than the risk of diminution of the residual value of the property. The residual value of the property is the value of the property at the end of the lease term. Stated differently, in a net lease, the rent is "net" to the landlord.

§ 1:2 Types of Net Leases

In most net leases, the landlord retains some exposure to the risks and costs relating to the property. Net leases are typically categorized based on the degree of exposure retained by the landlord. The following terms are often used to categorize net leases.

§ 1:2.1 Bond Lease

In a bond lease, the landlord retains none of the exposure to property level costs or risks. Thus, the tenant under a bond lease must pay rent during the term of the lease without exception. The National Association of Insurance Commissioners (NAIC) defines a "bond lease," in part, as follows:

> A bond lease is a lease between a lessor and a lessee for a specified period of time with specified rent payments that are at least sufficient to repay [lessor's mortgage loan]. The bond lease requires the lessee to perform all the obligations related to the leased premises. The investment community has historically defined a bond lease as a 'hell or high water lease', the general concept being that regardless of what occurs as to the leased premises, the lessee is obligated to continue to pay its rent. Therefore, [from the viewpoint of the lessor's mortgage lender], the focus is on the credit of the lessee . . . not the real property characteristics related to the premises.[1]

1. NAIC, Purposes and Procedures Manual of the NAIC Investment Analysis Office (Dec. 31, 2015), pt. four, sec. 1(a)(ii)(A) (copy on file with author). The NAIC Manual is available for purchase at http://www.naic.org/prod_serv_publications.htm.

§ 1:2.2 Absolute Net Lease

The term "absolute net lease" has no legal or regulatory meaning, but is often used to describe a lease under which the tenant performs all obligations related to the leased premises and has no cancellation right except in the event of a condemnation having a material adverse effect on tenant's operations. In other words, an absolute net lease differs from a bond lease only in that an absolute net lease may be terminated by the tenant following a material condemnation.

§ 1:2.3 Triple Net Lease

In a triple net lease, the tenant is responsible for real estate taxes, utilities, and maintenance of the property. However, the tenant often has the right to terminate the lease in the event of a casualty or condemnation having a material adverse effect on the tenant's operations. In addition, unless the tenant owned the property before the lease term commenced, the landlord may retain responsibility for environmental and other legal violations that predate the lease term. Finally, in some triple net leases, the landlord is required to pay for capital improvements to the property.

§ 1:2.4 Double Net Lease

A double net lease differs from a triple net lease only in that the landlord under a double net lease is responsible for the maintenance of the roof and structure. Often in double net leases, the tenant will retain responsibility for maintenance of the roof membrane and roofing surface.

§ 1:2.5 The Allocation of Capital Expenses and the Split Incentive Problem

A so-called "split incentive" occurs in a transaction where the benefits do not accrue to the party who pays for the transaction. Split incentives often interfere with rational investment decision making.[2] When the landlord is responsible for the payment of capital expenses (as is the case in double net leases and some triple net leases) and the tenant is responsible for the payment of utilities, a split incentive cuts

2. *See generally* "Policy Options for the Split Incentive: Increasing Energy Efficiency for Low-Income Renters," 48 ENERGY POLICY 506 (2012).

against either party investing in capital improvements, such as solar panels or energy efficient air conditioning, which could reduce utility expenses: the landlord has little incentive to pay for capital improvements to increase energy efficiency because it does not pay the utility bills while the tenant, who pays the utility bills, has no right or obligation to make capital improvements that could reduce utility costs.[3] By contrast, when the tenant is responsible both for capital expenses and utility bills as is the case in absolute and bond net leases, incentives are properly aligned: the tenant has the right and responsibility to select and pay for capital improvements that may reduce utility bills and the tenant benefits directly from any such reduction.

§ 1:3 Pricing and Valuation of Net Leased Properties

§ 1:3.1 *Basic Formulas*

As is the case with other types of investment real estate, the price of a net leased property is primarily a function of its capitalization rate or "cap" rate. The capitalization rate of an investment property is defined by the following formula:

Capitalization Rate = Net Operating Income (NOI) ÷ Price

Thus, generally:

Price = NOI ÷ Capitalization Rate

NOI, in turn, is calculated as follows:

NOI = Annual Rent – Landlord's Share of Real Estate Taxes, Utilities, Insurance, and Maintenance Expenses

In a net lease, the landlord's share of real estate taxes, utilities, insurance and maintenance expenses is zero. As a result, during the

3. *Id*. at 4–5.

term of a net lease, NOI is equal to the annual rent. Accordingly, in a long-term net lease:

$$\text{Capitalization Rate} = \text{Annual Rent} \div \text{Price}$$

And,

$$\text{Price} = \text{Annual Rent} \div \text{Capitalization Rate}$$

Consequently, the price of a property subject to a long-term net lease is primarily a function of the annual rent and the capitalization rate. The price is inversely related to the capitalization rate. Thus, prices rise as capitalization rates fall.

§ 1:3.2 The Two Meanings of Capitalization Rate

The term "capitalization rate" is used in two different ways. First, as above, it is simply the actual annual rate of return on a particular investment property given the price paid (or asked) for the property and the property's net operating income. We will refer to the capitalization rate in this sense as the actual capitalization rate. To calculate the actual capitalization rate, both the price and the net operating income must be known. Second, capitalization rate is used as a measure of the riskiness of a property's cash flows given such factors as the creditworthiness of the tenant and the location of the property. We will refer to the capitalization rate in this sense as the market capitalization rate. The market capitalization rate is used to calculate the value of an investment property given its net operating income. The market capitalization rate for a given property is generally calculated based on the actual capitalization rates of comparable properties.

§ 1:3.3 Discounted Cash Flow Model

The discounted cash flow model values an investment by discounting an investment's future free cash flow projections to present value based on actual or market weighted average cost of capital. Once the market capitalization rate (C) has been determined for a given investment property and assuming a known constant annual net operating income (NOI) for a period of n years, the value of an investment property may be calculated using the discounted cash flow model:

Property value = present value of cash flows using the market capitalization rate as the discount rate

$$= \frac{NOI}{1 + C} + \frac{NOI}{(1 + C)^2} + \ldots + \frac{NOI}{(1 + C)^n}$$

Where the cash flows are perpetual, this formula may be simplified by taking the limit of this formula as *n* approaches infinity. As shown in detail in Appendix A, the simplified formula for the present value of a stream of perpetual cash flows is as follows:

$$PV = \frac{NOI}{C}$$

Of course, this formula is the same as the formula derived from the actual capitalization rate shown above. A simple example will help to establish the soundness of the formula. Assume an investment has a 10% return rate and $100,000 in annual income. This income divided by such return rate yields $1 million. If you invest $1 million, you could produce such an annual income in perpetuity given the 10% return rate.

§ 1:3.4 Determining the Market Capitalization Rate of Long-Term Net Leases—Background

Since the annual rent under a net lease is typically a fixed, known amount, pricing a net leased property involves a determination of the proper capitalization rate for the property. Capitalization rate is a measure of the risk associated with the return in question. In the case of a long-term net lease (with the exception of certain ground leases),[4] since substantially all property level risk is born by the tenant, the capitalization rate is primarily a function of the tenant's financial strength. A property subject to a long-term net lease has similar economics to a bond issued by the tenant under the net lease. This is especially true when the lease is a bond lease and the rents are flat. However, there are two significant differences between an investor's

4. *See infra* section 1:3.4[A].

economic position as the landlord under a net lease as opposed to the holder of a bond: first, upon expiration of the net lease, the landlord is exposed to both the upside potential of increased market rents and the downside risk of decreased market rents and second, in the case of a tenant bankruptcy, the tenant's bondholders will have a claim in the tenant's bankruptcy for the full amount of the bond while the tenant's landlord will have a claim in the tenant's bankruptcy that is subject to the damage limitations of section 502(b)(6) of the U.S. Bankruptcy Code.[5]

[A] Ground Leases

In a ground lease, the tenant leases the land from the landlord and owns the improvements during the term of the lease. Ground leases typically provide that upon termination of the term of the lease, ownership of the improvements reverts to the landlord. Even in the absence of such provision, however, the termination of the ground lease effectively deprives the tenant of the benefit of the improvements as it cannot access them without committing a trespass. As a result, assuming the ground rent under the ground lease approximates the fair market rent of the land (without the improvements), the landlord under the ground lease is in a very secure position: if the tenant fails to pay rent, the landlord can obtain ownership and possession of the improvements and presumably a substantially higher rent by simply terminating the lease and evicting the tenant. For this reason, a default by the ground tenant is very unlikely as such default leads not only to loss of the leasehold but also to loss of the improvements. Accordingly, a property subject to such a ground lease will typically have a relatively low market capitalization rate regardless of the credit of the ground tenant.

§ 1:3.5 Determining the Market Capitalization Rate of Long-Term Net Leases Using Comparable Sales

Brokers calculate capitalization rates based on their knowledge of comparable sales. In the case of a long-term net lease, where the capitalization rate is primarily a function of the tenant's financial strength, brokers typically look to a tenant's credit rating. The major rating agencies—sometimes referred to as the nationally recognized

5. See *infra* section 3:1.3 for a discussion of this Bankruptcy Code section.

statistical rating organizations—are Standard & Poor's Ratings Services, Moody's Investors Service, Inc., and Fitch Ratings, Inc.[6] As a result, to determine the capitalization rate of a net leased property being offered for sale, brokers look at the capitalization rate of properties leased to tenants with credit ratings comparable to that of the tenant of the property being sold. The higher the tenant's credit rating, the lower the risk the tenant will default under the lease, and therefore the lower the capitalization rate.

§ 1:3.6 Pricing of Properties with Short-Term Net Leases

A property subject to a short-term net lease is valued using the same techniques applicable to multi-tenant properties with an adjustment for the existing short-term net lease. If the net lease has fixed price renewal options, those options impose a ceiling on the value of the property. The ceiling is equal to the value the property would have assuming the tenant exercised in advance all of the renewal options.

§ 1:4 Sale-Leasebacks

§ 1:4.1 What Is a Sale-Leaseback?

A sale-leaseback is the sale of a property from a seller to a buyer and the simultaneous lease of the property from the buyer back to the seller. Since the seller is entitled to possession of the property during the term of the lease, the net effect of a sale-leaseback is a promised stream of rental payments to the buyer plus the transfer from the seller to the buyer of the residual interest of the property—that is, the right to the use of the property upon expiration of the lease term.

§ 1:4.2 Sale-Leaseback As a Form of Financing

Companies that own their factories, retail outlets or other real estate facilities often find that the capital tied up in these assets would yield a higher return if reinvested in their core businesses. Accordingly, many companies monetize their real estate assets through various forms of asset-based financing. A sale-leaseback

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6. See *infra* section 2:2 for further discussion of credit ratings.

involving a long-term lease is often viewed as a form of asset-based financing, as the seller-tenant receives cash for the value of the property and retains possession of the property in return for periodic payments of rent to the buyer-landlord.

§ 1:4.3 Advantages of a Sale-Leaseback to the Seller-Tenant

From the standpoint of the seller-tenant, the real estate sale-leaseback offers several advantages over conventional mortgage financing. First, the sale-leaseback should provide the company with cash equal to 100% of the fair market value of the property, while conventional mortgage financing generally yields cash proceeds equal to 75% or less of the value of the property. Second, when long-term interest rates are low, a sale-leaseback may enable the company to lock in a low cost of funds for a longer term than is available to the company through conventional financing. Third, a company's ability to obtain a mortgage loan may be limited or precluded by state or federal regulations or by financial covenants under its existing credit facilities. In such cases, a sale-leaseback may be the company's only practical means of raising capital without violating such restrictions. Finally, under current U.S. accounting rules, a properly structured sale-leaseback provides the seller-tenant with favorable financial accounting treatment: the seller-tenant removes the real estate and related liabilities from its balance sheet and adds any profit from the sale to its income statement. By contrast, with conventional financing, the borrower does not sell the property so there is no gain to recognize. Although conventional financing generally offers a favorable means of generating tax-free cash, with conventional financing the borrower must show the financing as a liability on its balance sheet and must record annual depreciation charges for the property's improvements as an expense on its income statement. As a result, an off-balance sheet sale-leaseback will improve the company's reported earnings, return on assets and equity and debt-to-equity ratio as compared to conventional financing. Perhaps for these reasons, sale-leasebacks have been shown to produce a small, but statistically significant gain in the market value of the stock of the seller-tenant.[7]

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7. *See* Marshall E. Tracht, *Leasehold Recharacterization in Bankruptcy: A Review and Critique*, The ACREL Papers (Fall 2012), n.12 and

§ 1:4.4 Disadvantages of a Sale-Leaseback

Sale-leasebacks also have drawbacks for the seller-tenant. First, the seller-tenant gives up the right to share in future appreciation of the property. Second, the seller-tenant is locking itself in to a lease term that may extend beyond the period for which the seller-tenant can profitably use the property. Third, unless the seller-tenant is able and willing to engage in a section 1031 exchange, the seller-tenant may have to pay capital gains tax on its profit from the sale. Fourth, in certain states, a sale-leaseback triggers transfer taxes[8] and reassessment for purposes of real property taxation.[9]

§ 1:4.5 Sale-Leaseback Pricing

According to a recent study, properties transferred in a sale-leaseback sold at a premium of about 13% as compared to non-sale-leaseback properties.[10] The study analyzed the data for 3,978 office, industrial and retail properties in seven U.S. cities sold from 1993 through 2007. When adjusted for property type, location, building age and size, and market condition (year), the study found that sale-leaseback properties sold for about 13% more than the equivalent non-sale-leaseback properties. The study also found that this premium appeared to be explained by the fact that net operating income was higher (and thus, capitalization rates were lower) for sale-leaseback properties as compared with non-sale-leaseback properties. According to the authors,

> there are two possible reasons for these differentials: (1) the expected cash flows for a sale-leaseback property may be greater because of the lack of anticipated periodic vacancy caused by tenant turnover typically observed in commercial property markets, and (2) the credit profile for sale-leaseback tenants may be higher and the history of the firm (lessee) at the property location may lead to lower risk.[11]

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accompanying text, www.nyls.edu/faculty/wp-content/uploads/sites/148/2013/09/Tracht-Leasehold-Recharacterization-in-Bankruptcy.pdf.

8. *See infra* section 5:7.2.
9. *See infra* section 2:3.3[A][1].
10. C.F. Sirmans & Barrett A. Slade, *Sale-Leaseback Transactions: Price Premiums and Market Efficiency*, 32 J. REAL EST. RESEARCH 221 (2010).
11. *Id.* at 238.

§ 1:5 Volume of Net Lease Sales

According to a recent report by a leading U.S. real estate brokerage firm, there were approximately $47.2 billion in sales of net leased properties in 2017 consisting of $20.3 billion in sales of net leased office properties, $17.1 billion in sales of net leased industrial properties and $9.9 billion in sales of net leased retail properties.[12]

12. Jones Lang LaSalle IP, Inc., "Net Lease Investment Outlook" (H2 2017).