Current Net Lease Market in Texas and around the United States

Gavin Kam, Net Realty Advisors

Brad Motley, Trinity REIS

Emily Crockett, Vaquero Ventures

Doug Colquitt, STNL Real Estate

Vincent Knipp, Marcus & Millichap

The following is an overview from *REDNews* Texas Net Lease & 1031 Summit which was paneled with single-minded experts, focusing on the net lease market in Texas and around the United States. It's a segment of the industry that has evolved considerably over the past two decades, according to Net Realty Advisors partner Gavin Kam.

Back in 2001, Kam said he had just started at Marcus & Millichap, joining as a retail agent.

"One day, the office manager came up to me asked, 'Have you ever heard of triple net deals?' Of course, I said, 'No.' He handed me a list, some research and instructions, then said, 'Why don't you take a look at this list and start calling?'" recalled Kam.

Nineteen years on, it's clear those phone calls paid off. His company, Net Realty Advisors, specializes mostly in multi-tenant investment sales. Kam told the summit's attendees that he's watched net leases go from a tool used institutionally by retailers to something more developers and brokers are utilizing.

"The market was not as efficient as it is today," said Kam.

" … in a perfect world …"

While net leasing is increasing in popularity, it's not something about which the casual investor typically has much education. In acquiring a net-lease asset, the goal is for the investor to be actively involved as little as possible. The lease should protect cash flow for 10 to 20 years, while preventing the property owner from covering much of the expenses.

Brad Motley, Trinity REIS partner, laid out the three priorities investors should consider when entering a net lease. First, he said, review the rent schedule. Next, consider the length of the primary term, which is the lease time guaranteed before the tenant has renewal options. Finally, outline the landlord responsibilities.

"In a perfect world, you want to sign a lease where the tenant takes over all expense items such as property taxes and insurance," said Motley.

That can be tricky, according to attorney Emily Crockett, COO of Vaquero Ventures.

"Tenants have gotten smarter and more sophisticated in the past eight years I've been solely focused in real estate and working on leases," she said, adding that tenants want landlords to take on more liability and responsibility.

As a result, Crockett said preserving the triple-net nature of the lease is becoming more complicated and has created issues even with national tenants.

"I would say that there's a lot of heavy negotiating around the word 'controllable' in a venue," said Crockett.

Tenants, she asserted, want controllable expenses to be very limited, whereas landlords want controllable expenses to cover anything that isn't utilities: trash, recycling, snow and ice removal and the like. Landscaping costs, Crockett pointed out, have gone up significantly over time.

"To cap the increase on what would be considered controllable from a third party, we pushed for our controllables to really be limited just to management fees. We feel like that's something that we can control quite a bit more than third-party utility costs and vendors, et cetera," she said. "Those are the items that we fight the most about because the tenant wants the controllables to be everything and, of course, we want them to be as little as possible. We try to come to some sort of reasonable accommodation to limit it just to a management fee cap essentially."

Changes to access, visibility and signage have also become hot-button issues recently, Crockett said. Tenants are asking for the ability to get out of a lease if anything changes in that regard, even if it's something beyond the landlord's control, such as a road closure.

Another topic that tenants are focusing on is exclusivity. They often want the lease to outline what the landlord cannot do on any adjacent property or even property within a certain mile radius.

Crockett emphasized too the importance of doing your due diligence on the front end of negotiations as a means of protecting your investment. She said you should get current financials at the beginning of the process.

"When we're buying assets, we look at the guarantee and then the assignment, making sure that the net worth of what you're buying and that credit is going to stay there regardless," she said.

As all of this is negotiated and reviewed, our panel agreed that it's taking longer to close these deals.

"The majority of the buyers are well represented by counsel and are doing an extreme level of due diligence, which results in extensions," explained Crockett. "There's more handholding and educating buyers."

Good counsel, she added, takes note of issues raised by buyers and incorporates them into future leases.

"Sometimes they are things that we may not have had anybody else raise or thought was going to be an issue," Crockett said. "A lot of it is just institutional knowledge and then incorporating that into your next deals as much as you can to make those transactions go for some movement."

"... create opportunity ... "

The fact is, our panel agreed, that an educated client is the best client. Sometimes that requires being honest with them about the reality of the market.

"If you want property in Dallas, that's going to cost more than in Maine," Motley said, adding that real estate is cyclical. "We get more squeezed, then it levels out as everyone understands how those numbers have shifted and changed. We have to show our clients that this is where that value is if you're going to be there."

"I would agree with you," said moderator Vincent Knipp, senior managing director of investments for Marcus & Millichap. "For any really good credit national tenant with a long-term lease and a major market like DFW, I don't think I've seen any adjustment in cap rate and I think that there's a lack of supply with really good product. Oftentimes you can still see another record price. We sold a Chick-Fil-A at a 3.75 cap. We sold an In-N-Out at a 3.8 cap. And it's not necessarily because the deal really makes sense, it's just because it had a 20-year lease and it was in Dallas-Fort Worth."

Cap rates are just one factor that dictate the value of a net-leased property.

"I'd say the best part about cap rates being low has been we feel like they're now predicting. Even 18 to 36 months ago, your values weren't very predictable. Now we have a stabilized market," said Doug Colquitt, CEO of STNL Real Estate. "That allows you to go out and know where you need to buy in order to create a spread or create opportunity from a non-opportunistic point, which is how I put it."

That has helped high-profile new development be more aggressive, but it's made some investors pump the brakes, too.

"I think that there's probably some hypersensitivity in the private market for some things that don't check all the boxes," Motley added. "For that stuff, you're having to really adjust pricing."

"... move quickly ..."

The lender with whom you choose to work can also influence the impact of a deal. After all, that's who underwrites the credit and, in the most basic terms, the location.

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"Go out and identify some of these opportunities where you've got an above-market return and rates as low as 3.7 percent or 3.8 percent. Look at the spread there if you can pick up a property at a 7.5 cap," said Colquitt. "Ten years ago, you didn't see that sort of spread. Because you still have the credit behind the lease, you can borrow money at ridiculously low rate."

He added that his company, STNL Real Estate, has tried to align with trusted brokers who know what STNL does and how it performs. Then they bring in opportunities that fit in that wheelhouse.

"We established those relationships over time so they know we're able to move quickly and we do what we say we're going to do. Then we can underwrite small credit or challenging credit that most people aren't going to go chasing after," Colquitt explained.

That knowledge can influence whether you pursue a short- or long-term lease, each of which has its value in the net lease market.

Colquitt lauded long-term leases as an opportunity to pay down the principal owed on a property.

"If you have a corporate tenant that signs a 15-year lease, now you can go out and get a 10-year loan because you have a corporate guarantee," he said. "That mitigates a lot of your risks when that lease comes up."

As investors educate themselves about different options available, some of our panelists suggested 1031 exchanges are starting to provide competition. The biggest source of competition, however, may come from the institutional investors who dominated the net lease market. These days, they're willing to do smaller deals and pay a market cap rate.

As the real estate industry and investors embrace net leases as a passive investment option, Colquitt said clients are clearly dividing themselves into two fields.

Dollar Stores was offered up as an example of that kind of opportunity. Right now, Colquitt said, they're the highest-grossing stores in the country.

"Family Dollar already has a network of stores in any market, so they can predict themselves. You can go out now and buy one. It's 7.25 to 7.5 cap," he said. "You can borrow at 3.8 percent. Then over ten years, you can reduce your principal. You look at what your residual value is from that property in ten years and all the cash will be collected."

Not every investor can be convinced of that, though, which is why it's also important to be cognizant of the buyer's profile and what that individual considers a safe investment.

"I think buyers have learned how to factor risk into a deal better," said Kam.

Motley said it's up to individual firms how they handle that competition. In his case, Trinity REIS has decided to avoid it all together.

"The difference for us is that we don't have to place capital, as REITs do. Your bigger institutions have to place capital," he said, before offering his key to success. "We've proven that we can be patient. We just take a slow and steady approach versus having to place our investors capital."

"… our job is to …"

Looking ahead to 2020, we asked our panelists to offer up their analysis and predictions. It's a mixed bag in many ways, lifted by a strong economy, limited by the available opportunities.

"Our economy is like a flight landing. As it's coming in from a really high altitude, it's taken a slow approach into the landing," said Motley. "There are no signs of a recession looming, so I think from an investment perspective, that provides some predictability."

He added that he doesn't foresee banks or the Fed changing their tune about increasing interest rates. Motley is concerned about the results of the presidential election because the winning candidate will shape the economy from that point.

"I've heard people are scratching their head about how to invest through that," he said.

Due to the ideal financial conditions, Colquitt has concerns about finding deals that make sense, a point on which Knipp agreed.

"Even from a cap rates perspective, there's more demand for smaller assets just because they're portable. It's hard to find something under $2 million," he said. "Because construction costs, land prices and rents have gone through the roof, that eventually gets passed onto the landlord in terms of rent."

As the real estate industry and investors embrace net leases as a passive investment option, Colquitt said clients are clearly dividing themselves into two fields.

"The first type is more sophisticated. They've got a triple net portfolio and they know their criteria, whether by tenant, by market or demographics. Our job is to go out there and filter through the properties on the market (or off market) and find them opportunities," he said. "The second type of buyer is the individual 1031 a lot of times. We're trying to help them make decisions. Much of that involves coaching them, filtering the market."

As such, the role of a net lease professional is ever more valuable than it has been in years past, as is a skilled qualified intermediary who can guide you through the process of a 1031 exchange.