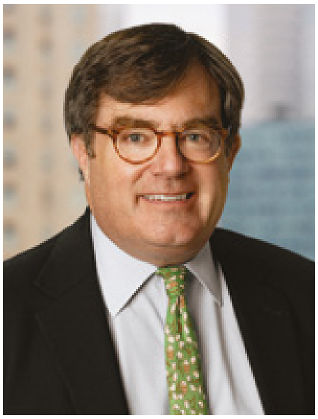
KEYNOTE INTERVIEW

Increasing opportunity in the net lease space



Investors appear to be flocking back to net lease strategies as market dynamics drive robust opportunity in the field, explains Gordon Whiting of TPG Angelo Gordon

Twenty years ago, players in the net lease sector were often spending time explaining the niche product to unfamiliar business leaders, but now, sale-leasebacks have become a ubiquitous financing tool for companies, and the associated triple-net lease transactions present an equally attractive opportunity for investors.

As founder and co-head of TPG Angelo Gordon's net lease real estate business, Gordon Whiting has built a team that has played a key part in growing the nascent strategy into a mainstream sector of real estate investing.

Against the backdrop of the current market environment, he sees a number of tailwinds for the sector and expects activity to be robust in the coming years.

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Q How has the net lease sector evolved over time? And how would you describe the state of the market today?

When starting my career in the net lease space 30-plus years ago, sale-leasebacks piqued my interest as an attractive risk-adjusted investment strategy that also provides potential benefits to companies looking to maintain long-term control of their assets in the most capital-effective way. Sale-leasebacks can be great for both real estate- and credit-focused investors since you get a long-term lease – typically 15-25 years with another 15-25 years of renewal options – and cashflows usually increase annually. Additionally, in cases where the net leased property is critical to the tenant generating revenue and EBITDA, we believe the lease is in a better position than the tenant's corporate-level debt when it comes to payment priority.

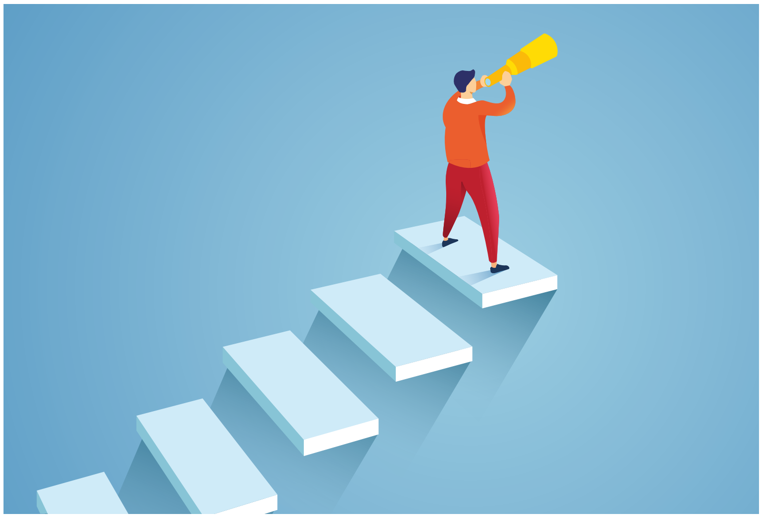
In terms of how the net lease space has evolved over time, three decades ago, institutional investors thought it was better and easier to underwrite multi-tenant buildings and regularly reset a portion of the rent to the market. There was less focus on the frictional costs of new tenants or short-term leases, though underestimating frictional costs can be punitive to returns, which opened the door for institutional investors to look at net leases.

We have also seen increased understanding of the importance of asset type and selection. Given the thesis behind net lease investing, deals often involve industrial-type facilities. Historically, institutional investors wanted shiny office buildings or corporate headquarters, but over time, the costs to re-tenant and values of those buildings can be very volatile.

What institutional investors ultimately discovered, and what retail investors already knew, was that buying industrial buildings is generally far less expensive on a price per square foot basis. The rent tends to be less expensive, and industrial buildouts are typically less costly and don't have significant drag from tenant improvements and allowances. It has been interesting to see the industry transform over the last three decades, specifically the changing views of both the tenants and investors.

When it comes to the state of the market today, we believe the current lack of credit availability is driving net lease transaction activity and will position the sector well for the years ahead. Net lease investment volume peaked in 2021, with approximately $90 billion of transactions across the sector – representing approximately 10 percent of property trades in the US. Today, the net lease environment is heating up again as corporations seek alternative forms of financing and investors look for real estate- and credit-adjacent strategies that can provide a high cash return, hedge against inflation and offset market volatility.

Investing in triple-net leased properties can check many boxes for investors by potentially creating long-term, growing cashflows and compelling risk-adjusted returns, while sale-leasebacks can also free up capital for businesses at relatively attractive terms.



Q How are macroeconomic or real estate market trends impacting demand for net leases?

Today, net lease cap rates are at 15-year highs, and market dynamics are similar to what we experienced in the post-GFC era. Against that backdrop, we believe sale-leasebacks are very well positioned for the coming years. Even with cap rates at higher levels, we believe they remain attractive relative to corporate borrowing costs, making sale-leasebacks a good alternative to traditional corporate debt in many instances. Simultaneously, this allows net lease providers to be opportunistic in pricing their capital.

In addition, as interest rates have ticked up, we have been witnessing a shift from a market environment where capital was freely available and inexpensive to an environment where capital is scarcer and more expensive. Looking to the pre-pandemic era, which was a benign credit environment where capital was abundant, we saw some corporate lenders become more competitive and less conservative on structures, leading to an uptick in covenant-lite loans in certain parts of the market. But those days are over, and companies that now need to refinance often must do so with loans that have higher rates and stricter covenants. Additionally, the available proceeds level is typically lower than what borrowers had before.

When you consider all these factors, we believe sale-leasebacks – where the tenant receives 100 percent of the value of the building, versus 50-60 percent from a mortgage – represent an attractive capital solution for companies. Plus, corporate tenants would typically need to pay a mortgage back with a balloon payment, so comparatively, a sale-leaseback can free up much more of the capital trapped in their property.

Q Are there any emerging sectors or niches within the net lease space that are experiencing significant growth or transformation?

When it comes to investing in the net lease space, we believe it is important to focus on essential properties or mission-critical facilities, as opposed to one's strategy being driven by short-term industry trends. With that in mind, our team has concentrated on a diverse set of industries, but with a focus on manufacturing and distribution-related businesses. For example, historically that has often meant targeting facilities that we believe are critical to supply chains, such as those related to food, industrials, transportation, healthcare and building products.

Recently, we have also been seeing opportunities in growing sectors like electric vehicle-related businesses, including charging stations and battery production facilities. Additionally, companies in both the US and Europe are increasingly investing in domestic manufacturing and onshoring or nearshoring supply chains; for example, there have been over $300 billion of announcements of onshoring in the US since 2021. We believe a net lease structure can be an efficient way to operate real estate for those companies.

Q How has the current cost of capital, when it comes to traditional methods of corporate financing, affected the demand for net leases in commercial real estate?

As the cost of capital goes up, we have observed greater demand for sale-leasebacks. As noted before, prospective tenants today are facing higher borrowing costs and diminished access to debt. Over the next two to three years, close to a third of all corporate debt in the US is coming due, and when it comes to refinancing, the available rates will likely be higher and proceeds will likely be lower. Even at current net lease cap rates, we believe a sale-leaseback can be an accretive tool in a company's capital structure.

Q How have the prevailing deal structures in net leases evolved over the past decade? And what key factors have influenced these changes?

The basic structure is the same: buy the building, lease it back to the seller, and the tenant pays all operating costs. What has changed in the last few decades is underlying mortgage borrowing costs and how inflation impacts rent escalations. It has been and remains common to have rent increases built into commercial real estate leases. In the past, contractual annual rent increases of 2 to 2.5 percent might have been the norm in the net lease space. Now, however, we are seeing increases of 2.5 to 3 percent or higher. Additionally, a fair number of deals still have rent escalations tied to CPI, to hedge those cashflows against inflation.

We are also seeing lease terms become longer. Previously, 15- or 20-year leases were viewed as the standard. Today, we are seeing leases as long as 25 years in certain sectors and very few 15-year deals. When it comes to sale-leasebacks, potential tenants are asking for quotes on 20- to 25-year leases instead.

I think these changes are partially related to inflation, but they are also being driven by tenant desire to control their facilities for a longer period of time. A longer lease term tends to be more valuable for both the landlord and the occupier.

One area where we have seen long-term sale-leaseback transactions becoming more prevalent is the less-than-investment-grade sector. We are seeing more growth there than in investment-grade spaces where there is greater availability of capital. This dynamic makes sense, as when companies have less access to capital, a sale-leaseback can become a great option to unlock funds.

"In our view, net lease portfolios have a higher likelihood of retaining value – even in an inflationary environment – as these leases are insulated from increasing expenses"

Q What factors are driving investor interest in net lease strategies today?

The recent inflationary environment has highlighted some of the potential benefits of net lease properties as compared to other asset classes. In our view, net lease portfolios have a higher likelihood of retaining value – even in an inflationary environment – as these leases are insulated from increasing expenses, which can drive higher net effective rent growth.

That is one of the great things about this particular investment structure. When you have a gross lease, the tenant pays rent and the landlord pays all other expenses associated with owning that property. With a triple net lease, the tenant pays the insurance, maintenance bills and taxes. And in today's environment, we have seen that all those expenses are increasing; the cost of labor, materials and insurance, they are all on the rise. In a net lease, the rent is determined upfront, and any inflationary costs are borne by the tenant. We believe this construct allows net lease portfolios to have a higher likelihood of maintaining value, as a well-structured lease can insulate the investment from the impacts of inflation. ■