

# Who's Netting Profit From Net Leases?

By Nellie Day

Net leases seem to always have their place within Southern California commercial real estate. But with space running thin and competition running fierce, the rules of the game are changing. Credit, risks, interest rates, profit margins and tenant improvements appear to be increasingly crucial to lenders—with their importance varying depending on whether you're a nationally known business giant or a mom-and-pop operation. On the following pages, some of the top net lease experts share with REAL ESTATE SOUTHERN CALIFORNIA what they think is in store and who will flourish, flounder or perish when it comes to these types of leases.



**KEVIN SHIELDS**  
President  
Griffin Capital



**On net lease trends:**

I am not aware of any significant trends that distinguish this market from the norm. It does appear, given the increased volatility in the interest rate market, that cap rates across the board are beginning to show signs of weakness (i.e., moderate increases). As we experienced cap rate compression over the past few years, many net lease buyers made a move to reach for yield by sliding down the credit curve. I see that trend continuing.

**On tenant and landlord concerns:**

One concern we are frequently confronted by, and this relates more to assets of significant size that are \$20 million and above, as opposed to small, free-standing retail, is when a tenant in a sale-leaseback executes a lease of long duration, usually 10 years or longer, and the lease is triple net. The tenants in that instance are getting more aggressive in requesting relief from significant capital expenses toward the end of the lease term. That is, a tenant does not want to be saddled with a substantial capital expense in, say, the 14th year of the lease, particularly if the tenant, today, does not know if it will be renewing and, as such, the improvement would be made at the tenant's expense but substantially inure to the replacement tenant.

**ALAN CLIFTON**  
Vice President,  
Leasing and Disposition  
Passco Companies LLC



**On net lease trends:**

Large national retailers are signaling an emerging trend by scaling back on their expansion plans. According to the Wall Street Journal, Wal-Mart has announced that it will open fewer stores in 2007 than previously projected, and other leading national players are following suit. These trends are nothing new, but are coming back to the forefront as the economy starts to slow and sales are not as brisk. At the end of the day, when consolidation occurs

in the retail industry and a smaller number of players are experiencing lower demand and consolidating locations, there may come a point where there is more product and/or space than demand. In the next 18 months, we will be coming into a closer equilibrium between the supply of retail space available and the demand of retailers to occupy that retail space.

**On tenant and landlord concerns:**

In another trend reflecting more cautious times, owners are doing a better job of ascertaining the credibility, creditworthiness and operational experience of the tenants they are moving into their centers. They are trying to hedge their bets in hopes that the same stable tenants will still be there five or 10 years down the road. Landlords want to fill their retail centers with tenants who have the best credit. While landlords are getting better at screening their prospective tenants, there are no guarantees after that. Smaller franchises and mom-and-pop service businesses, such as nail shops or dry cleaners, present risks and come under heightened scrutiny. Is this the first business they've owned? Will they be long-term tenants? Landlords don't want to spend a lot of money on tenant improvements, only to turn over the space in a year because the tenant cannot pay the rent. Landlords lose a lot of opportunity costs if they suddenly need to find a better tenant.

**DAVID COBB**  
President and CEO  
BentleyForbes



**On net lease trends:**

Tenants are requiring more flexibility in net leases, meaning more ability to reduce space in the future through downsizing rights, etc. Tenants are also requesting shorter lease terms than was historically the case. In summary, tenants are demanding better deals compared to the landlord.

**On credit and underwriting today:**

Obviously credit plays an important role in net lease transactions. However, given the massive liquidity in the commercial real estate market, lesser quality credits are increasingly able to borrow relatively inex-

pensive money via net leases as compared to superior credit tenants. Thus, there is strong demand for all categories of investment-grade tenants and strong demand for non-investment-grade tenants, including B-rated and even non-rated tenants.

**ED HANLEY**  
President  
Hanley Brown Group



**On net lease trends:**

As a category, health, wellness and "the fountain of youth" continue to be a recurring theme for net leases right now. We are seeing many more choices in the fast, casual restaurant category that capitalize on the baby boomers' desire for healthier eating versus the old junk-food-type tenant. The growth of tenants like the Veggie Grill, Salad Creations and Panera Bread, as well as meal prep companies such as Meal Makers, The Dinner A'Fare, Dream Dinners and Dinner's Ready! are healthy alternatives that were close to non-existent two years ago and are now popping up everywhere. Other categories penetrating the Southern California marketplace include medical spas, skin care, and athletic and fitness apparel tenants. Additionally, LA Fitness and 24 Hour Fitness are rapidly expanding, as are smaller yoga and pilates tenants, which offer an alternative to the typical gym experience.

**On tenant and landlord concerns:**

Landlords are paying close attention to clauses in the lease that allow the tenant the right to cancel the lease prior to the expiration date. These "kick-out" clauses are frequently tied to the tenant's sales figures and, therefore, landlords are diligently researching how a tenant may perform at the selected location in an effort to ensure that the tenant will meet their sales figure threshold. The research may include the correct demographic support for the use, population growth trends, traffic counts, co-tenant synergy and competition. Tenants are also starting to become more concerned with the tax portion of the triple-net lease. As properties continue to trade at record-high prices, tenants find their triple-net expenses can double, in some cases, when a property is sold. This unforeseen additional expense has an immediate negative effect on a tenant's profit margin. -SOCAL