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Net Lease

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Taking a credit-first approach to net leases



A net lease should be treated as a corporate finance transaction built on the three pillars of credit, real estate and lease structure, says Fortress Investment Group's Absan Aijaz

Led by Ahsan Aijaz, head of the Fortress global net lease business - a central element of the firm's success since its inception in 2002 - the unit has grown significantly over the last two decades.

Key to this growth has been combining discipline in credit analysis with traditional real estate knowhow. Aijaz outlines the approach his firm is taking and where he sees the market heading.

What attributes distinguish net lease investments from other asset classes?

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Most importantly, net lease investments have generally outperformed traditional real estate across credit and economic cycles, in both benign and challenging markets. As an asset class, net lease has been tested and broadly validated in terms of relative perfor-

With that said, as both a strategic transaction for corporations and as a strategic allocation for investors, I don't believe the benefits of net lease have ever been more pronounced or more relevant than they are today.

On the origination side, net lease will always provide an important alternative for companies looking to improve liquidity, strengthen balance sheets, or to free up cash to pursue any number of strategic objectives. The value of real estate holdings is generally not fully reflected in a company's valuation.

So, it can make a lot of sense to harvest and redeploy that value in ways that contribute to overall financial strength, or in ways that support revenue growth

Analysis

or increased profitability. For investors, the net lease asset class has a strong history of performance and resilience through multiple cycles and a range of economic environments. That has continued through the challenges that have become so pronounced in recent years - the volatility, pressures on asset values and the onset of inflationary markets.

If done correctly, investors benefit from a known and predictable stream of cashflows with a built-in inflation hedge, backed by real estate. So you receive the full benefits of real estate ownership - tax advantages, potential for capital appreciation and downside protection - but without what can be the onerous demands of maintaining and managing properties. In my view, these benefits make net leases the best way to own real estate.

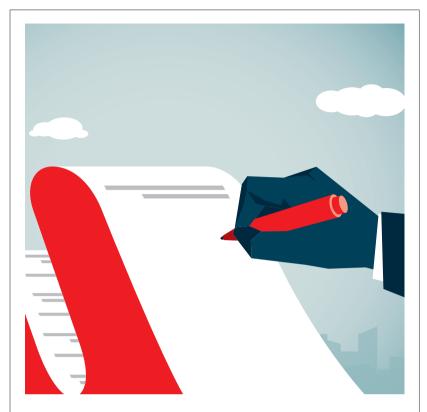
You say you have a creditfirst approach. How do you go about establishing creditworthiness?

The simple way to think about it is that net lease investments require the same rigor and discipline as underwriting a piece of debt for a company or acquiring a company outright. It has to be the same approach for the most creditworthy and consequential companies of our times to the smaller companies and everything in between.

The work of rating agencies is important, but should never be relied upon to form a final view on the risks of a net lease transaction. Investors need to perform their own fundamental bottom-up credit analysis on a potential tenant.

This includes reviewing, modeling and projecting their financial statements, analyzing the industries the tenant operates in and its fundamental position amongst its peers, any aspects unique to the company and its competitive position in the market.

Adhering to strict underwriting standards enhances an investor's ability to spot trends and pick winners early;



How do you go about lease structure?

You are effectively buying a bond that is backed by real estate, which is, conceptually, an extremely attractive structure. What ties one to the other is the lease itself. So, you have to spend considerable time structuring leases in the correct way.

For us, that generally means an absolute triple-net lease with all obligations of property management with the group that is best positioned to do it: the tenant. We have other clauses that are unique to our practice and beneficial not only for us but also our tenant.

Our goal is to work collaboratively with our tenant to structure a lease which allows our tenants to freely operate the asset while preserving and enhancing the value of that asset.

"I don't believe the benefits of net lease have ever been more pronounced"

that is absolutely essential because the company or the tenant with which you are contracting needs to be capable of not just paying the rent, but of also fulfilling all obligations under the lease, such as maintaining the building and paying property taxes and insurance - in many cases, for the next 25-plus years.

It sounds like you must do many different things simultaneously. What are the principal skills required?

Credit underwriting skills are very much to the fore and very similar to what would be required for a debt or private equity investing role. But net lease also requires the skills and experience typically associated with more traditional, brick-and-mortar real estate transactions.

Ultimately, it is the real estate that vou own, and vou must understand the many dynamics - from supply and demand in a local market to much broader macro considerations - that may affect your asset's value in the future.

So, we look for a blend of skills; our team must be capable of all of these aspects that together enable us not just to select assets, but to undertake asset management measures to optimize a portfolio's performance over time.

What does that involve?

Again, for net lease transactions, you must fully understand the risk from a credit point of view and how any individual property fits into a portfolio. But broader asset management is just as important as managing a tenant's credit risk up front.

Asset management can be about ensuring the long-term criticality of a property. It can mean considering and weighing the potential value of alternative uses. We generally look to acquire only properties that have a viable alternative use.

And asset management also means constantly monitoring our tenants' credit - investors must be obsessive about monitoring credits to enable the early identification and resolution of any issues or changes in a tenant's financial condition.

It is a great deal of work, it requires a diverse and deeply resourced team, but in the end it is the only way to effectively run a net lease business and portfolio.

The payoff for the discipline, the rigor and the expense of the type of underwriting and asset management I have described is an asset which we

"You have to consider potential transactions from all risk perspectives, you have to truly partner with counterparties throughout the process, and you have to have the people and resources needed to carry you through all market environments" believe offers the potential for superior relative performance.

What are the current challenges facing the net lease market?

Many of the potential challenges in the net lease space, in my opinion, can be effectively minimized with the type of underwriting and asset management I have described. That holds true for all market and economic backdrops.

Today, of course, we are early in a market broadly characterized by heightened volatility, pressures on asset values, and the onset of inflationary dynamics.

That does not mean that new risks have emerged - it means that the consequences of not doing your homework, of not devoting the resources needed to properly diligence an investment and after investment to properly asset manage it, can be more severe.

And finally, what are the opportunities and prospects for net lease real estate?

From a new business perspective, in any market it is about helping counterparties identify ways that a net lease can benefit their underlying business, their operations, growth dynamics, profitability and valuation.

You need to be in the business of structuring and providing effective capital solutions to improve a company's bottom line.

Clearly, the pullback in traditional bank financing for a range of corporate needs will fuel more interest in net leases, but in the end the calculus for success is the same in any market you have to consider potential transactions from all risk perspectives, you have to truly partner with counterparties throughout the process, and you have to have the people and resources needed to carry you through all market environments.

With that approach, it is a very exciting time for net leases.



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