LesMark Capital, LLC

THE CREDIT TENANT LEASE MARKET

By some estimates, credit tenant lease financing has actually been around for upwards of 50 years. Total volume of annual CTL-type financing is difficult to pin down, but has been estimated at about $5 billion a year. This, however, is only a fraction of the over $2 trillion of corporate-owned real estate available to be financed given the right internal and external market conditions. The enticement for large corporations has been to lever their credit rating into inexpensive long-term capital. Many companies realized this early on, opting to sell their real estate and lease it back, using the sale proceeds for business operations where better returns were possible. This also eliminates the management problems inherent with real estate ownership.

A number of economic and market factors currently drive the market for mortgage loan financing on real estate backed by credit tenant leases. First and foremost, it is the borrower's desire to maximize loan proceeds, which is accomplished by leveraging the long-term single credit tenant lease payment stream. Financing on multi-tenant properties with shorter-term leases usually tops out at 75% loan-to-value (LTV). Using CTL financing it is possible to increase the leveraging significantly, conceivably up to 100% LTV. Because there is typically no loan-to-cost (LTC) limitations imposed on CTL financing, developers often more than fully finance the cost of the project even before they break ground. Additional economic factors include the borrower's desire to defer gains by maximizing interest expense in the early years, as well as other tax, risk and estate planning reasons.

Supply and demand of capital and the pricing of alternative sources of real estate financing are the two global market factors influencing the flow of annual CTL financing. The recent economic downturn that eclipsed the CMBS market and dramatically curtailed the availability of commercial real estate loans from traditional lenders such as life insurance companies and banks has had less of an effect on CTL bond loan market. As CTL loans are generally priced off the corporate bonds spreads, which, particularly for the stronger credits, remained liquid and strong. Bond spreads, relative to real estate mortgage loan spreads (on fixed and floating benchmarks), will influence what debt product a borrower will choose. The overall interest rate relative to the project's capitalization (cap) rate will also affect the maximum loan proceeds which, again, usually drives the financing structure.

The tax benefit of Section 1031 of the Internal Revenue Code has also strongly influenced the CTL loan market. Commonly referred to as "like-kind" exchanges, capital gains tax is deferred when owners who sell their investment, rental, business or vacation real estate, and reinvest the net proceeds in other like-kind real estate. The desire for 1031 sellers to avoid capital gains means they are willing to pay higher prices on their reinvestment than other investors, thus driving down cap rates. This also means additional debt financing is needed, as the replacement property's value must exceed the sold property's value. Since single credit tenant commercial real estate is very popular in the 1031 exchange market, CTL financing is often employed.