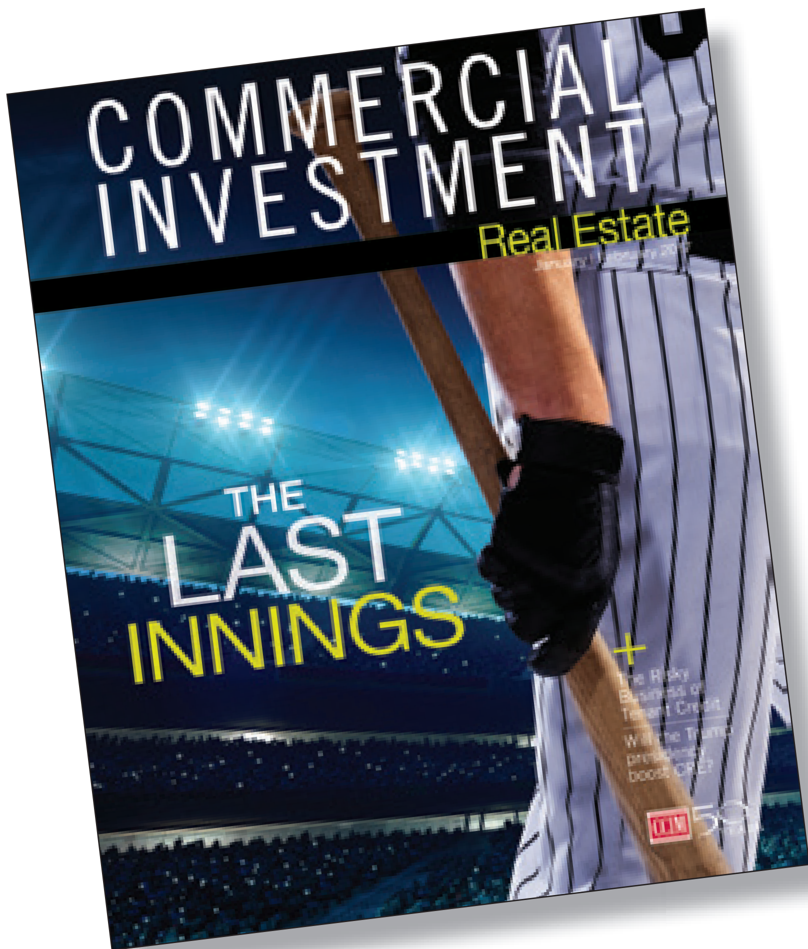

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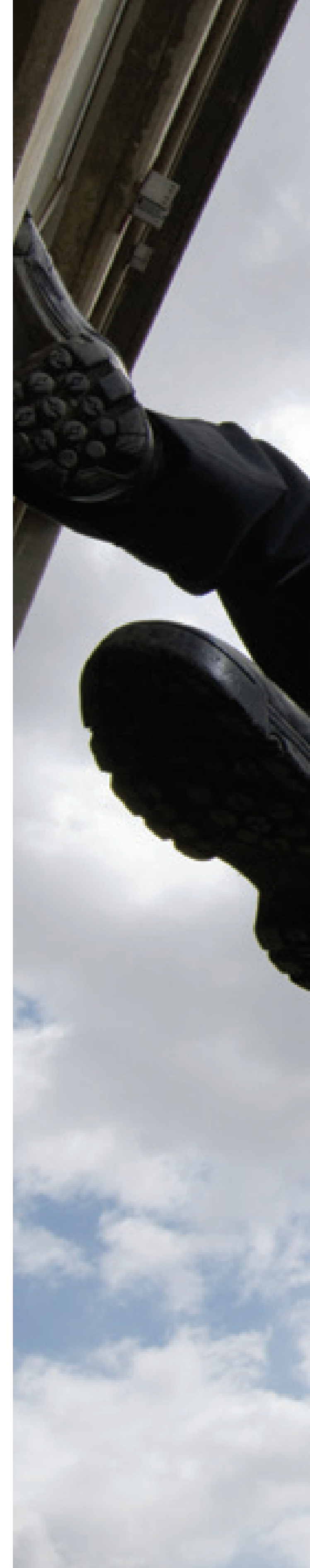
RISKY BUSINESS

Part II: Forecast tenants' credit risk for the decade ahead.

by Christopher H. Volk



Investors and brokers of real estate net leased properties confront a compelling risk analysis. Increasingly businesses are depending on leasing office, retail, or industrial space because of the cost of capital and corporate flexibility.

Part I of this article examined how the rents for profit center property investors come from profits of the individual stores they own, while the credit relies on whether the tenant company is solvent. This market dynamic poses risks for property investors.

Moving forward, investment risk does not center on how likely a tenant is to default within 12 to 18 months, which is the general timeframe of a corporate credit rating. The concern is how likely the lease contract is to perform over its entire life, which may be 10 years or longer.

Such an evaluation must look at the cumulative multi-year default risk, as well as the credit migration risk. For example, referring to the Credit Rating Primer, an A2 rating may have an annual default probability of .18 percent, but only about 60 percent of the time during a 10-year period.

This is because migration away from A2 investment grade status during a 10-year period happens about 40 percent of the time. Likewise, a Baa2 company will have an annual default probability of .43 percent only about 44 percent of the time, since migration away from investment grade status happens in about 56 percent of cases during a decade.

Weighing Differentials

Using these probabilities to weight the risk differentials between investment and noninvestment grade ratings for 10-year risk multipliers gives a much different picture. Incorporating credit migration statistics, a Ba3 company is just 6.8 times riskier than a company having a rating of A3.

The risk differentials are still big but getting smaller. To look at a 15-year weighted risk multiplier chart, the risk differentials would be smaller still.

As an example, by mid-2014, Walgreens leased about 80 percent of its approximately 8,400 locations. Similarly, CVS leased roughly 95 percent of its 7,800 units. Both companies had aggressively employed a developer model to grow their systems.

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That model involves engaging real estate developers to find and construct locations, with these large pharmacy chains executing self-drafted leases on the developed sites.

Once complete, the developers would realize the bulk of their profits by selling the finished net leased stores to passive real estate investors. With the lowest prevailing interest rates since the Great Recession, real estate lease rates, likewise compressed, provide investors with an ability to resell many of these properties at higher prices.

For the two pharmacy giants, the landlords' sale of the real estate they lease has had one negative impact. Their property taxes have risen as the stores they operate have been sold off for substantially more than they cost to build. The tenants have to pay the increased property taxes under the terms of the net leases.

To combat their higher property tax obligations as tenants, Walgreens and CVS began to appeal property tax bills nationwide. A Walgreens employee testified in one court case that the company was appealing the majority of property assessments of more than $3.5 million.

The argument regarding property taxes is that the assessments are too high, because they include returns on investment for the developer. In one brief, Walgreens stated that it "pays rent that is in excess of market because this business arrangement is, in essence, a financing mechanism."

The rationale for lower property tax valuations is that the prices being paid for the real estate are valuing the contractual lease agreements, as well as the real estate itself. Real estate transactions bear out this analysis. With pharmacy real estate values based on capitalizing rents, the credit ratings of tenants contributed to divergent valuations. In 2014, a prominent commercial real estate brokerage firm reported pharmacy prices of $457 per square feet for a Walgreens, $419 psf for a CVS, and $290 psf for drug stores leased to Rite Aid.

The disparity was primarily due to the cap rates at which the assets were sold. The investment grade net lease assets were sold at cap rates approximating 5.7 percent, while the Rite-Aid assets commanded a higher 7.4 percent cap rate. In October 2015, Rite-Aid real estate investors got a boost; the company agreed to be taken over by Walgreens.

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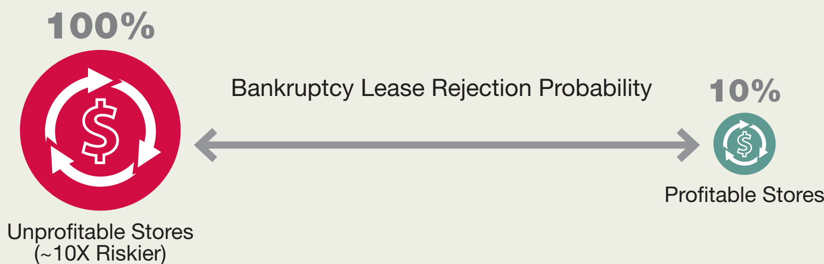
To summarize, real estate cap rates may be correlated with tenant credit ratings. However, lease contract risk is absolutely not correlated with credit quality, because a major portion of contract risk pertains to residual real estate value if a tenant default occurs or in the event of lease nonrenewal upon term expiration. For those investors acquiring assets for prices in excess of $400 psf, a property vacancy could result in a substantial loss.

In a Wisconsin property tax appeal case, a Walgreens appraiser valued two assets that had been purchased by investors for $2.9 million and $4.2 million respectively for approximately $1.7 million each. The appraiser noted that the leases were at above-market rates, with building improvements that would have only limited value to alternate tenants.

This begs the question. How important is tenant credit quality when the lower risk of highly rated tenants is offset by high risks of excessive real estate valuations? Instead, buyers are likely to discover eventually that they unknowingly bought into bonds at substantial premiums to par rather than the 6 percent or higher returns they expected.



Evaluating Store Profitability

The single-tenant commercial real estate world is basically broken down into just two types of properties: profit centers and cost centers. Cost centers include office and distribution properties, call centers, data centers, and bank branches, to name a few.

Evaluating whether cost centers are essential is a challenge for landlords. This analysis raises the need to ensure that buyers' real estate investment amounts and the rents charged are supported by the local real estate auction marketplace.

Profit centers contrast sharply with cost centers. The profits generated by the business operations within such assets speak more to their relevance to the tenant. As with cost centers, it's risky to buy profit-center net-leased assets that have above-market rate leases and pay prices well above their replacement costs.

Riskier still is not having a clue about the unit-level profitability of the investment. For example, through the end of 2015, Walgreens had its credit rating downgraded by an average of one notch every year for seven years.

Well into "BBB" territory, the company has about a 56 percent statistical probability of being noninvestment grade 10 years from now. The possibility even exists that the company will one day become insolvent. Landlords definitely don't want to own an asset that doesn't make any money for Walgreens.

But how important is unit-level profitability? For more than 30 years, the commercial real estate industry has recognized the profitability of the operations at properties as the primary reason the tenants choose to continue leasing a specific property.

There are two times when a tenant can choose to exit a lease agreement. The first opportunity is when a lease matures, and the tenant has the right to extend the lease. The second instance is if tenant insolvency and bankruptcy occurs. In such a case, a tenant can legally option to either affirm or reject a lease.

In my experience, there is a 90-percent chance of lease acceptance if the properties have sufficient cash flow after overhead to pay the rents twice over. Why just 90 percent? The company may vanish like Circuit City and Border's Books.

Alternatively, the chance of bankruptcy lease rejection or lease renegotiation is closer to 100 percent if the store cash flow after overhead is below the rent payment. The formula STORE Capital employs its investment evaluation is graduated between these two points.

Although no long-term statistical analysis supports this precise algorithm, I have been in the business for more than 30 years and believe that this formula is rational and even conservative. Based on my experience, many companies have retained unprofitable locations.

Realistically, some bankrupt companies will retain locations if they produce any cash flow that contributes to covering corporate overhead costs. Or unprofitable stores may stay open if the company believes in their future or considers them strategically critical.

Assessing Risks

To perform analysis on the range of risk involves the consideration of a 100-percent risk of bankruptcy lease rejection on the downside for unprofitable locations and a 10 percent risk of bankruptcy lease rejection for properties that have a 2:1 lease-coverage ratio.

rated tenants is offset by high risks of excessive real estate valuations?

In this case, the highly profitable locations are about 10 times less risky than the unprofitable ones.

To obtain 10 times lower risk from a credit rating vantage point, landlords and brokers would have to evaluate an A2 or A3 company compared to a B1 company. Keep in mind by the end of 2015, Moody's only rated eight U.S. companies as A3 or better, which use smaller free-standing real estate locations.

Also, note this analysis presumes just a 10-year timespan. Thinking about downward credit migration more than 15 years will show that store-level profitability is even more crucial.

As an isolated variable, unit-level profitability is simply proportionately more impactful on profit center real estate investment risk than corporate credit ratings. It's unfortunate that landlords of free-standing profit center properties do not demand that all of their tenants, regardless of credit rating, provide unit-level financial reporting.

Investment risk is more than just a probability of default or vacancy. Consider the concern about investment recovery when seeking to sell or lease a vacant asset. Recovery is easier if the real estate investment is first purchased at a lower price and second has rents that approximate market rents. Also, recovery depends on investing in profitable stores.

These conclusions have been supported by a Morgan Stanley Dean Witter study in 2000, which was conducted on a portfolio of almost 4,000 profit-center properties that were originated and managed at Franchise Finance Corporation of America. Such real estate investments will be less likely to default and more apt to realize superior recovery rates.

Likewise, store profitability depends on real estate value and location desirability. Taking recoveries into account, a landlord who has the ability to evaluate unit-level profits actually has the opportunity to reduce investment risk by more than 90 percent.

A final question is whether store profitability correlates to corporate credit quality. Anecdotally, corporate credit migration happens in part due to the changing balance sheet preferences of business leaders.

Credit migration also occurs for several other reasons, including unwise expansion or acquisitions, worsening economic climate, and increased competition. Store-level profitability, on the other hand, contends with fewer, less volatile variables, such as location, store management, local competition, and concept viability.

Measuring Viability

If investors own a piece of real estate that is subject to a long-term lease, what they really own is a contract backed by real estate. The value of any lease contract is going to be equal to the sum of its parts.

Tenant credit quality is one part. But the importance of credit is limited by its volatility over the potential term of the real estate investment.

As a result, investors are wise to discount investment grade credit ratings, which are more likely than not to migrate to noninvestment grade status over the term of a 10-year lease. A well-regarded leader in shopping center investments stated that "there is no credit in retail."

Over 10 years, how many times risker are companies rated:

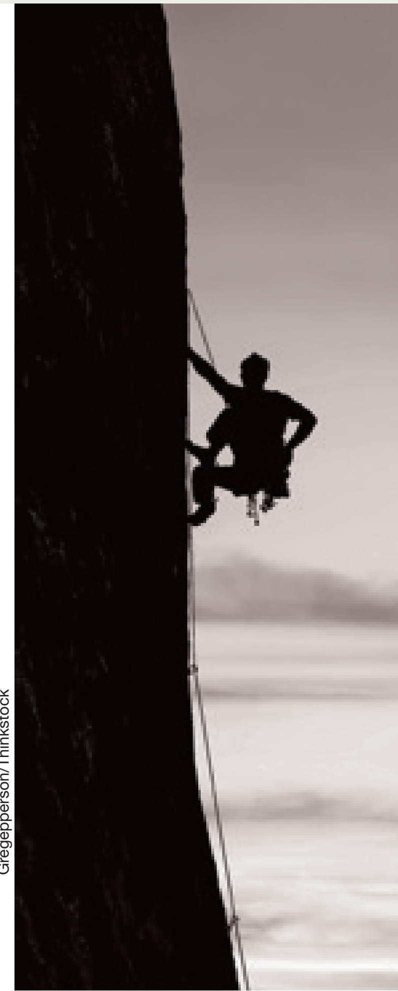
than companies rated:	Ba1	Ba2	Ba3	B1
A2	3.7X	5.5X	8.3X	12.4X
A3	3.0	4.5	6.8	10.1
Baa 1	1.7	2.6	3.9	5.8
Baa2	1.1	1.7	2.5	3.8
Baa 3	0.7	1.1	1.6	2.5

As supported by this information, contract attributes are as relevant as corporate credit and include location profitability, property investment, and the rents relative to the local marketplace. Other contract attributes encompass master leases and the small print in leases, which also play significant roles in minimizing investment risk and maximizing returns.

All too often, real estate investors stop at the credit rating of a tenant. They presume contract equality. In so doing, they presume that net-lease cap rate differentials equate to contract risk differentials. They presume that having an investment grade tenant means they also have an investment grade contract. Investors prefer the Home Depot investment to the Ashley Furniture investment without giving it a second thought.

Investors want to sleep well at night and are attracted to corporate credit quality without critical evaluations. Studies and experience suggest instead that investors dig deeper. Without enough analysis, they have a high likelihood of getting burned.

Christopher H. Volk is CEO and president of STORE Capital (NYSE:STOR), a company he co-founded in 2011 focused on commercial real estate net lease solutions, in Scottsdale, Ariz. Contact him at cvolk@storecapital.com.



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