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# SINGLE-TENANT RETAIL REAL ESTATE VALUATION AND FINANCING: AN ENTERPRISE APPROACH

The strong interest in loans backed by mortgages on single-tenant properties has increased interest in how these properties are valued and how much can be lent against them. Conventional real estate appraisal methods are often inappropriate.

Christopher H. Volk

Single-tenant retail property valuation methodology has drawn an increasing level of attention recently. This is a result of extensive well-received loan securitizations that have been backed by liens on single-tenant retail properties.

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These rated loan securitizations have been sold to institutional buyers of both asset-backed and commercial mortgage-backed securities. As these securities have been originated, two key related questions arise. What is the proper way to value single-tenant retail property? And what differentiates a loan that is fully secured from one that is not?

## **Background**

Single-tenant, free-standing retail real estate is frequently misunderstood. Such properties are not leased on a square-foot basis, as is multi-tenant real estate. Rather, the rents are a function of prop-

**EXHIBIT 1 RESTAURANT CHAIN STORE ANALYSIS—SELECT CHAIN STORE OPERATING CASH FLOW RANKINGS**

Restaurant Chain	Estimated New Store Sales	Estimated Operating Cash Flow
1 On The Border	\$3,000	\$551
2 Champps	\$5,000	\$549
3 Houlihan's	\$3,100	\$516
4 TGI Friday's	\$3,300	\$515
5 Rio Bravo	\$3,400	\$427
6 Applebee's	\$2,400	\$425
7 Black Angus	\$3,000	\$415
8 Chili's	\$2,300	\$369
9 Ryan's Family Steak House	\$2,500	\$365
10 Fuddruckers	\$1,750	\$363
11 Pizzeria Uno	\$1,800	\$325
12 Denny's	\$1,300	\$244
13 Tony Roma's	\$2,000	\$242
14 Friendly's	\$1,000	\$212
15 Steak 'N Shake	\$1,250	\$200
16 Black Eyed Pea	\$1,600	\$199
17 Bojangle's	\$1,300	\$197
18 Burger King	\$1,150	\$189
19 Wendy's	\$1,050	\$189
20 Del Taco	\$950	\$178
21 Bruegger's	\$900	\$171
22 KFC	\$900	\$170
23 Whataburger	\$1,000	\$169
24 Godfather's	\$800	\$167
25 Jack in the Box	\$1,100	\$160
26 Sizzler	\$1,300	\$159
27 Taco Bell	\$1,000	\$156
28 Perkins	\$1,400	\$154
29 Arby's	\$825	\$150
30 Long John Silver's	\$800	\$139
31 Pizza Hut	\$750	\$131
32 Hardee's	\$980	\$92
33 Sonic	\$625	\$89
34 Church's	\$600	\$48
35 Popeye's	\$800	(\$10)

erty construction cost and, therefore, must be acceptable to tenants on the basis of anticipated business earnings potential. Within the appraisal guidelines set forth in the 1996 Uniform Standards of Professional Appraisal Practice, however, real estate appraisals do not take into consideration tenant economics. They instead emphasize landlord economics. Such an approach falls short for single-tenant real estate, where value is inextricably linked to tenant business economics.

Traditional real estate valuations presume the presence of an auction market. The premise is that commercial tenants that are willing to pay rent must be able to generate earnings from the real estate they employ. Hence, there is always an implied link between tenant economics and property rents, because tenants presumably pay what they can afford. In turn, this means that because rent levels drive property valuations, there is effectively a link between tenant economics and real estate values. In fact, such a link is typically

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indirect at best, inasmuch as rent levels are also a function of real estate pricing in an auction market. This circuitous observation is clearly true in the case of most retail store fronts, which are situated within multi-tenanted real estate.

Single-tenant retail properties are not leased in an auction marketplace, because they are not speculatively constructed. Instead, single-tenant retail property rents are a function of the cost to build the property and are affected by long-term interest rates and tenant credit risk. This relationship exists because tenants who build and lease back their real estate also have the option of real estate ownership. Consequently, a lease becomes essentially a mortgage substitute and is part of a corporate strategic financing decision. In addition, the election to finance an asset is always a function of the profits it is expected to generate. As a result, in the case of single-tenant retail property, the link between rents and tenant economics is undeniably direct.

### **Valuation Methods**

Traditional approaches to real estate valuation as contained within the 1996 Uniform Standards of Professional Appraisal Practice include three methods: the income approach, the comparable sales approach, and the replacement cost approach. The income approach used in real estate appraisals simply discounts market rate rental streams and a residual real estate value at estimated market rates of return. The comparable sales approach estimates values on the basis of the sales prices of similar real estate. Lastly, the replacement cost approach estimates the cost to replace the property on the basis of land fair market values and the current value of the depreciated improvements. In general, the greatest weighting of the final valuation outcome is accorded to the first two approaches. This is because the income and the comparable sales approaches are both highly driven by landlord economics. However, none of the three approaches is fully suitable for single-tenant property. The merits and shortcomings of each of these valuation approaches are discussed in this article.

**Income Approach.** The income approach can be employed in two ways. One presumes a fee interest in a property and the other pertains to a property that is subject to an existing lease.

The income approach for fee-simple property typically relies on an estimate of fair market rents

within a given marketplace. Problems abound with this approach, because nearby multi-tenanted properties are all leased on a square-foot basis, whereas single-tenant property rents are more a function of construction costs and long-term interest rates. Therefore, the income approach is best used if it approaches property rents on the basis of the more global view of single-tenant market conditions for comparable property types.

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### **Single-tenant retail properties are not leased in an auction marketplace, because they are not speculatively constructed.**

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The income approach is the single best means of real estate valuation where the property valued is subject to a lease. In such a case, what is really being valued is a known contractual payment stream with an estimated residual value.

Whether using the income approach for fee simple property, or property subject to a lease, there are still pitfalls. Without an understanding of tenant economics, the real estate investor can have no ability to predict the certainty of rent collection over the long term or the likely residual value of the property. Retail properties that incur tenant losses represent higher credit risk over the long term, with leases that probably will not be renewed at current rent levels when they expire, if they are renewed at all.

**Comparable Approach.** The comparable approach and the income approach have similar issues: if local area rents or comparable property sales are employed, both approaches are problematic in the valuation of single-tenant retail property. In the case of the comparable approach, this is because there is generally great difficulty in finding appropriate comparables in close proximity to the single-tenant retail property being valued. If comparables are used that allow for a broader inclusion of transactions on a local, regional, or even national level, then the results should generally fall within the range of the results obtained from the income approach—providing that it, too, takes a more global approach. Still, comparables may deviate from income valuations, especially in the cases of properties that are purchased with above- or below-market rents or in

EXHIBIT 2 RESTAURANT CHAIN STORE ANALYSIS—ESTIMATED SELECT CHAIN STORE NET CASH FLOW RANKINGS FOR NEW STORES

	Approximate Building Size	Approximate Land Size	Land Cost	Building Cost	Equipment Cost	Total Cost	Sales	Operating Cash Flow	Occupancy Cost	Net Cash Flow	Net Cash Flow Margin
<b>Casual Dining</b>											
On The Border	7,500	70,000	\$700	\$1,100	\$550	\$2,350	\$3,000	\$551	\$300	\$251	8.4%
TGI Friday's	6,000	50,000	\$750	\$1,200	\$450	\$2,400	\$3,300	\$515	\$296	\$219	6.6%
Houlihan's	5,000	50,000	\$650	\$1,100	\$600	\$2,350	\$3,100	\$516	\$305	\$211	6.8%
Applebee's	5,300	50,000	\$600	\$900	\$375	\$1,875	\$2,400	\$425	\$233	\$182	8.0%
Fuddrucker's	6,000	50,000	\$500	\$700	\$300	\$1,500	\$1,750	\$363	\$187	\$177	10.1%
Black Angus	6,500	55,000	\$800	\$800	\$400	\$2,000	\$3,000	\$415	\$249	\$166	5.5%
Chili's	5,000	50,000	\$650	\$650	\$400	\$1,900	\$2,300	\$369	\$238	\$131	5.7%
Rio Bravo	6,800	45,000	\$900	\$485	\$400	\$2,385	\$3,400	\$427	\$298	\$130	3.8%
Pizzeria Uno	5,500	45,000	\$500	\$875	\$325	\$1,700	\$1,800	\$325	\$210	\$115	6.4%
Champps	8,600	60,000	\$925	\$2,154	\$885	\$3,964	\$5,000	\$549	\$502	\$46	0.9%
Tony Roma's	5,000	55,000	\$600	\$900	\$250	\$1,750	\$2,000	\$242	\$208	\$34	1.7%
<b>Family</b>											
Ryan's Family Steak House	11,000	60,000	\$500	\$1,300	\$300	\$2,100	\$2,500	\$365	\$250	\$115	4.6%
Friendly's	5,000	45,000	\$350	\$500	\$200	\$1,050	\$1,000	\$212	\$130	\$83	8.3%
Denny's	5,000	45,000	\$450	\$650	\$375	\$1,475	\$1,300	\$244	\$191	\$52	4.0%
Black Eyed Pea	4,900	40,000	\$500	\$700	\$400	\$1,600	\$1,600	\$199	\$207	(\$8)	-0.5%
Perkins	5,000	56,000	\$500	\$600	\$300	\$1,400	\$1,400	\$154	\$176	(\$22)	-1.6%
Sizzler	6,000	55,000	\$400	\$600	\$400	\$1,400	\$1,300	\$159	\$185	(\$27)	-2.1%
<b>Fast Food</b>											
Bruegger's	2,500	22,000	\$300	\$350	\$130	\$780	\$900	\$171	\$95	\$77	8.5%
Godfather's	3,100	40,000	\$300	\$350	\$125	\$775	\$800	\$167	\$94	\$73	9.2%
KFC	3,000	35,000	\$300	\$400	\$200	\$900	\$900	\$170	\$114	\$56	6.2%
Whataburger	3,000	35,000	\$375	\$400	\$180	\$955	\$1,000	\$169	\$118	\$51	5.1%
Wendy's	3,000	35,000	\$400	\$550	\$225	\$1,175	\$1,050	\$189	\$145	\$44	4.1%
Del Taco	2,500	40,000	\$400	\$500	\$200	\$1,100	\$950	\$178	\$135	\$43	4.5%
Bojangle's	2,750	40,000	\$400	\$600	\$250	\$1,250	\$1,300	\$197	\$156	\$41	3.2%
Taco Bell	2,600	35,000	\$300	\$350	\$250	\$900	\$1,000	\$156	\$119	\$37	3.7%
Burger King	4,000	45,000	\$375	\$500	\$300	\$1,175	\$1,150	\$189	\$153	\$36	3.2%
Long John Silver's	2,500	35,000	\$300	\$350	\$175	\$825	\$800	\$139	\$104	\$36	4.4%
Steak 'N Shake	3,630	45,000	\$425	\$500	\$350	\$1,275	\$1,250	\$200	\$168	\$32	2.5%
Sonic	1,350	25,000	\$140	\$200	\$140	\$480	\$625	\$89	\$64	\$25	4.0%
Pizza Hut	4,000	35,000	\$300	\$500	\$125	\$925	\$625	\$131	\$109	\$21	3.4%
Arby's	3,000	35,000	\$300	\$500	\$300	\$1,100	\$825	\$150	\$145	\$6	0.7%
Jack in the Box	3,500	37,500	\$450	\$650	\$225	\$1,325	\$1,100	\$160	\$161	(\$1)	-0.1%
Church's	2,000	25,000	\$200	\$200	\$100	\$500	\$600	\$48	\$62	(\$14)	-2.4%
Hardee's	3,500	35,000	\$275	\$400	\$200	\$875	\$980	\$92	\$111	(\$20)	-2.0%
Popeye's	2,800	30,000	\$250	\$350	\$175	\$775	\$800	(\$10)	\$98	(\$108)	-13.5%

## A NOTE ON THE EXHIBITS

The exhibits for this article were prepared from 35 separate chain-specific regression models, which were, in turn, prepared from a sampling of actual 1995 restaurant store-level financial statements. The chain profitability rankings are chiefly for illustrative purposes, since the sales realized by new restaurants tend to vary around the estimated mean and are greatly affected by such factors as operator quality, local market conditions, area market share, and individual site quality. Similarly, restaurant development cost typically varies around an estimated mean. Therefore, while the tables offer a general idea of which chains might be expected to encounter higher rates of new unit development, the lower ranked chains should not be ruled out for development. In addition, the net cash flows were stressed by presuming 100% financing of the restaurant development cost and equipment. This debt service is classified as "occupancy cost" within Exhibit 2. "Net Cash Flow" is defined as "Operating Cash Flow" (which includes an allowance of 5% of sales for indirect expenses) less Occupancy Cost.

What is clear from the preceding exhibits is that chains with higher revenue and operating cash flows tend to deploy more costly real estate. Such chains can and will pay more for their properties. Therefore, the varying amount of operating cash flows provided by the 35 chains shown in both tables essentially provides a hierarchy of use for chain restaurant real estate. At the same time, the tables illustrate that higher real estate and equipment costs do not *always* accompany higher revenues and operating cash flows. This is reflected by the variances in the net cash flow margins of the various chains reviewed. Such variances are caused by differences in essential economic fundamentals of each brand as well as by variations in development (and hence occupancy) costs. An examination of correlations bears out this point. Overall, the  $R^2$  of the operating cash flows to sales is .84, while the  $R^2$  of the net cash flows to sales for the 35 chains is just .38.

Some conclusions? First, the fair market rents for restaurants cannot be compartmentalized in terms of dollars or as a percentage of sales. Absolute rental costs vary by chain on the basis of real estate development costs, while relative rental costs are a function of both development costs and the various sales levels of each chain. Second, the ultimate value of the business enterprise created can actually be *less* than the real estate development cost. This is evident for restaurants that demonstrate little or no net cash flows. In such case, the "fair market value of the real estate" can be less than the business value. In other words, the real estate becomes worth less than it actually costs to develop and can support less in the way of financing. With such a link between property value and store economics, single-tenant retail property is indeed "plant and equipment."

the event that property-purchase decisions are affected by tax considerations, such as Section 1031 tax-deferred property exchanges.

**Replacement Cost Approach.** Replacement cost is the foundation for determining market rents for fee simple single-tenant retail real estate. As noted earlier, single-tenant retail property rents are a function of the cost to construct the property and are impacted by long-term interest rates. Therefore, above-market rents are those which, when discounted back with a residual at a market rate of return, result in a value that exceeds replacement cost.<sup>1</sup> Below-market rents are exactly the inverse. Likewise, the residual val-

ues of properties purchased with below-market rents are likely to be proportionately higher than those purchased with above-market rents. In theory, property residual values should approximate replacement cost at the time of lease expiration. This theory presumes that there is no "franchise value" to the real estate in question and that the tenant can rationally choose either to renew the lease or to rebuild the property.

There is an important caveat to the statement that replacement cost is one of the determinants of fair market rents: many single-tenant retail properties do not produce enough tenant earnings to support a market rate of return based on the replacement cost of the property. And yet,

because it may be costly to convert the property to an alternative retail use, such a property may still be at its "highest and best" use. The list of retailers with insufficient store economics to support new unit development is indeed a long one. Therefore, "market" rents for single-tenant retail properties, when discounted back with a residual value, are generally equal to *or less than* replacement cost.

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Readers can guess the identities of other chains having unit-level economics that will impede new store development.

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### ***The Chain Restaurant Industry***

The restaurant industry has more retail locations than any other industry, which makes it well-suited to display the linkage between retailer business fundamentals and real estate values. During the past 20 years, the restaurant industry has come to be dominated by chains. By the end of 1995, Technomic, Inc. estimated that the top 100 chains accounted for more than 48% of total industry sales, up from 30% in 1970. About 85% of chain restaurant locations within the largest 100 restaurant systems are associated with various fast food brands, with the remainder associated with various midscale and casual dining concepts. These chains all have different business fundamentals.

As is true in all retailing, there is a hierarchy of restaurant chains as defined by store-level economics. To provide an illustration of this point, we prepared regression models for 35 selected chains, based on actual 1995 store-level income statements. Since the restaurants within a given chain, by design, offer similar menus and have similar operational characteristics, regression models have been found to be a reliable predictor of chain restaurant economics. Upon preparing the regression models, we applied each chain's estimated average sales volumes for newly built properties to the models to determine predicted operating income, defined to be earnings before interest, taxes, depreciation, amortization, and lease payments (EBITDAL). Since

the chain restaurant industry is essentially a cash business, store-level EBITDAL essentially equates to cash flow. An allowance of 5% of revenues was employed for indirect general and administrative costs, such as regional managers and home-office costs. While not a direct cost, such charges cannot be overlooked when making the decision to build a series of restaurant locations. The results of this regression study are illustrated in Exhibit 1.

There can be no question that a hierarchy is clear. Even when the chains are grouped according to their sectors (fast food, midscale, and casual dining), there exists a hierarchy of operating performance. As a general rule, those chains with the highest operating cash flow tend to employ the largest real estate locations, or the most expensive, or to have the most expensive buildings. A second table using the same rankings was prepared to illustrate estimated free-standing unit costs and debt service. The estimates for new unit costs were derived from building characteristics contained within the Uniform Franchise Offering Circulars prepared by each chain, as well as from a sampling of actual development costs. The result is shown in Exhibit 2.

Regarding unit-level economics, Exhibits 1 and 2 illustrate two key points. The first is that some chains with lower predicted average unit operating cash flows will have difficulty expanding to new free-standing locations. Hence, Pizza Hut has constructed few new "red roof" restaurants and has focused instead on delivery and takeout units. Other chains that show poor signals for new store development include Church's, Popeye's and Hardee's. Readers can guess the identities of other chains having unit-level economics that will impede new store development. Such names as Ponderosa, Bonanza, and Western Sizzlin' come to mind, since all of these systems have shown little or no new store development over the past five years. Restaurants having higher sales and cash flows can and will pay higher prices for desired locations because they can achieve favorable returns on their investment. Those that exhibit poor unit-level economics cannot and will not pay the price for desired locations. Indeed, the "invisible hand" of the economic marketplace, once described by Adam Smith, is clearly at work. The development of free-standing restaurant property is a function of tenant economics, pure and simple.



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## ***Real Estate as Plant and Equipment***

In a philosophic sense, single-tenant free-standing properties are really the equivalent of plant and equipment. Their value and usefulness to a business is a function of the cash flow produced at the site. The diverse operating fundamentals of restaurant chains shown in Exhibit 1 result from various quantifiable differences, including different menu offerings, staffing requirements, and hours of business. Within chains, operational differences result from regional market share, site quality, and most important, the quality of management. Therefore, the amount that a restaurant operator will invest in real estate is a function of all of these factors contributing to a return on investment.

## ***Highest and Best Use***

Real estate appraisers have a concept of "highest and best use," the value that can be expected to be obtained from the sale of a property if it is put to a use that will realize the greatest landlord income potential. In the case of single-tenant retail properties, greater landlord income potential is inextricably tied to the tenant's earnings at the site. Therefore, given the analysis shown in Exhibits 1 and 2, the highest and best use appears clear: start at the top of the list in Exhibit 1 and work down. Companies with more favorable unit-level economics can and will pay more to secure choice real estate sites.

Once real estate has been sold and financed, the idea of highest and best use takes on a different light. Many restaurants cannot support rents based on their replacement cost. Some examples were discussed previously. Still, a restaurant may be at its highest and best use if the cost to convert the property to an alternative brand or use is not supportable by the incremental rents that would be realized. Such might be the case if the incremental investment results in a total investment that is in excess of its replacement cost.

What about the highest and best use of vacant single-tenant retail property? Since single-tenant retail properties are not speculatively constructed, relatively few vacancies occur. Still, they do occur, either as a result of tenant insolvency, tenant losses at the location, or lease non-renewal. In such cases, the highest and best use is, once again, determined by seeking out replacement tenants with the best store-level econom-

ics. Again, start at the top of Exhibit 1 and work down. As noted previously, appraisers often fall into the trap of estimating the income values of vacant single-tenant property on the basis of prevailing local area lease rates. As has been noted, however, single-tenant retail properties are not leased on a square-foot basis to begin with. They are leased on the basis of their cost to construct.<sup>7</sup> A second common trap is for appraisers to estimate a lease stream based on a percentage of sales common within the related industry as a sort of market rent benchmark. Within the restaurant industry, the benchmarks used often range from 6% to 9% of sales. However, such a benchmark for build-to-suit property cannot exist, for it presumes a consistent sales to property investment ratio throughout the industry and a stable lease rate environment. On the basis of the information contained within Exhibit 2, the restaurant industry has a wide range of sales/investment ratios. Furthermore, lease rates are generally a factor of both long-term interest rates and tenant credit quality. Why, then, would an income valuation be made using local market square-foot lease rates or percent-of-sales benchmarks when looking to value a single-tenant retail property? The answer often lies in the failure of appraisers to understand tenant economics and resulting single-tenant real estate dynamics.

## ***Financing Single-Tenant Retail Property***

If single-tenant retail property is philosophically "plant and equipment" with a value tied to its economic contribution to the user, it must be financed as a going concern. In the arena of commercial mortgage-backed securities, one of the most significant indicators of loan default is fixed charge coverage ratios (i.e., the relationship between the net rental streams of multi-tenanted properties to the mortgage payment). Single-tenant real estate is no different. In this case, however, it is the fixed charge coverage ratio<sup>8</sup> of the property occupant that is important. Retail properties that generate profits represent better credit risks. If a store is profitable, loan defaults are less likely, and if defaults occur, higher recoveries are more likely.

The amount that may be financed on a single-tenant retail property is principally a function of the store-level fixed charge coverage ratio of the borrower. For the extension of fully secured loans, property replacement cost is typically the ceil-

ing. Frequently, however, store-level economics simply do not justify loan advances that high. Another look at the restaurant store-level economics in Exhibit 2 offers some insight into a number of chains whose unit-level economics offer less justification for new store development and hence, the financing of existing units at replacement cost levels.

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**Companies with more favorable unit-level economics can and will pay more to secure choice real estate sites.**

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The legal environment is the arbiter of what is or is not considered a secured real estate loan. Such a determination is as much an art as a science, but the venue of deliberation is typically the bankruptcy court. And the ammunition for the assessment of what is or is not fully secured is typically a real estate appraisal. The dreaded "cramdowns" that bankruptcy courts inflict on financiers are the result of these deliberations, in which loans secured by real property are frequently split into a secured and an unsecured component. Given the preceding analysis of valuation methods, there are two basic means for estimating what comprises a secured single-tenant retail property loan.

**Loans Collateralized by Fee-Simple Property.** As a general rule, a single-tenant retail property loan equal to or less than replacement cost and secured by the real estate of a profitable retail establishment is considered a fully secured loan. Loans in excess of an amount that would be deemed secured are essentially unsecured general corporate obligations.

**Loans Collateralized by Property Subject to a Lease.** Loans that are secured by real property and the related assignment of a performing lease stream, with payments equal to or greater than the loan payments, will generally be considered a fully secured loan. The reliability of the lease stream is a factor of both tenant credit quality and the profitability of the related retail establishment financed. Within the context of a tenant bankruptcy, the ground rules are different, since a true lease

will be considered an executory contract, which can be either assumed or rejected within bankruptcy. The leases on profitable store locations tend to be assumed by the tenant, while those on unprofitable sites tend to be rejected or renegotiated. Therefore, as a general rule, a tenant bankruptcy will not adversely affect the landlord of a profitable store and hence the lender to the landlord who finances the property.

**Observation.** A key observation to be made is that a loan for an amount that exceeds the replacement cost of the property can be considered fully secured if it is backed by a lease contract. However, there can exist greater lender risk, since the repossession of such a property is likely to result in a proportionately higher loan loss. Therefore, such loans should ideally be secured by a strong lease stream that is supportable through a high fixed charge coverage ratio by the tenant. This is because even above-market leases are likely to be assumed within bankruptcy, providing they are considered to be true operating leases and the store in question is profitable. Exactly how high should the fixed charge coverage be when financing a property in excess of its fair market value? There seem to be no rules here. A lot of the decision is a function of general borrower and tenant creditworthiness. In addition, less expensive properties typically accompany less investment risk (all other things being equal). However, coverages of at least 1.5 to 1 would seem prudent, which is in excess of typical minimal coverage targets, which tend to be in the range of 1.25 to 1.

### ***Enterprise Approach***

A free-standing single-tenant retail property is more than just a profit center. It can be looked upon as a free-standing business. The 1996 Uniform Standards of Professional Appraisal Practice sets forth basic guidelines to the valuation of a business enterprise. The methodology employed varies with the business to be valued. With "mature" retail locations (which generally includes most restaurant properties), the constant growth formula for discounted cash flow valuation is frequently applicable.<sup>4</sup> In the end, the valuation, like that of any business enterprise, ultimately comes down to a multiple of cash flow.

It would seem that the more a single-tenant retail property costs to develop, the higher its sales and cash flow. This is not the case. Sales/investment

ratios are not static, and different restaurant brands can and do generate different cash flows at the same level of store sales. Therefore, the valuation of a business enterprise is separate and distinct from the cost to develop the real estate that is used by the single-tenant retail property occupant. The value of the enterprise may be higher than, equal to, or lower than the replacement cost of the underlying single-tenant real estate.

For the financier of single-tenant retail real estate, the relationship of the loan amount to the enterprise value is effectively one measure of risk. The lower the loan/value ratio, the better the risk. Such an approach is applicable for loans that are "secured" as described previously. The risks of unsecured loans should be measured by an overall corporate valuation.

### A Perspective

The investment and risk dynamics of single-tenant retail property are different from those of multi-tenanted retail real estate. First, there is an undeniable link between tenant economics and property valuation. Single-tenant retail property is philosophically viewed by its tenants as "plant and equipment" and is generally constructed on a build-to-suit basis. Second, lease streams are less a function of local market dynamics than they are a function of property construction costs, long-term interest rates, and tenant credit risk. Leases are essentially mortgage substitutes, are generally long term, and are net to the landlord. As a result of these fundamental differences, the single-tenant retail property lexicon differs from other retail real estate. Gone are discussions of rent per square foot and sales per square foot, which are prevalent with multi-tenanted property. Instead, there is landlord concern regarding full store earnings statement disclosure and tenant fixed charge coverage ratios.

With such different asset dynamics from more traditional real estate, single-tenant retail property cannot be valued using a weighting of traditional real estate valuation approaches set forth within the 1996 Uniform Standards of Professional Appraisal Practice. Instead, the valuation methodology must fit the dynamics of the asset—that is to say, either replacement cost tempered by store-level economics or an income approach supported by both a long-term lease contract and favorable store-level economics. Both methods effectively require an enterprise

valuation approach that centers on store cash flows and views the retail store as a going concern. In such a valuation focus, tenant economics must take a rightful front seat next to landlord economics. ■

### Notes

- <sup>1</sup> Essentially, this is the income value of the specific lease, which is determined by adding the net present value of expected future lease payments to the net present value of the residual value of the real estate, which is, in turn, determined by dividing expected final year rents by the going-in capitalization rate (i.e., first-year rents divided by the property purchase price). The annual interest rate used in determining the net present value is the rate of return required by the real estate investor. The depreciation factor used in determining replacement cost may be nominal, since many single-tenant retail properties are well maintained and have remaining expected useful lives that are not materially different from newly constructed assets.
- <sup>2</sup> Appraisers often correctly note that the per-square-foot-lease rates of single-tenant property exceed the local market rents for multi-tenanted real estate. Again, the reason for this is that single-tenant properties are typically leased on the basis of their cost to construct. In an auction marketplace, multi-tenanted property may realize an inferior return on construction cost. A related reason for the square-foot rental differential is that the ratio of land value to total value for single-tenant property is higher than for multi-tenanted properties. In the case of the restaurant industry, for example, it is not uncommon for land values to approximate 50% of the combined value of land and building. The proportionately higher investment in land for single-tenant properties is a contributing factor to higher building rent rates per square foot.
- <sup>3</sup> Single-tenant retail property fixed charge coverage ratios should be calculated as follows:

$$\frac{\text{EBITDAL} - \text{Allocated Indirect General and Administrative Costs}}{\text{Lease payments and secured loan payments}}$$

A discussion of what would be considered a secured loan appears later in this section. Unsecured loans, or any portion of a loan that exceeds an amount that might be considered secured, are general corporate obligations and should not be allocated at the store level for determining fixed charge coverage.

- <sup>4</sup> The constant growth formula is:

$$\frac{\text{Cash Flow}}{\text{Discount Rate} - \text{Projected Sustained Cash Flow Growth Rate}}$$