

# Opportunistic Investing in Single Tenant Properties

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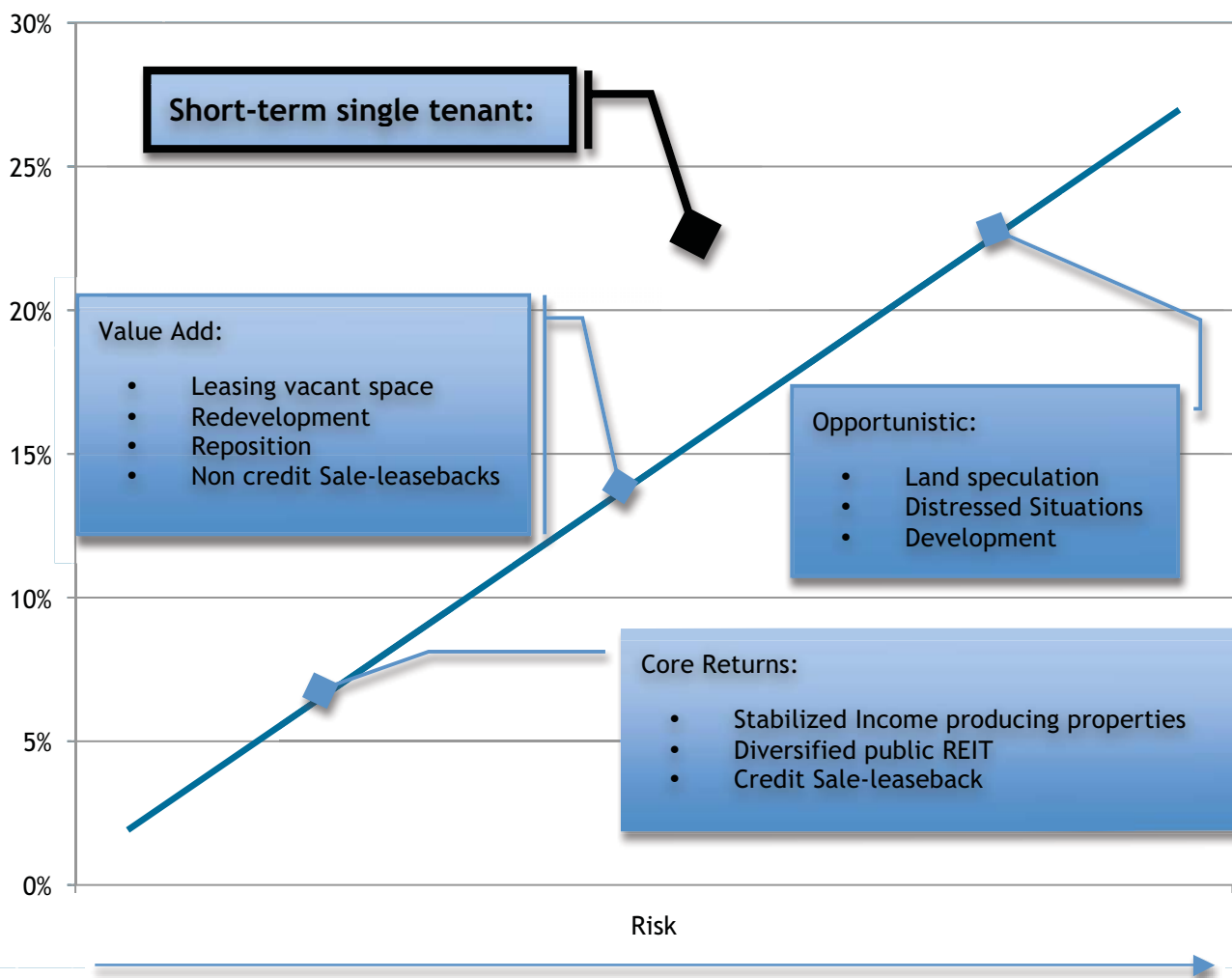
An opportunistic real estate investor focuses on the question “Am I being properly compensated given the risk level inherent in this transaction?” Investors seeking IRR’s of 20% or above are required to heavily scrutinize the risk/reward profile of an investment. Although single tenant properties are typically associated with long-term leases and core returns, opportunistic results can be achieved in the single tenant sector by investing in assets leased on a short-term basis. The risk-adjusted return on these investments is pragmatic and should be acceptable to all investors pursuing high yield strategies when rationally quantified. This type of opportunistic investing is not for everyone, but institutions and high net worth individuals seeking superior returns on real estate investments should do so by placing funds where high risk-adjusted returns are available. This can be accomplished by pursuing a contrarian investment strategy: short term leased single tenant commercial real estate.

The critical variable in opportunistic investment is the assumption through which returns are achieved. Investors need to focus on the incremental return factors (i.e. rent growth, cap rate compression, absorption rates, etc.). For example, a developer of an industrial park would expect to achieve opportunistic returns but would take on development risk, construction risk, leasing risk, market risk for rents, absorption, vacancy and numerous other factors. The returns on that type of investment would

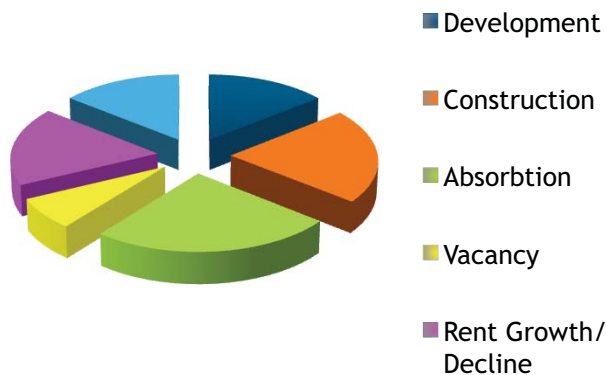
need to be well above average. Otherwise the risk-adjusted returns are not worth pursuing. Compare this with a short-term single tenant investment, where the determinant of success is most often a renewal/extension of an existing lease. Other factors, disposition environment, rent growth, etc. can come into play in terms of maximizing or minimizing returns, however the general success of the investment is tied to a single outcome or variable, simplifying the investment decision. Additionally, under this investment strategy, a large incremental percentage of a return is secured from the cash flow of the property during the hold period. Unlike other alternative high yield strategies where returns are most often achieved upon speculation of residual valuation, incremental and double-digit cash flow returns can be virtually assured in the short term leased sector.

## Real Estate Return Spectrum

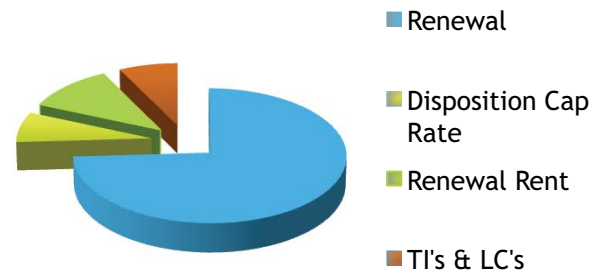
IRR



## Traditional Risk Exposure



## Short-Term Single Tenant Risk



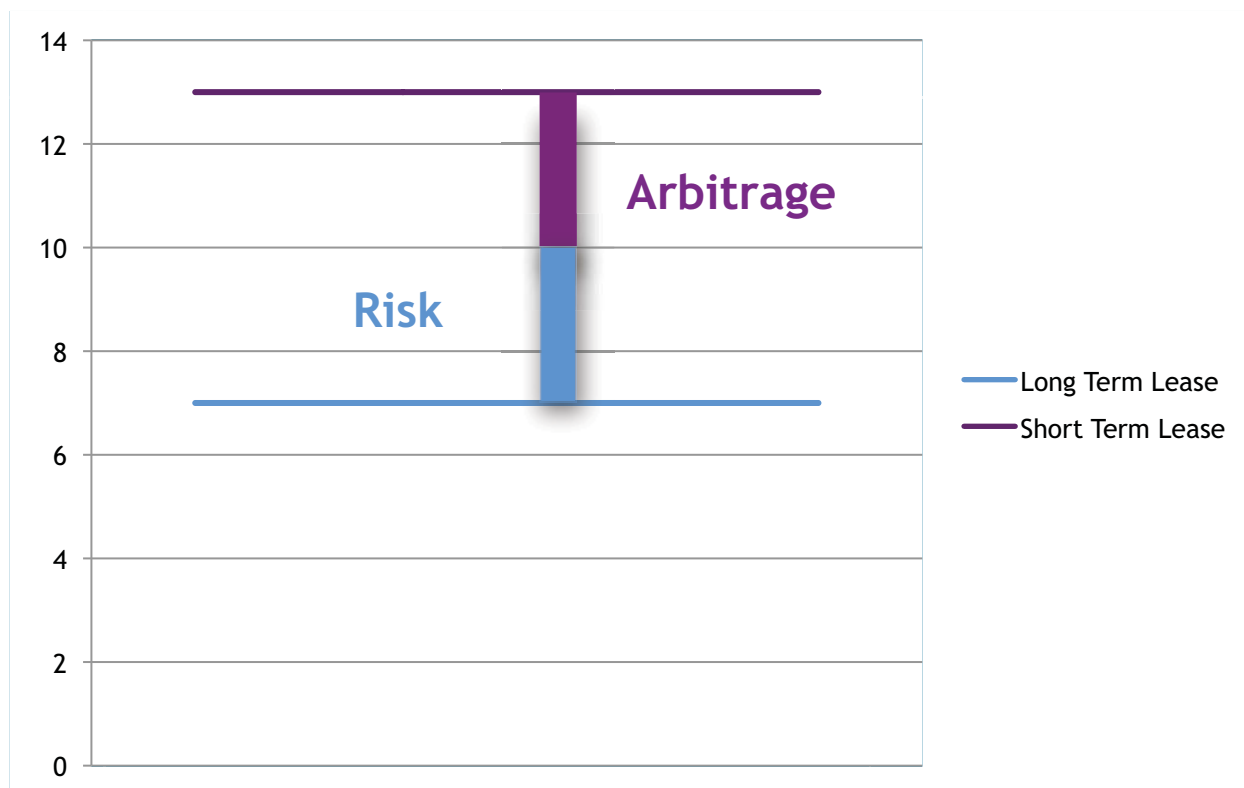
Short-term single tenant deals are being doubly penalized (or rewarded depending on which side of the buyer/seller equation you sit on) because of a lack of demand for these assets. If the opportunistic component of a business plan is considered risky, the reward must be similarly increased to justify the investment. The greatest risk mitigation in real estate is price. The core meaning of the phrase “there is a price for everything” is the mitigation of risk achieved through valuation. All things being equal, the best way to acquire assets at attractive valuations is to be a contrarian investor and purchase real estate when everyone else is in disposition mode. Or in the case of single tenant commercial properties, acquire properties that few are considering. There is currently a dearth of both equity and debt targeting short-term single tenant commercial real estate. Very few individuals or firms target short-term leases regardless of tenant, location, and/or product type. Concurrently, there are ample investors for long-term single tenant leases. Critics will argue that this is due to the rollover risk intrinsic in a short-term lease. While this is undeniably true, the rollover risk incremental discount factor is already priced into these assets.

Arbitrage is the practice of taking advantage of a price differential between two or more markets: finding deals that capitalize upon market imbalance. For illustrative purposes, let’s assume a 10-year Microsoft leased property trades for a 7.5 cap rate. Furthermore, let’s assume that the same building, with the same tenant, has a 3-year lease with a 7-year fair market value renewal option. Now let’s say very few bidders come to the table, and it trades for a 10 cap rate. The discounted valuation for the short-term lease equates in this scenario to 250 basis points. Same tenant, same metro, same building, identical submarket projections for rent growth, vacancy, etc. If the

quantification of the rollover risk of the Microsoft lease came to a 150 basis point discount, a buyer should capitalize on the 100 basis point arbitrage “opportunity” presented by the transaction. This dislocation of information, the inaccurate pricing of risk on short-term single tenant leases, does not occur in markets and/or business segments that are heavily covered and invested in. The efficient markets theory holds true in real estate where coverage is omniscient amongst institutions, and presents excellent opportunities when it is not. Coverage is not the only reason this situation presents itself. In today’s economic climate, the risk appetite of even opportunistic investors is at an absolute minimum as capital preservation takes precedent over capital creation. Again, this becomes a conduit for opportunity, as the investment itself may have the same risk profile as it would have had five years ago, but a lack of buyers further depresses the valuation, ensuring an investment can and will be financially viable for those willing to take on the discounted risk.

## Arbitrage Illustration

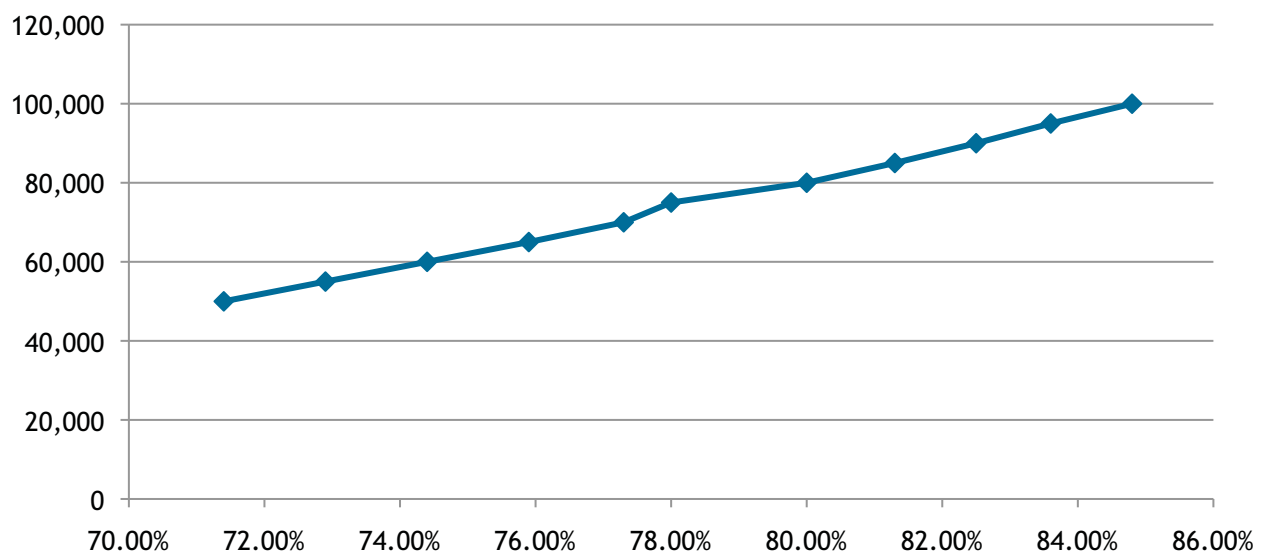
Cap Rate



The crux of any short term lease antagonists' argument against investing in a single tenant deal is the rollover risk, but, very few investors have actually attempted to quantify the percentage of single tenants that elect to move and vacate a property. Historical retention rates of single tenant properties are anywhere from 71% to 85% for single tenant office and industrial properties depending on building size, market, tenant and various other factors. This is a renewal level many previously hesitant investors could surely accept if properly educated.

## Renewal Probability

Sq/Ft



\* Based on research conducted at MIT

Another investment mantra that is a further justification for short-term single tenant assets is portfolio diversification. On an individual property basis, an investor may not be willing to live with the worst case scenario returns of an opportunistic investment however this can be avoided by accumulating or purchasing a portfolio. Utilizing the law of averages, the more properties acquired under an attractive risk-adjusted return profile, the closer the performance of that portfolio will come to the weighted average return.



The best way to address the rollover risk of short-term properties is to acquire assets that allow for an easy transition into multi-tenant buildings. A critical component of the risk-adjusted returns profile is maximizing the returns of investments that do not proceed according to the base case scenario. Specialized spaces, undesirable locations, and shallow markets should be eliminated from consideration so that a single investment does not dilute the performance of an entire portfolio. If Wal-Mart vacates a big box retail space in a secondary market, the probability of recouping that investment are minimal. This is precisely why office and industrial short-term single tenant assets, especially in a portfolio, provide attractive risk-adjusted return opportunities while retail properties do not. Retail assets can be cost prohibitive to subdivide and very difficult to backfill in a short period of time.

Acquiring properties leased on a short term basis and subsequently disposing of said properties after an extension has been executed also allows an investor the value add opportunity of asset repositioning without major capital contributions. As discussed above, there is a lack of demand for short-term leases but there is ample demand for long-term leases. The repositioning of the asset to a larger investment universe correctively changes the discount associated with valuation to a premium. The return requirements of investments in core, core-plus and value add assets are less than that of opportunistic investments. This further exacerbates an assets valuation upon repositioning because it allows a non-opportunistic investor to acquire at an increased valuation while still achieving the lower core or core-plus return hurdle. A subcomponent of this demand is the availability of financing for long-term leases. While debt does unequivocally exist for short-term leases, albeit at less desirable terms, it is easier to obtain financing for long-term leases. Accordingly, a buyer would pay a valuation indicative of a demand and debt constrained short term investment and dispose at a valuation indicative of excess demand and financing readily available for long term leases.

Various myths contribute to the lack of demand for short-term leases that in fact further justify this investment strategy. A common misconception is that properties purchased under long term leases allow an owner to drastically reduce their cost basis in an asset to the point where once a rollover does occur; all risk has been removed from the transaction. However, if analyzed closely, the reduction in cost basis in short term versus long-term leases is analogous because of the discounted acquisition valuations. A 15-year lease may allow an investor to reduce their basis by 45% over the hold period.



However, a short term lease acquired at a much more favorable cap rate can accomplish the same 45% cost reduction over a 5 year period. The cost basis benefit to short term investing is compounded when you realize that the same building, under a 5 versus a 15 year lease will sell for a much lower price per foot under the shorter term; giving the short term lease asset a heads start on the cost basis reduction. This is a result of the high ongoing cash on cash yield achieved when investing in short term net leased properties. Due to the discounted acquisition valuation, even in the current economic climate where LTV's are advantageous to lenders, 15%+ cash on cash yields are not uncommon in this investment strategy and can be secured for anywhere up to 5 year periods.

An attractive acquisition cap rate also protects an investor from interest rate risk. The delta between the rate of financing and cap rate at time of acquisition is less on long term leases than the same delta between the inflated costs of financing associated with short term properties and their cap rates. The increased cost of debt for short-term leases only partially offsets the discount on cap rates, again creating an arbitrage profit environment that can provide intrinsic returns to an investor. Along this same line of thinking, short-term leases allow for the revaluation of rents and costs. With inflation looming around the corner, any rent or cost structure that can be adjusted in tune with the market will allow an investor greater control and increase the transparency of future returns. Under a long-term lease, a fixed percentage or amount can become wholly disconnected at times with what's actually occurring in the economy from an inflation perspective. Inflation risk is considerably higher on long-term leases than short-term leases, despite the fact that pricing would indicate that the reverse is true.

The alpha that can be achieved by investing in short term single tenant assets is superior to alternative real estate investment strategies seeking opportunistic returns. As is standard for a contrarian investment, many of the reasons investors typically avoid short term leases are precisely the reasons those investments should be targeted for opportunistic returns. With the correct quantitative analysis and thorough due diligence, the risk associated with a short term lease and the profit arbitrage environment that exists in today's market make short term single tenant leased properties an attractive choice for a real estate investor to achieve consistently high returns while maintaining a focus on capital preservation.

*Randy Blankstein and Noah Gottlieb are partners with Boulder Net Lease Funds. Boulder Net Lease Funds is a sponsor of joint ventures and real estate funds that invest in short term leased single tenant properties.*