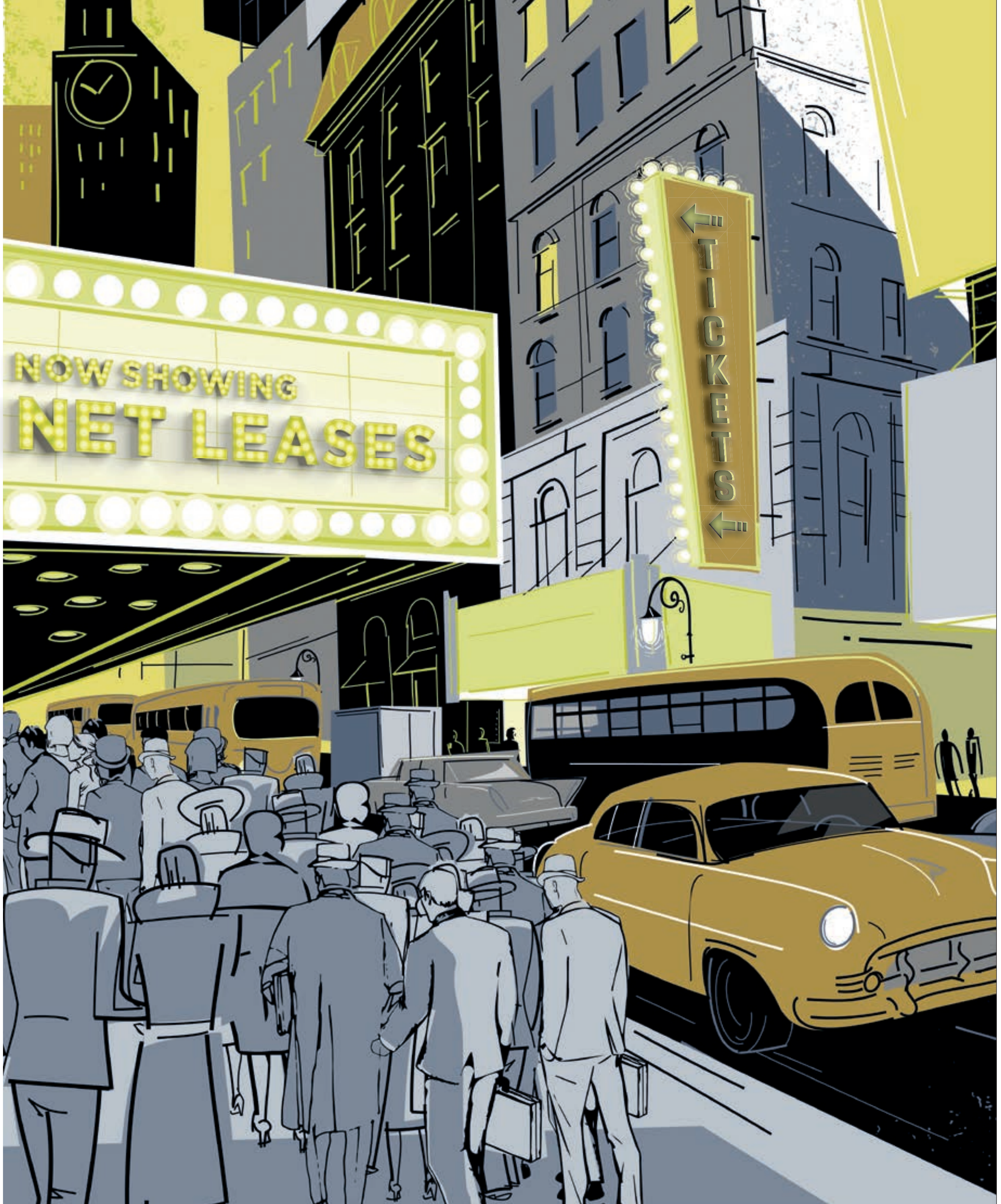
Cover story



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PERE

Why private equity is making big bets on net lease strategies

Cover story

Firms including KKR, Ares and Carlyle are buying or growing net lease investment platforms. Peter Benson investigates the reasons behind this high-profile interest

M&A transactions in the private real estate market valued at more than $3 billion usually capture attention. Two such deals that were completed in February did even more: they demonstrated the growing institutionalization of a once-fringe format of real estate investing.

In February, Washington, DC-based private equity firm Carlyle Group announced its global credit business had acquired ground lease real estate investment trust iStar's net lease business for $3.07 billion. In the same month, New York-based competitor Ares Management announced a combination of its alternative credit strategy and real estate group's funds had purchased Capital Automotive, a portfolio of net lease care dealerships, from Toronto-based asset management giant Brookfield for $3.8 billion.

The transactions propelled a style of real estate investing which had quietly been gathering momentum already, with growing interest from institutional investors. They also highlighted the US private equity industry's particular focus on the strategy. Last year, New

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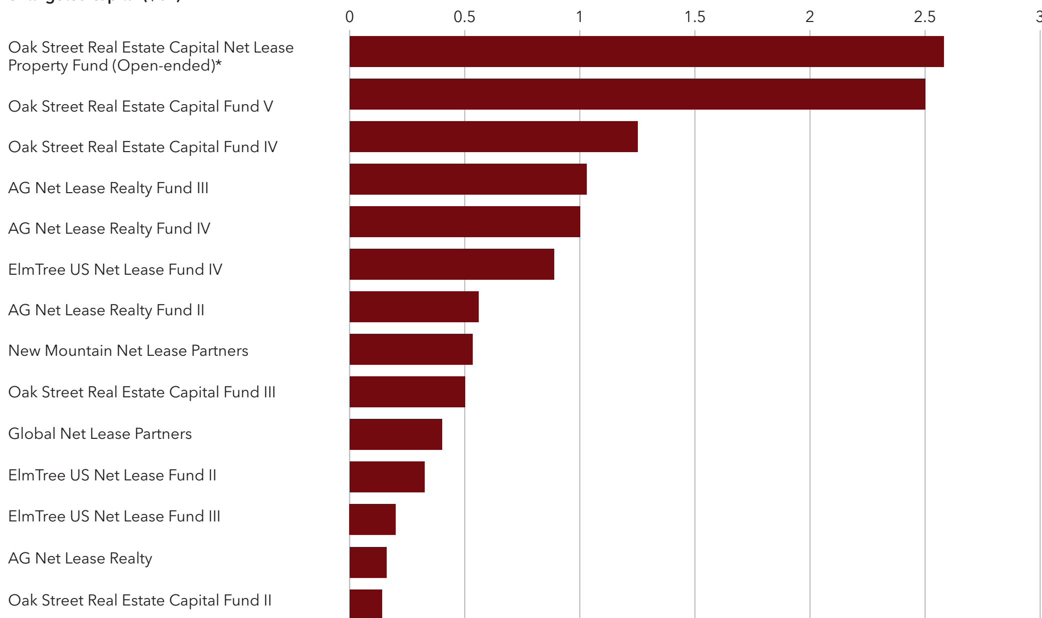
The net lease space has a few large dedicated funds, but most of the new entrants have opted for deploying out of their diversified vehicles instead of targeted capital ($bn)



*Fund still in the market raising capital
Source: PERE

> *"You can't look at net lease on a cap rate basis. You have to look at it as a spread above corporate [debt]"*
>
> **JOEL HOLSINGER**
> **Ares**

York-headquartered manager KKR took the organic route by launching a dedicated net lease platform, Strategic Lease Partners. The firm has stated an ambition to acquire more than $3 billion of assets itself and has closed on $780 million of equity for the strategy.

These managers are drawn by a growing volume of transactions in the space. Approximately $95.5 billion in sales in single-tenant, net lease properties in the US were recorded last year, according to New York-based brokerage firm Stan Johnson, smashing a record of just more than $80 billion set in 2019. That included a spending spree of $36.3 billion in Q4 alone, the highest ever quarterly transaction activity.

Colliers, the Toronto-headquartered global brokerage firm, sees most of the activity in the US being driven by domestic, institutional-level managers, for which net acquisitions hit a record $7.3 billion in deals in 2021 also, according to its year-end net lease report.

With such scaling activity, *PERE* has examined the forces behind this notable progress for the investment type, speaking with newer entrants and legacy firms alike.

Straddling an intersection

The newer private equity entrants to the net lease market say their interest started with the realization they had the tools to execute on such deals. They describe the market as a hybrid business, straddling the intersection between real estate and credit assets. While the underlying real estate is important, its long-term lease means the creditworthiness of the tenant is equally keenly underwritten.

"You can't look at net lease on a cap rate basis. You have to look at it as a spread above corporate [debt]," Joel Holsinger, portfolio manager and co-head of alternative credit at Ares, tells *PERE*.

This theme plays out in how managers have structured their teams to

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invest in net leases. At Ares, Holsinger works with Ben Fox, managing director for the Ares Net Lease Strategy. At KKR, Jenny Box, a partner in credit, and Billy Butcher, a partner and chief operating officer in its real estate business, jointly oversee the firm's investments via the Strategic Lease Partners platform. Roger Cozzi, managing director and head of real estate credit at Carlyle, meanwhile, oversees his firm's net lease operations.

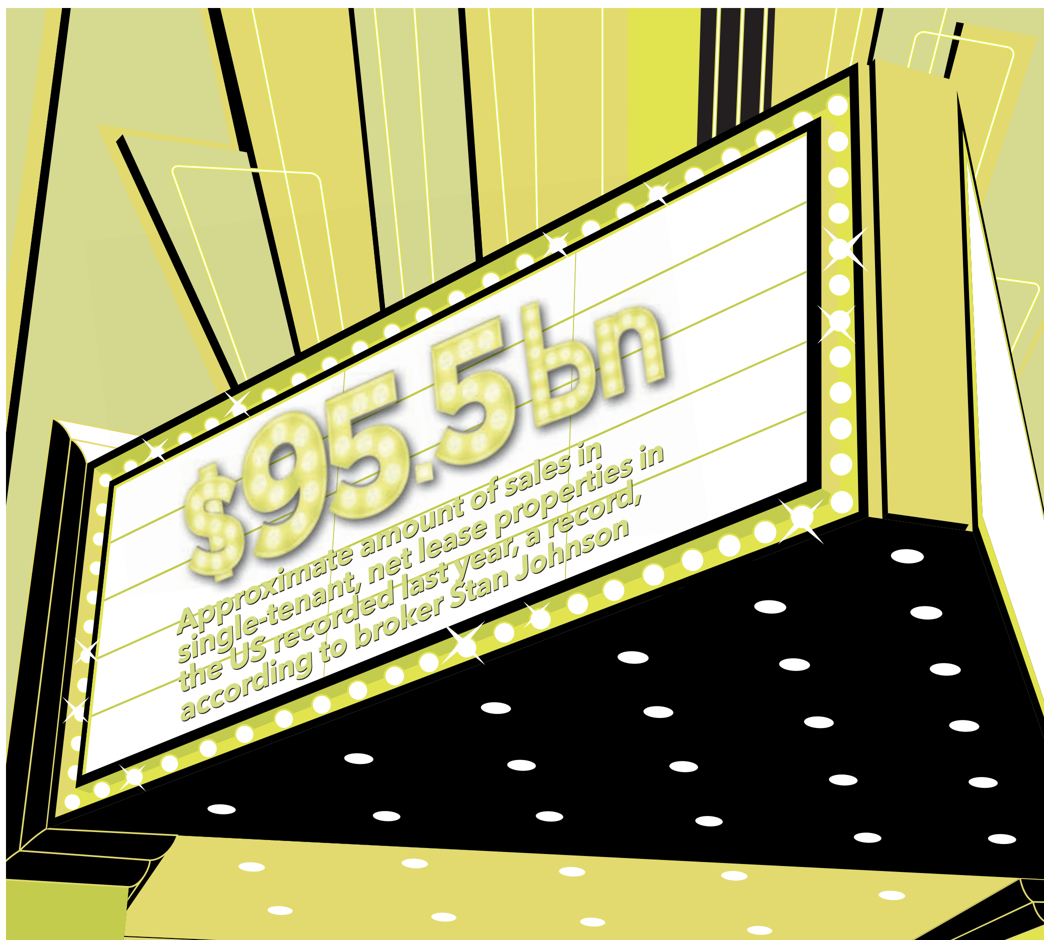
Accordingly, all three firms deploy capital from vehicles not dedicated to the net lease market. Moreover, they are typically combining resources from across equity and credit vehicles, as well as from their balance sheets. Rather than opening up the possibility of confused ownership, they extol the flexibility that a spread of capital sources offers to them.

"There are certain deals in the net lease space that are more reliant on the credit of the tenants, and others where you're more reliant on the quality of the real estate," says Butcher. "I think each investor in the space probably tends to have a bias in terms of what combination of the two and how they think about the two in concert."

That deals with the 'what' and the 'how' of net leases. But what about the 'why now?'

PERE is told the current inflationary environment is a big reason for the present rush. Real estate has always been an attractive inflation hedge, says Cozzi, pointing to values of hard assets generally increasing as rental rates increase. There is a natural inflation protection built into property types with regular lease turnover, too.

But while net lease contracts are usually long – typically more than 10 years – rental increases are generally set at a baseline of 1.5-3 percent per year, Cozzi says. When the consumer price



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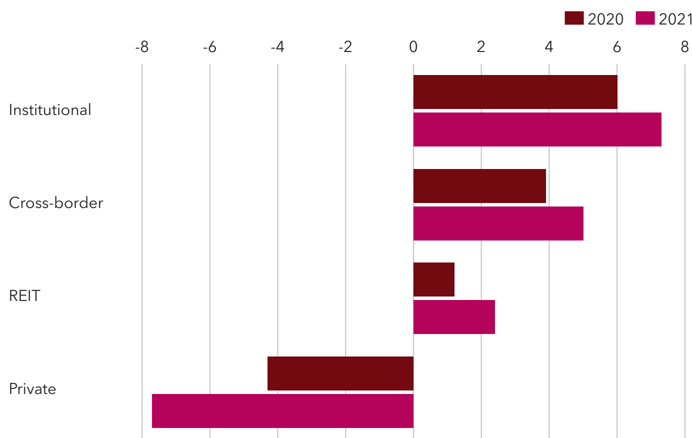
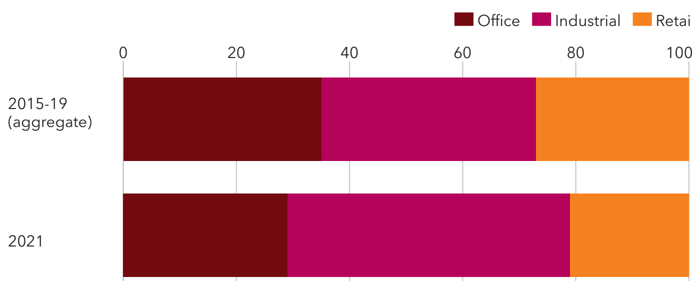
Net acquisitions in the net lease sector show institutions and international investors driving the buying ($bn)



Pre-pandemic, the three main net lease asset types had a more even share of the market. Since then, much like in the broader market, industrial has become the largest sector (%)



Source: Colliers/Real Capital Analytics

index, one of the primary measures of inflation, exceeds these baselines, it can become the new increase rate if the terms in a contract stipulate. That factor is highly relevant presently after CPI annually rose 7.9 percent at the end of February 2022, according to the US Bureau of Labor Statistics.

An education

An increase in focus from managers has resulted in an education about net leases for their investors. One important area institutions have sought to understand is where to place these assets given they can be classified as both real estate and credit. Depending on the investor, they can fit into either bucket, Teddy Kaplan, managing director and head of net lease real estate for New York-based New Mountain Capital, says. "Really wherever they are looking for long-term, stable cash-flows," he added.

Longer standing managers in the net lease space have raised capital specifically for such transactions. For instance, according to *PERE* fundraising data, there have been four such funds for Angelo Gordon and three such ElmTree Funds vehicles, two of the more established players in the space. The firms have raised $2.75 billion and $1.3 billion in discretionary capital for net leases, respectively.

Chicago-based Oak Street Real Estate Capital is another legacy manager in the market with its open-ended Real Estate Capital Net Lease Property fund. For that, the firm has raised $80 million more than its initial $2.5 billion target, per *PERE* data. It has also raised six closed-end funds, the most recent of which was closed in 2021 with $2.5 billion in commitments. During those fundraises, there was a lot of explanation on the function and purpose of the asset class to investors, says Marc Zahr, president of Oak Street.

For its part, ElmTree found some investors actively sought the asset type as a means of addressing under-allocated real estate targets. The firm also found

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the recent entrance of larger competitors is helping investors unfamiliar with the sector understand it better and that has made it easier for existing managers to raise capital.

"[The larger private equity firms entering the market] are educating the LP base and have made institutional capital much more comfortable," says James Koman, founder and chief executive of ElmTree.

"They are paving the way for groups like ourselves to allow us to keep growing and expanding."

Defining the space

The evolution of net lease as an investment class has made it easier to crystalize definitions in a sector that has historically been hard to label. Legacy managers use two terms to define assets: investment grade or non-investment grade. This is in reference to the tenant in the building. Predictably, most investors are most comfortable buying assets with investment grade tenants given they are easier to underwrite.

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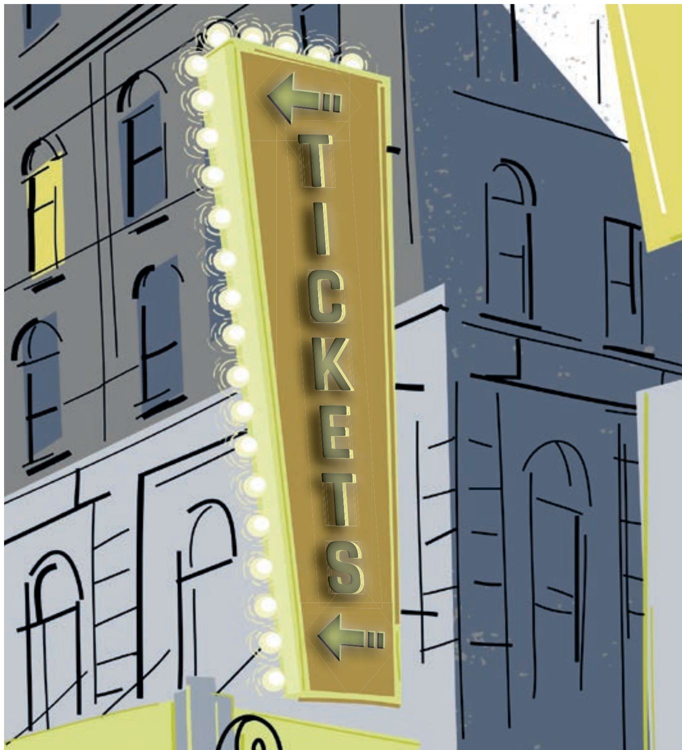
>
> **GORDON WHITING**
> **Angelo Gordon**

The non-investment grade sector brings higher risk but higher rewards in tandem as higher rents can be charged, Gordon Whiting, head of net lease real estate at Angelo Gordon, says. Angelo Gordon's platform focuses on both the investment and non-investment grade sector.

"You need to be able to do the real estate underwriting properly because if a tenant goes away, you want to make sure you were in at the right basis and had at, or below, market rent," Whiting says. "When it comes to non-investment grade, the real estate underwriting is essential, whereas with investment grade tenants, there tends to be less focus on it."



Most of the newer entrants stick to investment-grade tenants, though KKR's strategic lease partners platform does predominantly invest in the non-investment grade space, Butcher says. It plays in the investment grade space via other strategies, including its Drawbridge Realty strategy, which focuses primarily on single-tenant office buildings, Butcher adds.

The most concrete definition came from specialist manager LCN Partners' co-founder and managing partner Edward LaPuma, who referred to the market in terms of primary and secondary investments.

Primary investments in the net lease space include sale leasebacks – the act of buying a company's underlying real estate and leasing it back to them in a triple net lease agreement; and build-to-suit developments, where the manager does not undertake the leasing risk. Secondary investments entail the acquisition of an already leased building, which accounts for the majority of activity of new entrants.

Not all market participants *PERE* spoke with use the 'primary' and 'secondary' market descriptors, though

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generally agreed it was a useful way to define the market.

Protecting the legacy

LCN's definition of the primary and secondary markets does dovetail with how the sector's legacy firms are maintaining their footing in the net lease space despite increased competition. Sale-leasebacks and the development of new assets is where firms like ElmTree, Oak Street and ICG Real Estate have remained, despite the growing acquisitions market. Most newer entrants are buying their way into the sector via established assets.

"The impact of having many entrants has been mitigated because everybody is not doing the same thing," Whiting says.

That dynamic could change. Many of the new entrants are led by former REIT executives. KKR, for instance, hired two former seniors from net lease specialist WP Carey, Andrés Dallal and Joseph Mastrocola, in August 2021 as it was launching its platform. Cozzi joined Carlyle from Gramercy Property Trust, a now Blackstone-owned industrial net lease specialty REIT. He also formerly worked at iStar, the platform it purchased earlier this year, for which he was instrumental. Fox was one of six executives leading Realty Income, the largest REIT in the space, before joining Ares. WP Carey's roots in particular permeate the existing side of the market, with Angelo Gordon's Whiting and LCN's LaPuma both having spent the early part of their careers there.

"I'm not sure there's a ton of special sauce there. It's really the economics of it," Zachary Pasanen, managing director at WP Carey, says of the potential for group think, noting any differentiation will come from how a firm underwrites its cap rates, debt and the spread between the two.

Most participants say they have not seen a material difference in net lease pricing because of the increased level of competition. Average cap rates in the single-tenant office and retail spaces have remained steady. Office cap rates were 6.4 percent in all four quarters last year, while retail fell immaterially from 6.2 percent at the start of the year to a flat 6 percent at the end of 2021.

Over time, the compression has been muted in both sectors, with average office and retail cap rates opening 2017 at 6.7 percent and 6.2 percent, respectively. By comparison, average industrial cap rates have materially compressed, falling from 6.6 percent to 5.6 percent in the same period, per data from Colliers and Real Capital Analytics.

Many of the newer managers are combining balance sheet capital with the existing pools they have in other asset classes, and they do not intend to change that funding model at present. For them, the primary objective is to find deals, Holsinger says. The scale of the capital from the current set up allows Ares to do conversions into REITs as well as originate loans against the properties, undertake single property

"I'm not sure there's a ton of special sauce there. It's really the economics of it"

ZACHARY PASANEN
WP Carey

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acquisitions or buy big portfolios, he adds.

"That can't be done by your other pools of capital," Holsinger says. "For those kinds of transactions, we're not competing with the REITs. We're not really competing with some of the other traditional net lease players. The ability to have that flexible capital in scale is really a key driver."

Room for growth

There is typically a drop-off in activity in the early part of the year, according to Colliers' director of US capital markets research Aaron Jodka. On current reading, investment volume appears to be at or higher than previous first quarter levels, he adds. That, combined with the amount of capital being raised for net leases, has led to a belief there is room for meaningful growth.

Within that growth, the asset class proportions are likely to change in conjunction with broader real estate trends. Industrial, office and retail are the main three property types in the space. While the balance between the three used to be even at the beginning of the post-global financial crisis cycle, industrial has since become the dominant property type. In fact, industrial represented half of the record number of investments last year, despite representing only 38 percent of aggregate purchases between 2015 and 2019. Retail, aligning with broader trends, has become a smaller part of the market. Between 2015 and 2019, retail made up 27 percent of the market. In 2021, it was just 21 percent.

"I don't see any headwinds that would change [industrial's current dominance]," Scott Merkle, managing partner of sale-leaseback-focused advisory firm SLB Capital Advisors, says.

But a contributing factor to the sector's growth could be an expansion of other acceptable asset classes for institutional net lease investment, beyond real estate's traditional food groups. Ares' purchase of Capital Automotive is an example of this: the company's portfolio comprises mostly car dealerships. Most of the properties have protective rights, including exclusivity in their respective markets and locations, Holsinger says. They also have a 25-year history of rental payments through multiple cycles, making Ares comfortable committing a large amount of capital to this non-traditional asset type.

Holsinger says of the investment: "Honestly [it has] some of the best stats I have ever seen in anything I've been doing in my 25 years of net lease experience."

Ares notes it also sees opportunities in wineries and other agricultural land, in another example of non-traditional, net lease-worthy asset types. Gaming properties are also becoming increasingly popular. An example of that came when Blackstone, via its non-traded BREIT, agreed to a $3.9 billion sale leaseback with MGM Resorts that included the Aria hotel & casino last year. KKR has a separate investment arrangement targeting healthcare and medical office properties that serves its existing net lease investors alongside Strategic Lease Partners.

Oak Street is among the managers also looking at other net lease-worthy asset types. "Universities are sitting on a substantial amount of real estate," Zahr offers. "You could structure a deal with a university on any assets they own. It could be their engineering building, or it could be ground leases underneath their real estate for 99 years."

It is this type of lateral thinking that has the brokerage community reluctant to predict the natural parameters of this market space. Neither Colliers nor Stan Johnson have future size estimates. Participants *PERE* spoke to estimated that the qualifiable properties owned by corporations in the US alone were "in the trillions" of dollars in value.

"All of that is a potential sale-leaseback," Whiting says. "Having more managers come into the space has increased the amount of potential investor capital. As more people have become familiar with the strategy, I think it has become more of an institutional asset class." ■

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