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Are We In a Real Estate Bubble?

By Dennis Monroe

For years, John Hamburger and I have expounded on the virtues of real estate ownership and the flexibility it provides. But it seems as if the current market conditions discourage ownership in favor of a sale-leaseback structure. As we all know, interest rates are at historic low levels, and that includes rates on financial instruments such as triple-net leases.

Below is a list of recent capitalization (or "cap") rates I have heard about. The cap rate, when multiplied by the price of the real estate, determines the annual rent on the real estate. This information is purely anecdotal and not based on a scientific study, but it is indicative of the current market:

McDonald's	4.00%	**Starbucks**	5.00%
Panera Bread	5.25%	**Wendy's**	5.75%
Taco Bell	5.75%	**Del Taco**	5.75%
KFC	6.00%	**Popeye's**	6.75%
Hardee's	7.00%	**Applebee's**	5.50%

This may look tremendous for the restaurant industry because cap rates are so low, operators are hard pressed to own the real estate using traditional bank financing. Yet there are, I believe, good reasons to look at factors other than just the low cap rates when considering sale-leasebacks for financing in what looks increasingly like an overheated market.

Let's look historically at what the sale-leaseback market has done. In the 1980s, Franchise Finance Corporation of America (FFCA) was one of the major sources of financing for new unit development for real estate-intensive franchise restaurant companies. The early cap rates were fairly high in today's terms, but they settled at about 12.5%.

The sale-leaseback rates were considerably higher than the rates for traditional bank financing, because in most cases, the sale-leaseback group financed 100% of the project cost (including soft costs), unlike traditional bank financing. Some programs even allowed the cost of the furniture, fixtures and equipment folded into the triple net lease. After a while there was a consolidation in the market, with GE acquiring a good share of the sale-leaseback groups. We then saw a leveling out of rates. Most sale-leasebacks were to tier-one, tier-two and possibly tier-three restaurant concepts.

Along the way, broker groups like The Midtown Niki Group and Marcus & Millichap came to this space. They brought a broker approach to the industry, tapping into private individuals and small investors who wanted to get an enhanced return. These brokers have done a great job of packaging and finding investors for individual sale-leasebacks, and in large part, taking advantage of the 1031 exchange market.

Over the last 15 years, we have normally had cap rates ranging from 7% to 12%. Ten years ago the hot properties (if you wanted an assured return for the long term, even though the cap rates were not as attractive) were leases to Wal-Mart, Target and Costco. People thought these leases were as good as holding government debt. Around five years ago, we saw some Applebee's transactions in the high 6's.

Things have changed, and today's cap rates are far lower than we've ever seen. The current abundance of available money in the marketplace has pushed the rates for sale-leaseback to historic lows. But I don't believe this is the new normal. These rates will start to creep up when interest rates rise.

Let the seller beware: Low cap rates are great in that they lower the initial base rent, but a sale-leaseback still takes away the flexibility of owning your own real estate, particularly if you can retain the real estate and utilize traditional financing, also at historic low rates and amortized over 15 years. This latter approach allows you to quickly build equity while maintaining adaptability of the real estate, but this approach normally will not allow for 100% financing. Lenders do require equity.

Tenants have very little negotiating as to the actual lease form, particularly if you are doing leases for multiple locations. The groups providing sale-leaseback financing work to ensure the lease documents are uniform and minimize any risk for the landlord/investor.

In most cases, the lease used is some kind of master lease for multiple properties where all the properties are tied together; thus, if there is default in one lease, there is default in all leases. This type of structure is intended to protect, among other things, cherry-picking by a tenant as to what store to default on and rejecting certain, but not all, leases in bankruptcy.

Additionally, there will be escalators (rents increasing) in the leases and absolute triple-net provisions. It may be difficult to get broad use provisions and assignment rights as that would decrease certainty and may affect the future value of the real estate resulting in a higher cap rate.

Finally, because the landlords in sale-leaseback transactions are passive and look to the lease as purely an income stream, they have very little appetite to provide any landlord improvement dollars beyond the initial investment. In general, the sale-leaseback arrangement is rigid for tenants, and that's the tradeoff for a low cap rate.

I would give the following advice to all who are looking at sale-leasebacks: Negotiate into your lease as much flexibility as possible, such as a right of first refusal, right of substitution or buyout options. Do not just look at the cap rate, but at who is your current and potential future landlord. Be wary of private individual landlords, because you will possibly have to deal with estates or successors of the landlord. In using sale-leaseback financing to fuel development, it is tempting to pour all the costs you can to the total development cost. However, that's the number applied to the cap rate, creating a higher base rent number and that base rent is then subject to the escalators.

In general, do not forget to pursue other financing options and decide what the better model is for both short-term and long-term strategies.

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