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# Built to Suit



## Single-Tenant Retail Construction

By David G. Etter and Wayne E. Etter

Single-tenant retail buildings continue to be financed and developed in many U.S. towns and cities. What factors explain their popularity with retailers and with those developing, financing and investing in them? What special risk should lenders and equity investors consider when they finance and invest in these properties?

Many free-standing retail buildings occupied by national firms are actually owned by institutional or individual investors. Some developers specialize in constructing single-tenant retail buildings for particular retailers; they sell the completed, leased property to investors.

The reason these retailers prefer to lease rather than to own a building is simple: retailers want to capture and maintain market share. This requires them to enter new markets and to retain present markets by building new stores. In addition to the cost of acquiring the land and constructing the building, each new store requires considerable investment in inventory, furniture and fixtures.

Because retailers do not have unlimited financial resources, they let others undertake the land acquisition and construction. This enables a retailer to open more stores. Implicit in this choice is the expectation that profits will be larger if the retailer operates more leased stores rather than fewer owned stores.

Typically, single-tenant retail buildings are occupied under a long-term lease. The lease term may be as long as 20 years; during this time, the tenant pays the owner a fixed-lease

payment and assumes the responsibility for paying some or all of the building's operating expenses. The owner may or may not be responsible for roof and structural maintenance. This is usually called a triple-net lease. The annual lease payment may or may not remain constant during the term of the lease. At the end of the lease, the investor will re-lease the building to the tenant at the rent initially agreed upon, secure a new tenant or

sell the building.

From the investor's viewpoint, leasing the building to a national credit tenant under the terms of a long-term, triple-net lease provides a highly predictable cash flow during the life of the lease. Many investors consider such an arrangement to be low-risk because of the reduced probability that the tenant will fail to pay the lease payment as agreed. Another advantage for the investor is that this arrangement eliminates the usual property management problems—such as vacancy and rent collection—associated with the ownership of multi-tenant retail centers.

From the lender's viewpoint, financing acquisition and construction for a national credit tenant may result in a low-risk loan. First, if the tenant has an excellent credit rating, the risk that the tenant will default on the lease payment to the investor is reduced. This, in turn, reduces the possibility that the investor will default on the loan payments. Thus, the tenant's credit rating has a direct effect on the mortgage terms available to the investor.

Second, the mortgage loan is usually amortized during the term of the lease. This lets the lender avoid any risk that the investor will be unable to service the mortgage because of an inability to re-lease or sell the property at the end of the primary lease period.

### Example Investment

A typical property that might be purchased by an individual investor in the 30 percent tax bracket illustrates the benefits and risks of investing in single-tenant retail buildings leased by a national credit retail tenant

*The investor must be prepared to see the property through periods of negative cash flow.*



under the terms of a 20-year, triple-net lease. The annual lease payment is \$143,989. Other project data are:

Building cost	\$ 639,100 (39.5-year depreciation)
Land cost	<u>629,526</u>
Total cost	\$1,268,626
Mortgage loan	<u>1,141,763</u> (20-year maturity, 9.35 percent)
Equity investment	\$ 126,863

With these data, the **first year's** estimated before-tax-cash flow (BTCF) and after-tax cash flow (ATCF) are calculated as follows:

Lease payment	\$143,989
Interest	-106,755
Depreciation	<u>-16,180</u>
Taxable income	\$ 21,054
Tax rate	<u>.30</u>
Income tax	\$ 6,316
Lease payment	\$143,989
Mortgage payment	<u>-128,211</u>
Before-tax cash flow	\$ 15,778
Income tax	<u>-6,316</u>
After-tax cash flow	\$ 9,462

Using this information and the planned initial equity investment, the investor can then calculate the **first year's** expected before- and after-tax return on initial equity.

<u>Before-tax cash flow</u>	=	<u>15,778</u>	=	12.44 percent
Initial equity		\$126,863		
<u>After-tax cash flow</u>	=	<u>9,462</u>	=	7.46 percent
Initial equity		\$126,863		

## Investment Risks and Opportunities

**W**ith a level lease payment and decreasing interest deductions, each year's taxable income and tax liability increases. Eventually, the mortgage payment plus the tax liability exceeds the annual lease payment and a negative ATCF results. With periodic increases in the lease payment, this effect will be delayed or avoided. For the example investment, this begins in the twelfth year and continues through the lease's end in the twentieth year.

	<u>Twelfth Year</u>	<u>Twentieth Year</u>
Lease payment	\$143,989	\$143,989
Mortgage payment	<u>-128,211</u>	<u>-128,211</u>
Before-tax cash flow	\$ 15,778	\$ 15,778
Income tax	<u>-17,085</u>	<u>-35,054</u>
After-tax cash flow	\$ -1,307	\$-19,276

The lease payment, the mortgage payment, the interest deduction and the depreciation deduction are fixed at the transaction's inception; thus, these amounts are contractual and/or outside the investor's control after the initiation of the agreement. The investor's tax rate might change, but it could increase as well as decrease.

**A**lthough the before-tax and after-tax returns on initial equity in the first year are attractive, negative ATCFs in the twelfth through the twentieth years could be an unwelcome prospect for an individual investor and the lender. The investor will need to contribute additional funds in each of those years to pay the mortgage payment and the income tax due. Thus, similar to many real estate investments made in the 1980s, the investment will require "feeding." With eight years remaining on the lease and a fixed annual lease payment, it might be difficult for the investor to sell or refinance the property; therefore, **the investor must be prepared to see the property through the period of negative cash flow.** The investor's ability to do so should be carefully evaluated by the lender.

The property's reversion value is another significant consideration for the investor. Usually, if only the property's annual ATCFs are used to calculate the property's internal rate of return (IRR), the IRR will probably be negative because, at a positive discount rate, the present value of only the annual ATCFs is nearly always less than the equity investment. For the example investment, the IRR without consideration of the property's reversion value is -4.8 percent.

The property's value at the end of the 20-year lease will be the primary determinant of whether or not the investor will receive a satisfactory rate of return. The property's reversion value is unlikely to decline to the point that the IRR will be negative, but if the property shows even a modest annual value increase during the 20-year holding period, the investor's IRR will be attractive. A moderate or a large increase in value makes the investor's IRR exceptionally attractive. Using property reversion growth rates ranging from -2 percent to +2 percent to illustrate this possibility, the following after-tax IRRs were calculated for the example investment.

<u>Property value growth rate (percent)</u>	<u>IRR (percent)</u>
-2	11.41
-1	12.25
0	3.13
+1	14.04
+2	14.98

Accordingly, the investor should evaluate carefully the property's prospects for appreciation during the holding period, even if the intention is to re-lease the property at the end of the holding period—the future lease rate will have to reflect the property's higher value at the end of the initial lease period.

Because the property's appreciation contributes significantly to a successful investment, an investor might develop a strategy that emphasizes acquiring properties with high growth potential. Strong retail tenants will seek prime locations with high market potential. Such locations will be on major traffic arteries, near regional shopping malls and in established shopping areas. Likewise, an investor will want to avoid properties in mediocre locations that have little growth potential.

While forecasting 20 years ahead is difficult, properties in rural or smaller communities or those located away from a community's principal shopping areas might be expected to have less appreciation potential; some may even decline in value. ☐

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