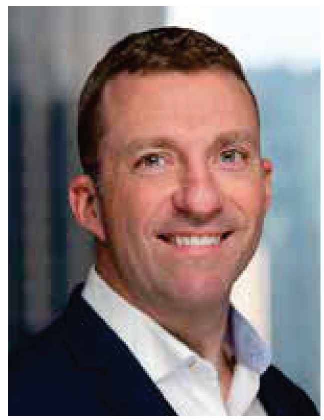
**KEYNOTE INTERVIEW**

# Locking in stability



*Net lease sector's consistent income and 'sleep-well-at-night' risk profile make it appealing to a wide pool of capital allocators, say USRA's David Grazioli and Justin Arasin*

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Net lease is an attractive option for investors seeking to diversify their portfolios while earning stable income, inflation protection and tax benefits, explain David Grazioli, managing partner at US Realty Advisors, and Justin Arasin, head of capital formation and product development.

## Q With operating costs on the rise, is net lease real estate a good option for avoiding income erosion?

**David Grazioli:** A net lease transaction is when a company leases a real estate asset for a long-term period, generally 20 years with renewal options, and the tenant is responsible for all the expenses and capex associated with the property. Given that the tenant assumes all operating and capital responsibilities, these long-term leases deliver forecastable, durable income to landlords largely unaffected by external forces such as inflation. This is contrary to other real estate asset classes that depend on market dynamics and ongoing, successful business plan execution to generate income.

The success of a multifamily asset, for example, depends on occupancy, rental growth and how well one manages expenses such as insurance, taxes and labor, all of which are largely outside of a manager's control. Meanwhile, in a properly structured net lease, all those variables are locked in at inception; income erosion simply does not exist. We like to refer to net lease investing as 'sleep-well-at-night' real estate investing. It is not that you set it and forget it, but it is an asset class that offers predictability from the day you close a transaction.

## Q Can net lease real estate be a core allocation in investment portfolios?

**DG:** Net lease can be an essential building block to a diversified income portfolio. I was recently speaking with an investment consultant, and I asked where they think net lease fits within their client portfolios. The consultant answered, 'Net lease is a great diversifier in a well thought out allocation. The asset class has fixed income-like characteristics, but also attractive real estate equity upside.'

**Justin Arasin:** For us, as it relates to net lease, CORE is an acronym that stands for Consistent income across Operationally critical assets for that underlying tenant, providing Reduced downside – particularly since the asset class is not highly correlated to traditional parts of the market – offering an Embedded inflation hedge, given the long-term nature of the leases alongside escalating rents.

**Q Which types of investors should consider an allocation to net lease?**

**DG:** We think the asset class fits well across diverse client portfolios. Certainly, high-net-worth investors can rely on the stable, tax-advantaged income from net lease properties, but HNWs and institutions alike can benefit from inflation protection, diversification and consistent, real yields. It is also appropriate for investors that are trying to meet their benchmark returns and are looking to diversify away from the traditional 60/40 mandate with stable, fixed-income returns coupled with equity-like upside.

**JA:** Net lease is a space that has been resonating more with allocators and investors over the past 10 years as education around the asset class has been more widespread. As such, today is less about educating around the merits of the asset class, and more about determining how one implements the strategy across client allocations. We are also seeing strong appetite from investors for drawdown net lease vehicles as it affords the ability to deploy capital patiently to the right opportunities, enhancing the probability for positive investment outcomes.

**Q Given the contractual rent, could a net lease serve as a surrogate to private credit allocations?**

**DG:** Yes. Whether it is a substitute entirely or a complement that offers more diversification, we believe net lease can be more attractive than private credit offerings.

**Q How important is credit and real estate underwriting to the overall investment process?**

**DG:** Manager execution and relative performance have always been key variables when considering allocation decisions. We feel it is important that a net lease manager has an integrated investment process that starts with origination and is backed up by disciplined credit underwriting, proactive asset management and deep real estate expertise and experience.

I have referred to net lease as the 'sleep-well-at-night' real estate investment, but we are not sleeping. We are proactively managing our assets. Even though we do not bear the responsibility of running the day-to-day operations of the properties, we are not on-site repairing HVAC or fixing cracks in the foundation, we are ensuring our tenants are doing just that. We are routinely visiting our assets and monitoring each tenant's credit throughout the lease term. If there is a major capex project required, or something changes with the credit of our tenant, we immediately begin working on a solution that provides a favorable outcome to our investors.

Additionally, we are not waiting for the end of the lease or a vacancy to start looking to re-tenant the property. In fact, we might be working with the tenant to re-lease the property several years from expiration. Fortunately, most of our operationally essential properties experience very high renewal rates, so the effort spent on re-leasing is minimized.

Throughout our 35-year history and multiple economic cycles, we are and always have been focused solely on net lease, and within our funds to date, our realized net returns are just north of a 20 percent IRR and 2.5x net MOIC, with no historical losses.

First, net lease transactions provide tax-efficient income – 50 percent of annual distributions can be tax deferred, and when ultimately taxed, is often at a beneficial tax rate considering depreciation recapture, capital gains and the like – compared to the income earned from private credit investments, which is generally taxable as ordinary income.

Second, a net lease investment provides 20 years of call protection because the tenant cannot buy back the property and shorten the guaranteed lease period. Private credit loans are generally floating rate with little to no call protection, so in a tightening spread or declining rate environment, floating rate lenders are likely to be repaid early or receive lower interest income.

Lastly, we also believe that risk mitigation is different in the net lease space as compared to private credit. Our assets are operationally essential. Even in an unlikely bankruptcy restructuring of a tenant, the fact that our collateral is critical to the tenant's operations (they cannot manufacture, distribute or otherwise serve their customers without it) means they are deeply incentivized to continue paying their rent. We therefore believe that, practically, we are structurally senior to some of the term loans that private credit investors are investing in.

**JA:** Adding further to that point, net lease is just another solution for investors in today's environment. Why have private credit flows been astronomically high over the last three years? Obviously, cash has been yielding 4-5 percent over that time and investors have looked for other sources of cashflow that is floating in nature. Private credit has offered exactly that, yields in the 9 to 10 percent range, adjusting for interest rate hikes along the way.

Private credit investors are now realizing, however, that there is another factor to consider. After taxation, you are probably more in the 5-7 percent range. Additionally, if rates start to subside, private credit yields will decrease, in contrast to net lease investments with contractual rent escalators which provide an income stream that is increasing annually and long-term in nature.

### Q What is the current opportunity set in net lease real estate investment?

**JA:** From a sector standpoint, we continue to see strong opportunity across the industrial space. Post-pandemic, e-commerce penetration rates have remained elevated, requiring deep investment in warehouse facilities and last-mile logistical centers. We see this trend continuing for the foreseeable future, especially as today's younger population, who prefer to shop online as opposed to traditional brick and mortar, are entering their prime spending years and will represent about two-thirds of the workforce by 2025.

**DG:** Over the past 20 years, net lease cap rates have fluctuated within a relatively tight band, with the low around 6 percent and the high just above 8 percent. We believe at this point in the current real estate cycle, prudent net lease managers have an opportunity to acquire net lease assets at discounted valuations compared to the previous two decades. Based on the forward interest rate curve, the market expects the inverted yield curve to normalize by late 2024 or early 2025. As the market stabilizes, buyers will be rewarded with asset appreciation as cap rates revert closer to historical norms.

The opportunities in the net lease industry are growing at historic rates driven by tenant demand from various industries like semi-conductors, electric vehicles, alternative energy and biomanufacturing to name a few. Specifically, we are seeing strong demand from occupiers in the manufacturing space. This is evidenced by the record $250 billion-$300 billion of annual construction spending on manufacturing in the US – three times the historical norm.

Geopolitical tensions and domestic incentive programs are also responsible for a portion of the increased demand. Post-covid, the supply chain disruption was put front and center with US policymakers and US-based companies. We are seeing a large breadth of companies looking to onshore their production, driving the demand for capital from net lease providers to build new domestic facilities. ■

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