

Single Tenant Net Lease Guidelines to Achieve Maximum Financing

While certain of our clients may understand all of the ways lease nuances affect how well a single tenant property can be financed, some may not. This report is the first in a series that Norseman will produce on topics important to participants in the net lease business. It discusses key lease issues and provides guidance to ensure that the lease characteristics negotiated, or the existing lease on a property being acquired, are compatible with the best financing approaches available.

Developers and acquirers of single credit tenant properties sometimes overlook lease terms that can dramatically affect the ultimate capital leverage – or lowest and most accretive interest rate – that could be achievable on a particular property. Where remaining lease terms are greater than 15 years, this is a bit less of an issue. Where terms are less than 15 years, it's critical. These lease issues can reduce the maximum leverage attainable based on the cash flows by more than 25%. These issues are subtle and part of Corporate America's push to sign shorter, more flexible leases than the 20-Year bond-type leases common 5-10 years ago. Real estate professionals cannot be faulted for not focusing on the financing implications of the structural nuances of these lease provisions and the financial constraints they create in the capital markets. This report outlines the perspective of lenders and the capital markets on these lease issues and provisions to help developers and acquirers achieve the optimal capital structure and understand the specific economics of lease terms that impinge on the capital structure.

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BASIC SENIOR FINANCING FRAMEWORK

Single tenant properties with lease terms less than 15 years are not good candidates for Credit Tenant Lease (CTL) financings because the present value of the remaining lease terms' cash flows is often less than the advance rate of a traditional 30-Year mortgage and always less than owners have come to expect from CTL financing. As you can see in **Exhibit I**, a CTL financing cannot provide attractive financing for lease terms less than 15 years.



EXHIBIT 1

The Light Blue Boxes Represent Total CTL Leverage Realized in Lease Terms less than 15 years. A higher cap rate and longer lease term translates into more cash flow and overall leverage. The CTL financing fully amortizes over the lease term at a rate of 6.50% and a DSCR of 1.00. For the purposes of the analysis, the loan rate of 6.50% was not adjusted to reflect the average life of CTL Loan. In addition, the analysis assumes a NNN lease with no rent escalations.

CAP RATES			
LEASE TERM	8.00%	9.00%	10.00%
7	43.88%	49.36%	54.85%
10	57.51%	64.70%	71.89%
12	65.27%	73.43%	81.59%
14	72.11%	81.12%	90.14%

In today's cap rate environment that hovers in the 8.00% to 9.00% range for credit tenants, a CTL financing provides the borrower leverage of 43.88% to 81.12% as seen above. Since a CTL zero's out the cash flow, this is not attractive to borrowers. In this instance, borrowers have had to look to traditional mortgage lenders for life company or conduit loans with 20-30 year amortizations. While conduit lenders may provide slightly higher advance rates (LTV) than life companies, both lending sources usually require final maturities co-terminus or inside the lease expiration. Further, while the long amortization schedules keep debt service costs down and increase cash flow available to returns, conduits generally limit advance rates to 80% LTV and life companies and other lenders to 70-75% for single tenant properties. In 2003 and continuing into 2004 many lenders have been reducing advance rates and 65-75% LTV loans have become more common.

Given that many single tenant properties have tenants that are investment grade, why then have these lenders reduced advance rates, especially when compared to what can be achieved through a CTL financing on a 15-20 year single tenant leased property? It's simple. The CTL financing must be fully amortizing within the term of the lease to shift the credit from the borrower to the tenant. The lender (investor) is only betting on the tenant's probability of default. Leases that are 15 years or less are not financed with CTL's because the present value of the cash flows over the lease term provides the borrower with insufficient leverage. For example, a single tenant property trading at a cap rate equal to 10% with \$5,000,000 of cash flow flat for 10 years will yield the borrower debt proceeds equal to 71.89% LTV, assuming that 100% of the cash flows are discounted at 6.50%. By varying the ingoing cap rate and the length of the lease, you can see that a lease term less than 15 years does not provide high leverage (95%+) for the borrower.

Due to the high vacancy levels in several US markets coupled with deterioration in corporate credits during 2003, senior lenders seemed to slightly reduce these advance rates to the point where 65-75% LTV loans are becoming the standard. With a shorter lease term and a 20-30 year mortgage, the loan is not fully amortizing within the remaining lease term; and there is typically a 40% - 60% balloon (remaining principal balance) at maturity. For the loan to be paid off at maturity the tenant either has to renew the lease or the borrower (owner) will



need to re-let the property to another tenant. Recognition of the uncertainty of renewal causes lenders to reduce the leverage they are willing to provide in order to be more comfortable that the borrower will have the ability to refinance the mortgage. It also causes lenders to implement policies that reserve cash to ensure that any expenses associated with re-letting the property are available at the time the tenant gives notice that they are not renewing, which is usually a reasonable period before actual lease termination. This is either done by reserving cash each year or by sweeping all of the excess cash flows in the last year or two. The result of these concerns and policies is obviously much lower proceeds than one would think a single credit tenant property deserves.

SINGLE TENANT MEZZANINE LOANS ONLY BECAME AVAILABLE IN 2003

Until today, maximum leverage obtained on a single tenant property with lease terms less than 15 years was directly correlated to the mortgage lenders advance rate, leaving the remaining 25%-35% of the capital structure to be funded with precious landlord equity. Borrowers could not look to traditional forms of mezzanine debt to bridge the equity gap mainly because the rates (12%-15%) were far too high relative to the strong creditworthiness of even lower investment grade tenants. When Norseman introduced its Credit Tenant Note (CTN™) financing in early 2003, it did so at rates that reflected a tenant's specific credit, resulting in a *much lower interest rate than any other mezzanine loan available*. However, the Norseman CTN™ is a fully amortizing loan and therefore has a cash flow constant only slightly lower than the rate – and constant – of traditional mezzanine loans. The Norseman CTN™ loan is very similar to a CTL in a mezzanine position in a landlord's capital structure. The loan is the present value of the *excess cash flows* (NNN Rent minus Mortgage Payment) over the shorter of the lease or mortgage term. The CTN™ rate is approximately 200-500 basis points (AAA-BB Credits) higher than the tenants' senior unsecured borrowing rate for same average life loans. The Norseman CTN™ loan behind a traditional 20-30 year mortgage creates total capital leverage (95% LTV) very similar to a CTL financing for a 20-25 year bond-type lease. **However, there are several lease issues that can dramatically reduce the amount of secondary financing a given lease cash flow can support.** These issues are considered in the context of a \$12,500,000 property occupied by a single A-credit tenant with a 10-Year lease term. The initial rent of \$1,031,250 escalates by 1% per annum, which translates to an in-going cap rate equal to 8.25%.

EXHIBIT 2
General Asset Assumptions for Case Study

Purchase Price	12,500,000
Tenant Credit	A
Cap Rate	8.25%
Lease Term	10
NNN Rent	1,031,250
Rent Escalations Per Annum	1.00%



MAXIMUM LEVERAGE FOR CASE STUDY

Maximum leverage is obtained by getting the longest possible amortization term on the senior mortgage, because the longest term leaves the most excess cash flow for mezzanine financing. In the case study, a 10-Year first mortgage maturity with a 30-Year amortization schedule is assumed. As discussed earlier, the senior loan amortization is dependant on the value, use, and location of the property, plus the tenant’s credit, and the length of the lease term. In order to obtain maximum leverage, the **base case assumes a pure triple net lease where the landlord bears no responsibilities under the lease and the tenant is unable to terminate except in the event of casualty and condemnation.** The mortgage assumptions described in **Exhibit 3** create significant excess cash flows available to service Norseman’s mezzanine loan.

EXHIBIT 3

Mortgage Assumptions for Case Study— A 70% advance rate coupled with a 30 year amortization generates significant excess cash flow available to service a Norseman mezzanine loan. As you can see below, the senior financing underwrites a balloon equal to 59% of the initial property value. A 59% balloon typically means the senior lender is comfortable that his loan will get repaid in the event the tenant does not renew its lease at loan maturity. The size of the balloon is directly correlated to the market dynamics and the reusability of the asset.

Mortgage LTV	70.00%
Mortgage Rate	6.25%
Mortgage Amortization	30
Mortgage Term	10
Balloon LTV	59%
Debt Service Coverage	1.00
Loan Constant	7.46%
Mortgage Proceeds	8,750,000
Mortgage Payments	652,775
Mortgage Balloon	7,337,659

A senior mortgage loan constant of **7.46%** is accretive to the lease cash flow with an initial yield (cap rate) of **8.25%**. **Exhibit 4** illustrates the excess cash flows available to pay the Norseman CTN mezzanine loan from a NNN lease with 1.00% rent escalations per annum.

EXHIBIT 4

Access Cash Flows Available for Norseman Mezzanine Loan

Years	Free & Clear Cash Flow	Mortgage Payment	Excess Cash Flow
1	1,031,250	652,775	378,475
2	1,046,719	652,775	393,944
3	1,062,420	652,775	409,645
4	1,078,356	652,775	425,581
5	1,094,531	652,775	441,756
6	1,110,949	652,775	458,574
7	1,127,613	652,775	474,839
8	1,144,528	652,775	491,753
9	1,161,695	652,775	508,921
10	1,179,121	652,775	526,346

The Norseman CTN™ mezzanine loan proceeds are determined by present valuing the excess cash flows over the shorter of the lease or mortgage maturity.



In this example there are 10 years of excess cash flow available to the Norseman. The CTN™ loan rate is commensurate with the creditworthiness of the tenant. An A-Rated tenant translates into a loan rate of 6.65%. (Note that the CTN™ rate for an A-credit tenant is only 40 basis points higher than the 6.25% rate for the first mortgage). Assuming a 1.00 DSCR, Norseman can raise \$3,157,360 of mezzanine debt or an additional 25.26% of the capital stack. The total leverage (**Exhibit 5**) realized is 95.26% LTV or \$11,907,360. The borrower contributes \$592,640 or 4.74% of equity to buy a \$12,500,000 property.

EXHIBIT 5

*The Maximum Financing below represents a 30 year mortgage and a 10 year fully amortizing Norseman CTN™. The blended amortization of the two loans equal 25 years. Although Norseman's loan constant individually equals approximately **14.28%**, the blended constant is 9.27%, which is 1.02% more than the property's incoming cap rate of 8.25%. Although the blended loan constant is not accretive to the cash flow, the low blended loan rate of 6.36% and 95% leverage will tremendously increase the project's internal rate of return.*

Total LTV	95.26%
Total Rate	6.36%
Total Amortization	25
Total Term	10
Balloon LTV	59%
Debt Service Coverage	1.00
Blended Loan Constant	9.27%
Total Proceeds	11,907,360
Total Payments	1,103,718
Total Balloon	7,337,659

The Base Case Study assumes a pure NNN lease. As the lease terms deviate from those of a pure NNN, the overall financing will be incrementally lowered.

OPTIMIZING YOUR LEASES FOR CAPITAL MARKETS

As lease terms deviate from those of a pure NNN, the overall financing will be incrementally lowered. The following section highlights those lease issues that often negatively effect the maximum leverage attainable.

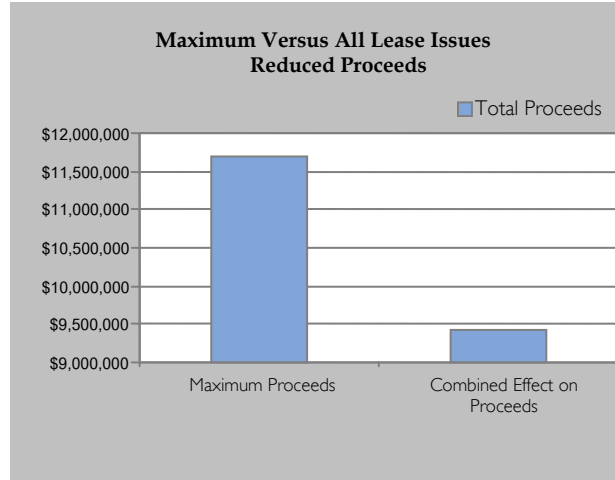
EFFECTS OF MULTIPLE LEASE ISSUES ON PROCEEDS

While each of the major lease issues that will be discussed can have a significant impact on the total financial leverage possible for a given asset, the impact of having several lease issues associated with an asset can make it impossible to leverage an asset above what can be obtained by a traditional senior 30-Year mortgage alone. If an owner gives the tenant an early termination option, rent abatement rights, and retains roof and structure responsibility, this can become the case. **Exhibit 6** compares the maximum proceeds (95% LTV) already discussed with what debt can be raised should the three major lease terms deviate from pure NNN (77% LTV).



EXHIBIT 6

\$11,907,360 Maximum Proceeds versus \$9,610,262 Reduced Proceeds from the following lease issues: early termination option, rent abatement, and capital reserves associated with roof and structure responsibilities.



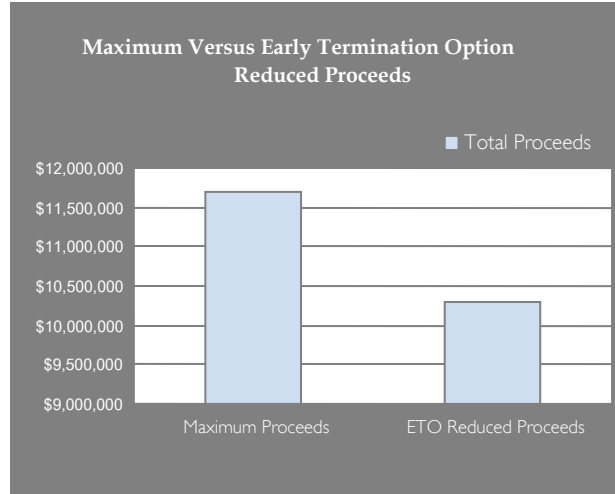
EARLY TERMINATION OPTIONS (MAJOR)

Many corporate tenants in the past few years have negotiated shorter term leases and leases with early termination options (ETO), which have penalties associated with their exercise that are often quite expensive. The problem is that lenders universally adjust the lease expiration date to the date of the ETO and few give any credit to any penalty that would accrue if the tenant exercised that option. This can be disastrous to the ultimate financial leverage for two reasons. Let's consider a 10-Year remaining lease term with a 5-Year ETO. First, the senior lender is less willing or unable to offer the higher LTV loan, because there is very little amortization in the first 5 years, making the loan almost an interest-only loan that puts an even higher burden on the borrower to come up with the balance due at maturity. Second, it reduces the proceeds that a Norseman CTN™ can add, since there is much less cash flow to present value. It is clear that -- regardless of any penalty charged for an ETO in the lease -- *landlords should do everything in their power to avoid giving the tenant this option.*



EXHIBIT 7

An Early Termination Option reduces overall financing proceeds because the Norseman mezzanine loan must be co-terminus to the date of the ETO. The maximum financing proceeds are reduced to \$10,438,044 with the ETO. For simplicity, the analysis solely deals with the ETO impact on the Norseman mezzanine loan. It is highly accurate to assume similar limitations (shortening of amortization schedule) and impact on the senior financing.



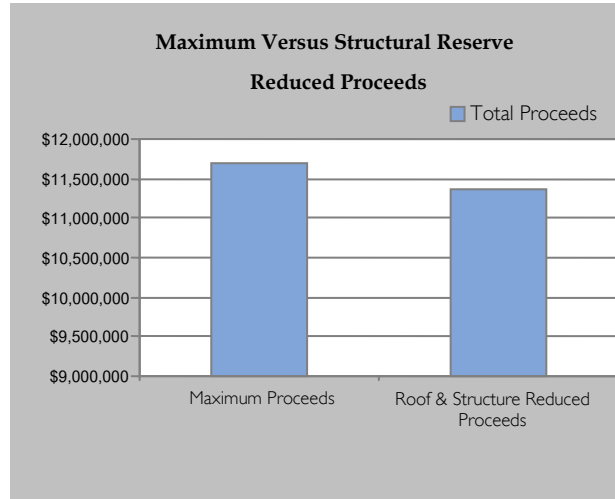
ROOF AND STRUCTURE

Perhaps the most common obligation transferred to or retained by the lessor is that of roof and structure. Lenders need to be sure that the owner will have the capital to make any repairs or maintenance required to satisfy these obligations. If the lease does not completely specify the obligation, the lenders will have to make a conservative estimate on what these costs might be and will either reduce proceeds or, as with ETO, sweep cash flows to reserve for these costs. There are cases where the parties agreed to fairly specific limits to these costs and whether they are wholly the responsibility of the owner or shared on some specified basis with the lessee. As an example, limiting the landlord's maximum capital cost per year enables lenders to precisely reserve the specific expense exposure, rather than estimating an always much higher cost. Wherever possible, it would be better all around for the lessor not to have these obligations, even if it means slightly lower rents. The trade-off can be analyzed several ways, but lower rent is usually preferable. There are two reasons for this. First, no capital costs may be necessary during the term of the lease for roof and structure, yet the presence of the obligation will cause lenders to skim cash flow to reserve for it. Second, the lower net cash flow from lower rents still usually provides more net cash flow for debt service than the net cash flow after the lender reserves for anticipated capital expenses. **Exhibit 8** displays the reduction in overall financing proceeds. The analysis assumes there is a capital reserve requirement of \$50,000 per annum.



EXHIBIT 8

Capital Reserve requirements for roof and structure obligations in the lease reduce financing proceeds to \$11,550,428 or 92% LTV. As you can see, the impact on capital reserve requirements is not as detrimental as an Early Termination Option in the lease.

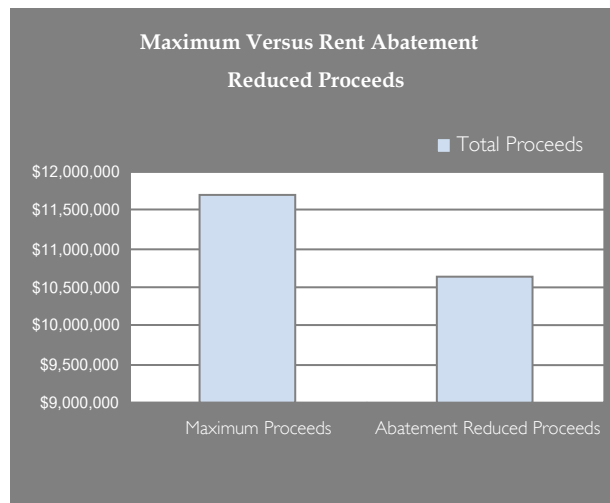


OFFSETS AND ABATEMENTS

Any lease provision that gives the tenant the ability to offset or abate its rent obligation should be as clear and specific as possible and ideally should have some ability for the landlord to recover the abatements upon some event occurring. In the event the lease does not allow the landlord to recover the abatements, Norseman will reduce excess cash flow available for debt service accordingly. The amount of abatement is typically specified in the lease. The impact of the rent abatement is very similar to capital reserve requirements although rent abatement penalties are typically higher.

EXHIBIT 9

Rent abatement rights will reduce excess cash flow available to debt service. The analysis assumes the tenant has the ability to reduce \$150,000 of rent per annum. The rent abatement rights reduce financing proceeds to \$10,836,565 or 87% LTV.





FREE RENT

Owners may give a prospective lessee 6-12 months of free rent as an inducement to entering into a long term NNN lease. While this may seem reasonable and attractive, and may even result in the same total rents being paid over the full lease term, it will seriously reduce the total financing potential of the deal. This is because any senior or mezzanine loan will need to be repaid from the date the loan is made. This means there will be negative amortization, which effectively increases the owner's basis in the deal and that increase will be reserved out of the proceeds from the loan thereby decreasing the net proceeds of the loan. The effect is lessened where the loan is interest only in the first year rather than fully amortizing.

PARTIAL CASUALTY

In the event that some portion of the premises becomes untenable for some reason, tenants often look for the owner to reduce rent on some pro rata basis, when the condition persists. Unless the owner can obtain some form of lease enhancement insurance that will cover the loss of rent in this event, there needs to be some way that the owner can remediate the problem in a specific and clear-cut and straightforward manner. If there is the potential for an indeterminate reduction in net rents, the senior lender will reduce the advance rate and Norseman would have no stable cash flows to underwrite. The best solution is for the tenant to retain the responsibility or to insure against it. An acceptable alternative would be some cap on the rent reduction. Again, any potential for less cash flow and especially one with uncertainty of any sort will result in lower combined loan proceeds.

CLOSING OUT CONSTRUCTIONS OBLIGATIONS

There are many leases that have surviving owner obligations that related only to the construction period and these obligations require that the lenders obtain estoppels from the tenant verifying that they no longer exist. It is always better that the original lease have specific language and triggers that terminate these obligations once construction has been completed or the obligation otherwise fulfilled and in no case longer than 1-Year after occupancy. In general all owner or landlord obligations that are included in a lease need to have very clear termination or fulfillment language. Absent such language, lenders must either obtain estoppels or reduce proceeds.

CASUALTY AND CONDEMNATION

Typically all leases that are not bondable enable the tenant to vacate the premises in the event of casualty and condemnation. Both the senior lender and Norseman will require the landlord to buy some sort of lease enhancement and/or property insurance sufficient to cover the initial loan proceeds. Typically, the cost of this insurance is a one time fee that ranges from 0.5% to 1.5% of the total loan proceeds.



CONCLUSION

The Norseman CTN™ Loan was only introduced to the marketplace last year and so the uses of the loan were not entirely clear to the landlord community. Norseman wanted to identify those lease provisions that reduce not only Norseman financing proceeds, but those of the senior financing as well. Rent abatement rights, early termination options, and structural reserves all reduce the excess cash flows available to service debt. As Norseman clients negotiate new leases or evaluate leases in acquisitions, this report demonstrates the negative impact these lease variable can have on maximizing financing or minimizing rate. Whether an owner that is positioned for maximum leverage or current yield, the Norseman mezzanine loan is so attractive because of its extremely low loan rates compared to traditional forms of mezzanine debt and equity capital. **Exhibit 10** on the back page presents the Norseman pricing matrix for fixed or floating rate loans for specific credits and loan maturities.

APPLYING THE NORSEMAN LOAN

MOST COMMON USE OF THE NORSEMAN CTN™ LOAN - MAXIMUM LEVERAGE

As discussed in the prior Base Case Study, our clients customarily use the Norseman CTN™ loan to achieve maximum leverage similar to that of a CTL financing with 20 year leases. Recently, a 1031 Tax Exchange Advisor bought a one story building outside of San Francisco occupied by a 100-Year old law firm for \$36,000,000. The law firm was paying \$400,000 a month in net rent with significant rent escalations in the lease. The borrower was able to get a \$23,400,000 65% LTV first mortgage with a 20-Year amortization term and a 10-Year maturity at a rate of 7.00%. Norseman was able to add a fully amortizing \$12,000,000 34.5% LTV Credit Tenant Note at 11.00% with a 10-Year maturity. The combined financing resulted in approximately 100% financing. The financing monetized 100% of the cash flows and left no current yield to the borrower over the remaining life of the lease.

The lease was a true and absolute NNN lease and the senior lender caused the borrower to buy casualty and condemnation insurance that covered both the first and the Norseman CTN balances. ***Norseman's collateral was a foreclosable pledge of partnership interest.*** The only issue with the transaction was that the tenant was an unrated entity, which made it difficult to price the interest rate spread on the Norseman CTN loan. Our client was able to obtain the law firm's financials; however, and Norseman was able to derive an internal private credit rating for the company. Furthermore, Norseman reviewed the law firm's history, noting that it had been in continuous existence for more than 100 years and that its profit per partner was in the top 50 law firms in the states. Given the average life of 6 years, the loan was priced to the 6-Year SWAP rate of 3.75% and added 725 basis points to yield an 11.00% loan rate.



NORSEMAN CTN™ LOAN AS INCREMENTAL LEVERAGE

Most landlords purchase single tenant properties for the cash flow and would not use the Norseman loan for maximum leverage. Instead, a borrower will look to exchange a portion of the current yield for an increase in the project's internal rate of return. Because the Norseman loan is fully amortizing, a 10-Year fully amortizing loan creates a high constant equal to a rate of 13.00% to 16.00%. The constant subtracts from the current yield. However, so as long as the Norseman loan rate is less than the in-going cap rate, it will increase the project internal rate of returns.

A cash flow buyer recently approached Norseman to increase the leverage on a property from 65% to 80% LTV. The financing was viable because the senior mortgage had a 30-Year amortization and a loan constant of 7.39%, generating a current yield to the equity of 11.28%. The Norseman loan reduced the current yield from 11.28% to 9.50% but the borrower was able to increase his total project internal rate of return by 3.00% based on a 10-Year forecast. The borrower's choice to increase leverage was driven by the belief that the project's internal rate of return would be heavily weighted by a significant increase in the property value.

NORSEMAN CTN™ LOAN AS EQUITY SUBSTITUTE

Owners of single tenant properties find situations where they would like to take some equity out of a property they own for a variety of reasons. The Norseman loan is a good source of capital for partnership buy-outs. Norseman often sees partnerships where each partner has different objectives and taking some equity out of the property can be used to solve the issues that can arise in these situations. Alternatively, an owner may simply want to take some equity out of a property to fund another investment. As long as the Norseman CTN rate is equal to the equity return that the owner would pay otherwise, the CTN is an attractive alternative, since the borrower does not have to deal with a partner and ramifications like sharing the upside of the property's appreciation.

As an example, a development opportunity fund utilized the Norseman loan to take out equity in a completed built-to-suit research facility with an A-rated tenant. The fund decided to take out a 5-Year, \$9,000,000 floating rate loan priced at a rate of 3.50% over 30 Day Libor (1.10%) or 4.60%. The opportunity fund saw the Norseman loan as a way to take out capital at a low rate and reallocate the capital into higher yielding assets. (Note that this is the subject of the second Norseman Special Report that discusses funds reallocating capital from real estate into the stock market.) The 5-Year loan term was chosen to match with the approximate time horizon of the fund. The fund managers chose to price the loan over 30 Day Libor to retain prepayment flexibility in the event they wanted to sell the property prior to the loan maturity.



CONSULT WITH NORSEMAN

Norseman professionals have extensive experience in evaluating lease terms vis-à-vis their affect on loan pricing and maximizing proceeds. Commercial property owners of all types are invited to contact the individuals listed in this report to consult on your financing needs and explore solutions that accomplish your transaction requirements.

EXHIBIT 10

NORSEMAN MEZZANINE PRICING MATRIX

FIXED RATE MEZZANINE LOANS

Swap Rate	Loan Term	AAA	AA	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-
2.74%	5 Year	5.38%	6.01%	6.12%	6.19%	6.45%	6.76%	7.07%	7.31%	8.14%	8.71%	8.81%
3.19%	7 Year	5.83%	6.46%	6.57%	6.64%	6.90%	7.21%	7.52%	7.76%	8.59%	9.16%	9.26%
3.87%	10 Year	6.51%	7.14%	7.25%	7.32%	7.58%	7.89%	8.20%	8.44%	9.27%	9.84%	9.94%
4.44%	15 Year	7.08%	7.71%	7.82%	7.89%	8.15%	8.46%	8.77%	9.01%			
4.73%	20 Year	7.37%	8.00%	8.11%	8.18%	8.44%						

FLOATING RATE MEZZANINE LOANS

30 Day Libor	Loan Term	AAA	AA	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-
1.10%	Floating Rate	3.74%	4.37%	4.48%	4.55%	4.81%	5.12%	5.43%	5.67%	6.50%	7.07%	7.17%

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