Securitized Products Special Topics

Net Leases: Scarcity Value as Issuance Poised to Pick Up

Reduce Headline Risk Via Net Lease Exposure

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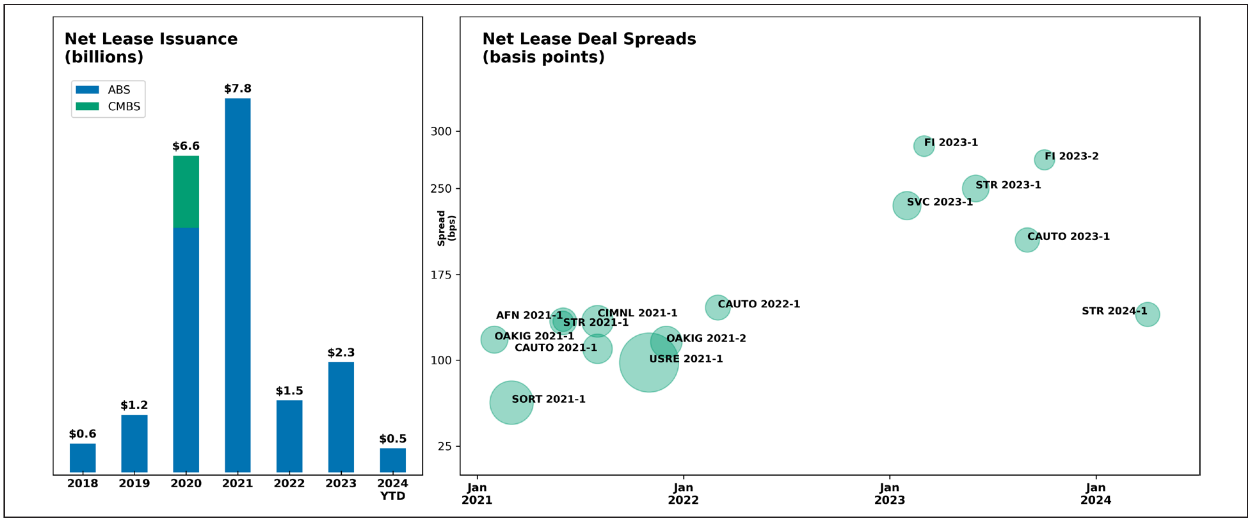
Outstanding net lease deals offer scarcity value as the sector is poised for recovery, and a pickup in new issuance volume. We view net lease properties as less risky compared to more precarious sectors such as office. Net lease investment activity should increase once economic conditions stabilize. Overall net lease investment volume fell by 45% YoY in Q4 2023 to $8.3 billion, according to CBRE.

Rising investment volumes should bolster net lease securitization. Issuance has been muted over the past couple of years (Figure 1). STORE Capital's $450 million STR 2024-1 is the only net lease ABS transaction issued YTD. The upsized deal priced its triple-A class at 140bp over the Treasury benchmark. In turn, the last standalone net lease SASB CMBS deals priced back in 2020. Net lease landlords are now tapping the market again. For example, Global Net Lease financed a 20-property net lease industrial portfolio via a CMBS loan to the tune of $237 million. The landlord shifted the properties from a corporate credit facility into a CMBS pool. A $70 million pari-passu note of the whole loan is the top exposure in the just-issued BMO 2024-5C4 deal.

Figure 1. Net Lease Securitization Issuance and Spreads



Source: Bloomberg and Academy Securities

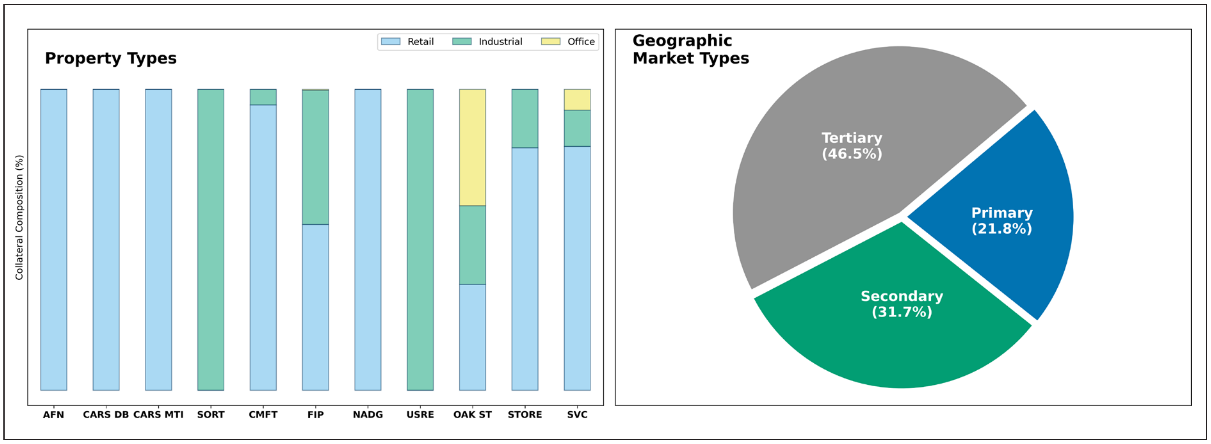
Aspects to Track as ABS and CMBS Collateral Overlap Rises

We identify a few aspects to track as investors analyze net lease pools:

- **Issuance straddles both ABS and CMBS.** We see much similarity between net lease pools that back ABS and CMBS deals. The growing collateral overlap echoes a trend in data center securitizations, where properties with similar characteristics can land in either master trust ABS vehicles or CMBS conduit and SASB deals.[1] Such collateral overlap has two key implications: (1) Rating agencies are increasingly harmonizing their rating approach to net lease transactions by incorporating CMBS-like property analysis into their net lease ABS methodology. This is consistent with the approach the agencies are implementing for data center securitizations as well[2]; (2) CMBS investors looking for exposure to the net lease sector may take a closer look at ABS deals. Amid the shifts in rating methodologies, investors can more fully leverage existing property-level expertise to get comfortable with non-CMBS net lease collateral. This could also facilitate portfolio diversification away from sectors prone to headline risk, such as office and multifamily.

- **Rising industrial exposure.** Net lease transactions increasingly offer a broader range of underlying properties, beyond the traditional single-tenant retail exposure. Deals can feature 100% exposure to net-lease industrial pools (for example, SORT or USRE issuers), a mix of retail and industrial pools (FIP and STORE), or occasionally office components (Oak Street) (Figure 2, left). STR 2024-1 even had exposure to assisted living properties. The growing dominance of net lease industrial properties is also reflected in the sector's investment activity. Industrial/ logistics' share of net lease investment volume rose to 50% in Q4 2023 from 43% in Q4 2022. This bodes well for the liquidation values of net lease pools. Rating agencies place a significant emphasis on property liquidations when projecting deal cashflows.

Figure 2. Net Lease ABS Property and Market Type Breakdowns



Source: Deal Documents, Ratings Agencies, and Academy Securities

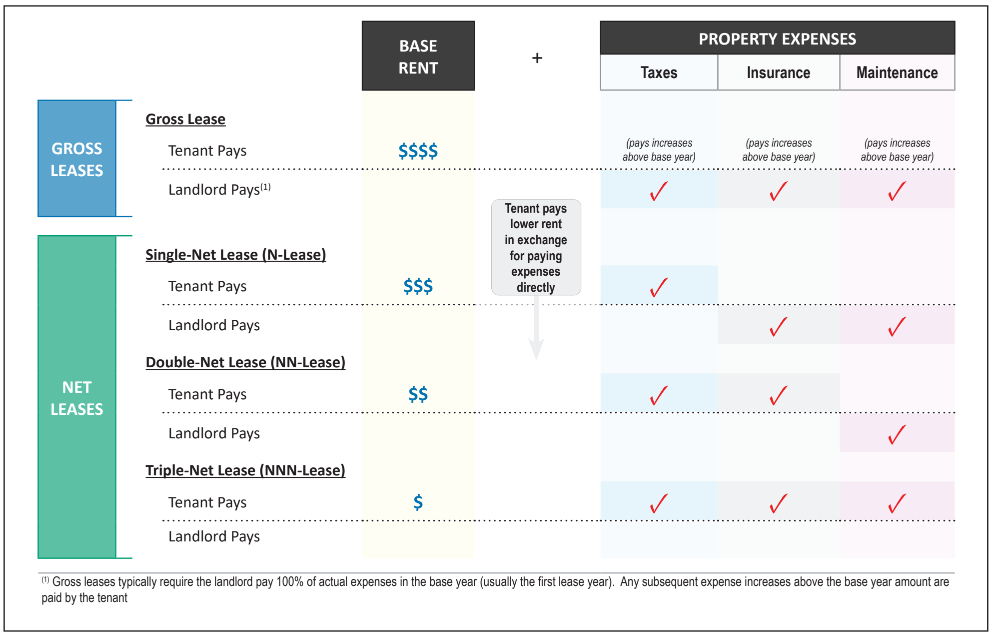
1 "Data Centers: A Strong Segment Juggles ABS and CMBS," Securitized Products Special Topics, Academy Securities, October 4, 2022
2 "Data Centers: Performance Wrinkles to Test Operators' Role," Securitized Products Special Topics, Academy Securities, February 21, 2024

- **Secondary and tertiary locations.** The elevated exposure of net lease pools to historically weaker secondary and tertiary locations counter-intuitively point to collateral strength amid the current struggles of some primary/CBD locations. Deal exposures to primary markets range from only 7.5% to 35.7%, based on rating agencies data. Tertiary locations account for 20.8% to 75.4% across different issuers (Figure 2, right).

Focus on Tenants Strength in Net Leases

Net lease pools mostly include triple-net lease agreements. In such leases the tenant pays property taxes, insurance, and building maintenance, in addition to the rent. Other types of net leases include single-net lease and double-net lease (Figure 3).

Figure 3. Gross vs. Net Leases



Source: Academy Securities

- **Double-Net Lease:** the tenant pays property taxes and insurance, in addition to the rent. For context, STR 2024-1 featured only 1.1% exposure to such leases.

- **Single-Net Lease:** the tenant pays property taxes, in addition to the rent. This is the least common net lease type, according to commercial brokers.

In contrast to net leases, in a typical gross lease, the tenant pays a base rental amount and nothing else. The property owner pays all expenses. Gross leases expose the landlord to greater expense volatility, especially amid rising insurance premiums and property taxes. On the flip side, net leases can have lower rent levels and require more focus on the tenant's credit profile given its responsibility for a range of uncertain expenses. As such, net lease pools may have elevated sensitivity to tenant bankruptcies. Delinquencies and vacancies increased in 2023 in some portfolios, partially on the heels of tenant bankruptcies, according to S&P. For example, the bankruptcy filing of Bed, Bath & Beyond in April 2023 led to multiple downgrades on exposed pools.

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