Sharon Kilmer

Episode 180: Net Lease: The Intersection of Credit and Real Estate

GUEST Q & A

Stewart: Welcome to another edition of the Insurance AUM.com podcast. I'm Stewart Foley. I'll be your host. Today's topic is net lease investments, and we're joined today by Sharon Kilmer, a managing director on TPG Angelo Gordon's Net Lease Real Estate team. Sharon, welcome. Thanks for taking the time.

Sharon: Thanks. My pleasure to be here.

Stewart: We are thrilled. This is an asset class that I've got a lot to learn on, so I am tickled. Before we get going too far, I want to start this the way we start them all. What's the town that you grew up in? What was your first job? Not the fancy one. And what makes insurance asset management so cool?

Sharon: Well, I grew up in the Midwest in a small town called Wauwatosa, Wisconsin, which no one's ever heard of, so that's where I grew up. And my first job was flipping burgers at McDonald's.

Stewart: Me too. Mine too. I saw a commercial the other day – a McDonald's commercial – that said 1 in 8 people have worked at McDonald's.

Sharon: That's a pretty staggering number.

Stewart: That's amazing, isn't it? And what makes insurance asset management so cool. I know, in spite of your current title, you have real deep insurance chops. What do you think makes it so interesting?

Sharon: Well, I've been a credit manager and a fixed income portfolio manager in my past life for many, many years, and it's interesting. I think the fixed income universe is just interesting, and I've watched it grow. There are so many different ways that you can accomplish matching your assets with your liabilities in an insurance company. And actually net lease is a pretty unique way to do it, so I'm looking forward to telling you about it.

Stewart: Yeah, and I think that's a great start, a great segue into what is – for me and those of us who may not be steeped in the tea here – what is a net lease?

Sharon: Well, when we refer to net lease, it's generally shorthand for triple net lease, where the leases are struck with the tenant who pays taxes, maintenance, and insurance. That's the triple net lease. There are leases out there that could be gross leases, where the landlord has a lot of obligations. There can be double net leases, where the landlord has a few obligations, but we specifically do triple net leases, where the landlord has no obligations. It all lies on the tenants, on their shoulders to pay for.

Stewart: Very good. So how big is the net lease market, just to give our audience a sense of size?

Sharon: Well, generally the issuance is anywhere from $70 to $90 billion a year. But $90 would be the peak, which was probably 2022 or late 2021. It's slowed down a little bit, like most real estate markets have, just because the cost of financing has increased recently. But it's a sizable market that has a fair amount of liquidity and has grown and become fairly mainstream in the last 10 years.

Stewart: That's interesting. And, I mean, you've run money for some large life companies. You've run money for insurance companies as a third-party manager, so you understand what insurance companies are up against as far as all the externalities that they deal with. Can you talk a little bit about why net lease assets make good investments for insurance companies in particular?

Sharon: Sure, absolutely. I mean, insurance companies in general – this is an overgeneralization – but they are just large bond portfolios because that's the way they try to match their assets and liabilities through the fixed income investments. And so, if you're looking at versus a large bond portfolio where, in general, you're an unsecured creditor, if there is a default with a bond where you're an unsecured creditor, you kind of stand in line to get paid with every other unsecured creditor.

Now as a landlord, you're an unsecured creditor as well, but if you pick the right building – the one that the company needs to be in regardless of whether they're restructuring their debt or not, and they need to be in it because it's their main manufacturing plant or it's their only distribution center in North America or something along those lines – where the business interruption of leaving there would never allow them to come out of bankruptcy in a timely manner. If you pick that right building, there's a high likelihood, a very high likelihood, they pay rent despite what they're doing on the restructuring front. And that's the type of building we look for. That isn't everyone's strategy, but it is our strategy.

Stewart: I just realized while you were speaking that I have some biases, and what I was thinking about was these were office leases, but they're not just office leases. So can you talk a little bit about what kinds of assets, what kinds of properties, make up the net lease market?

Sharon: We focus specifically on the single-tenant net lease market, but there are multi-tenant net leases. There's a variety of different structures, but the asset class matters dramatically as far as pricing and your return profile. What I was describing to you as a building that is very important to the company is generally an industrial building. So we buy primarily industrial. You can do triple net leases on retail, on convenience stores, on restaurants, on cinemas, on office buildings, on multifamily. But we specifically focus on industrial because there you can make the case that there is a mission-critical piece of real estate. It's much harder in retail; if they have 77 stores, to pick the one that they're never going to leave is much harder. But industrial, manufacturing, cold storage, you can tell how much cashflow is coming from that property and how important it is to the company. So we generally focus on industrial.

Stewart: I'm really glad we made that distinction because I think that's important. As you mentioned, I mean, I was talking to somebody this morning, and they said the world has changed in the way that we work, and it has ramifications for the real estate market. And we've talked about that on other podcasts. But to talk about, we're never market timers here obviously, but can you talk about, is this the right time or a good time to be buying real estate assets?

Sharon: In general, real estate assets have struggled I'd say in the last year because the cost of financing has increased more rapidly than the real estate market has repriced, which is pretty typical. The capital markets reprice instantly when there's a change in treasuries, and the auction markets – which a real estate market is – takes time. And sellers get anchored to higher prices and it takes them a while to get realistic about where they're willing to sell, and vice versa. Buyers want to buy something cheap immediately, and the market doesn't get there as quickly as they'd like. So, activity slows, and that's kind of where we have been.

Then you – as a real estate buyer – have to decide, what is the risk of that building being vacant and how long. So, office as we mentioned before, is not something we focus on because really if you incentivize a company with much, much lower rent, you can get them to move their whole operations out of an office building across the street over a weekend. And so that's not a risk we're willing to underwrite, which is why we stick with industrial. Because if it's cold storage and 90% of their volume is being shipped out of that building, you have a real solid reason to believe they're going to stay in that building.

Stewart: That makes a ton of sense. Obviously, inflation seems to be in the headlines just about daily. Can you talk a little bit about how a net leased real estate asset works as an inflation hedge?

Sharon: In general, leases are struck on when you consummate the deal, but in that lease are all the terms for the whole time period or the whole term of that lease. We generally have very long leases, 15, 20, 25-year leases. There are other players in the space that have 5-year leases. They can run the gamut, but we want long-term leases because we want to be a real estate partner with these tenants and help them as their real estate needs change over time. But in that lease that gets struck upfront, we put all the terms – including what the annual rent increases will be – so your cashflow is positive on day one and also increasing on a schedule that is known both to the tenant and to the landlord on day one, which is the beauty of the investment. There are some real estate strategies where the whole return is predicated on the landlord or the owner of the building putting in a lot of money first and then hoping to sell it for a much higher price.

With a net leased or a triple net leased asset, that isn't the case. We, as a landlord, generally tend to never put any money into these buildings if we can help it because the lease is structured so that obligation all sits with the tenant. So, the rent increases are known upfront, but if interest rates were to rise or inflation increase, the increase in the rent over time will help keep the landlord or the owner of the property even with inflation. There might be a lag and it won't be matched one-to-one, but over time it will keep you kind of abreast of the current prevailing rates. And rents can be fixed in their annual increases or they can be tied to an index.

Stewart: That's interesting because a lot of our clients deal with liabilities that are not necessarily tied to inflation but go up with inflation, and some have medical costs associated with them and that even goes up higher. So that facet is an interesting one if you've got business lines that are exposed to inflation on the liability side for sure. What happens if I own a net lease investment and the tenant files for bankruptcy? What's that process like?

Sharon: Well, it depends on what type of an asset you own. If you've chosen what we call the mission-critical property – the one that they really need to be in, it's the guts of the business – generally, bankruptcy can be a good thing for you. They will continue to pay their rent because, while they're restructuring their debt, they really can't afford to move or they would lose customers and that would be the end of their ability to come out of bankruptcy. So generally, they pay rent, they negotiate with their creditors, they take the debt leverage down to whatever – they were probably very highly levered when they went into bankruptcy, say 10 times levered. But if they restructure, they come out of bankruptcy with much lower leverage, and therefore the certainty of cashflow on that lease is much higher.

So, when we actually have tenants that go through a bankruptcy situation, it often is a good time to sell because the company has much lower leverage and the certainty of that cashflow being paid over time is so much higher that the next buyer will put a much better or tighter cap rate on it, and it's a good time to exit. So the real risk in this strategy is liquidation. If the tenant really ceases to exist – just they're beyond restructuring their debt, they can't or they're unable to come to an agreement and the company disappears – then we get the building back. We have to start covering maintenance, taxes, and insurance, and we have to put money into the building to reconfigure it or make it attractive to a next user. And that takes time and it obviously, as I said, takes money, so that's a drag on returns.

But, the beauty of the strategy – unlike a fixed income security, where the recoveries are 39, 40 cents on the dollar – [is] we own this hard asset, and so while we're putting money into it, we're adding value to it. And there's a building at the end of the day that you can either re-tenant or sell, and that caps your downside. You have a hard asset that you can maintain value with. So the recoveries in our situations when there have been liquidations are anywhere from 60 to 90 cents on the dollar. And some of them, if you're in a really good real estate market – like Southern California, for example – can be more than 100 cents on the dollar. They're far less of a drag on the returns than an unsecured creditor would realize in a bankruptcy.

Stewart: I'm going to expose my ignorance real quick. So, if I am a landlord and I own an industrial building and I lease it to X, Y, Z company and then I've got a lease, that's the asset. Are you buying that lease from me? Or are you the landlord and you own the building, and this is the net lease that you've entered into and you're selling those cash flows into the market?

Sharon: We buy the building, so we own the hard asset. And then we strike a lease with the seller of the building – the single tenant, the company, the whatever it happens to be, whatever industry it happens to be in – to lease it back to them, on a long-term lease where all their occupancy costs are known right upfront on day one. So, the hard asset is ours as well as the value that we add is created in that lease that we negotiate. Every lease is negotiated on a bespoke basis. There's a lot of terms that are similar, but if it happens to be a manufacturing plant where the company really needs to spend a lot of money on CapEx and it's not discretionary, we might put a covenant in the lease saying you have to put $6 million into the building; I'm making the numbers up, but it's an example of what they have to do to add value and maintain the value of that asset that we own over time. So there's covenants and there's a negotiated annual rent increase as well as term and renewal periods, just about everything is struck upfront. So, the asset is owned by us as well as the lease struck by us, but the lease is generally with the seller.

Stewart: And it makes total sense to me that a manufacturing facility would like to free up their capital that they've got in the building and devote their resources to making the donuts, if you will. Right? That's the idea.

Sharon: Absolutely, yeah. They use it to pay down debt or they use it to grow their business.

Stewart: Right. That makes total sense to me. What would you like our audience, if there's a couple of key takeaways to wrap – I've got one more fun question for you – but to wrap on net lease investments, what are a couple of key takeaways that our insurance investment audience should know?

Sharon: Well, as I mentioned upfront, and I have managed bond portfolios in different times in my career, but I think this is a better bond substitute or effectively a bond portfolio – if you have a group of net lease assets in a portfolio that you're investing – because of the fact that you own the hard asset, the cash flows are known upfront, they're increasing over time, and they're predictable. If you happen to be an owner of high yield bonds, you know that your prices can vary wildly based on the quality of the credit and wherever interest rates tend to be heading, either up or down over time. Here, because the cashflow is all negotiated upfront in this lease, it doesn't have the same type of volatility. So, it actually acts as a volatility dampener in a bond portfolio.

And I should step back and talk a little bit about how we finance this because the financing matters. You can finance net leased assets with variable rate debt where your costs, the owner of the building, your costs change daily. We don't do that. We put 10-year fixed-rate debt on all of our properties, so we're not essentially specking interest rates like some other players might be that do net lease investing. With 10-year fixed-rate assets, our interest costs are known and our rent is increasing over time, so that mathematically shows you that the spread between our cost of financing and the income that we're earning every year is increasing over time. And that all accrues to the benefit of our investors because we pay distributions of that income, because we do this in a REIT format. We distribute 90% of our income over time to our investors.

Stewart: That makes total sense to me. And it's interesting. I mean, what you're describing is effectively the mirror image of an annuity rider, right? I mean it's exactly the same. Now, we talked about this upfront before I hit the record button, but, your particular strategy is longer duration. And if you can give us an idea, a sense of about what duration? And you said that there are opportunities for shorter duration, that other folks may have that, but your focus is up the curve. Can you talk a little bit about that?

Sharon: We tend to choose to be in the longer end of the market because we believe in our mission-critical thesis, that they're really never going to leave this building. We strike 15, 20, 25 year leases, so at any one time in the portfolio, if you were to invest, it probably has a 14-year weighted average life or lease term remaining – so much longer than players that strike 5 and 7 and 10-year leases, which are much more common in the retail world and the office world. But again, those are not asset classes that we get involved with. Some for reasons that I've explained and others for, you can't make a mission-critical case for some of these types of assets. But because insurance companies have long tail liabilities, that's why these assets are a much easier way to match your assets and liabilities than a fixed income security, because fixed income securities can also be called; almost all of them can be taken away from you if the issuer of the debt decides that they can refinance elsewhere.

You can't call a lease. The lease is struck at our discretion, and we can enforce it for the entire term of the lease that is struck upfront. So it's a non-callable asset against a very long liability stream.

Stewart: That makes lots of sense. Sharon, thank you so much. I've learned so much about this asset class. I feel like I really understand it, and that makes me feel empowered and I appreciate that very much. So we've got a couple of questions for you out the door. You can take either one or both if you want. It's up to you. The best piece of advice you've ever gotten or given? And who would you most like to have lunch with alive or dead?

Sharon: I'll take the first question. I had a finance teacher that I really thought very highly of in business school, and he boiled down all of finance into three basic rules. Sooner is better than later, more is better than less, and safe is better than sorry. And if you remember all of that, investing is relatively easy.

Stewart: I love that. I'm speaking at the University of Missouri in about two weeks, and that one's coming with me. So thank you very much. I really appreciate it. Thanks for being on.

Sharon: Appreciate your time.

Stewart: We have been joined today by Sharon Kilmer, a managing director on TPG Angelo Gordon’s Net Lease Real Estate team. Thanks for listening. If you like us, please rate us and review us on Apple Podcast, Spotify, Amazon, Google Play, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the Insurance AUM.com podcast.