TD Asset Management

INVESTMENT SOLUTIONS

Credit tenant lease loans

Uncovering the benefits of a "smart" mortgage

A conversation with TDAM's private debt specialists on credit tenant lease loans and commercial mortgages

We recently had an opportunity to sit with two of TD Asset Management Inc.'s (TDAM) private debt specialists to shed some light on credit tenant lease loans (CTL) and commercial mortgages to help provide some clarity around the similarities and differences between both investments. Donna Beck CFA, Vice President & Director, is a real estate/credit tenant lease loan specialist with over 20 years of relevant experience and Bruce MacKinnon leads the team responsible for TDAM's private debt sourcing and research.

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Vice President & Director

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What is a credit tenant lease loan?

BM: A CTL is a unique investment vehicle which is designed to finance real property leased to an investment grade (IG) single tenant. This is a niche product in the private debt market and offers our clients a high quality alternative to investing in the traditional commercial mortgage market.

DB: A CTL is essentially a mortgage loan on real property structured to rely primarily on the credit standing of an IG single tenant. The credit risk profile looks like a cross between a public bond and a commercial mortgage. The rental payments from the IG tenant flow directly to the lender to repay principal and interest on the loan. Through the nature of a "come hell or high water" lease structure, an investor benefits from a predictable and stable cash flow stream, similar to the payment stream on an investment grade bond.

BM: Importantly, when structured properly, a CTL provides an investor with an enhanced yield without sacrificing quality. A CTL is structured to be inherently safer than a traditional commercial mortgage or an unsecured bond with a similar credit rating as it benefits from both the tenant's IG credit profile and the collateral over real estate. This is why we like to refer to CTLs as "smart mortgages".

Why would an investment grade corporation choose to lease and not buy its real estate?

BM: Leasing rather than owning real estate allows a company to invest available capital back in the business rather than tying it up in real estate. It also keeps property debt off the balance sheet and, as rent is a pre-tax expense, can reduce a company's corporate tax. Many CTLs are created initially from the sale and leaseback of an underlying tenant's key property assets.

DB: Another reason is location. A tenant may choose to be in a specific property location owned by a real estate investor. Leasing the property under a long term lease with renewal options secures the location for the long term.

What are the key elements in analyzing a CTL?

DB: There are three key elements in analyzing a CTL: credit risk assessment, lease structure review and property risk considerations. Specific sector credit expertise is required to understand the risk associated with the long term ability of a tenant to pay the rent which services the debt. This requires a well-resourced and experienced credit team. As well, leases come in all shapes and sizes and a lender requires expertise in understanding lease contracts and the myriad of property obligations of both landlords and tenants and how to structure the loan to restrict the risk to the tenant. Finally, understanding property risk in terms of type and location is important as the debt is secured by a first mortgage on the property which enhances the credit of the CTL and provides collateral and leverage to the lender in any credit event of the tenant.

BM: With respect to property risk, we look for the critical nature of the property to the tenant. For example, we like financing corporate headquarters, key distribution facilities and regional health centres in good locations. The importance of the asset to the tenant increases the likelihood that the rent is paid, even in extreme corporate credit event scenarios. The leases can't be terminated and generally come with multiple renewal terms at favourable leasing rates, supporting a commitment to the property and its location by the tenant for the long term.

What are some of the key differences between a CTL and a commercial mortgage?

DB: With a typical commercial mortgage, the primary credit risk is driven by the value of the underlying real estate property. A lender looks at traditional financial metrics such as loan to value and debt service coverage to evaluate the financing, and there can be multiple tenants, multiple leases and lease terms. Commercial mortgages tend to be short, as well, with terms of 5, 7 and 10 years. A CTL, however, is generally longer term in nature as the loan typically matches the longer term nature of the underlying lease. Terms can be 15 to 40 years, with fixed rents paid by a single IG tenant over the term of the lease and the loan. CTLs are structured so that a lender can rely on the creditworthiness of the tenant as the primary credit risk throughout the term of the loan. The underlying real estate value is secondary but, importantly, provides a lender with the full benefit of collateral in the form of a first mortgage on the specific property asset as additional comfort in case something goes wrong.

BM: With a typical commercial mortgage, a lender is exposed to the credit risk of both the landlord and the tenant as the landlord generally manages the property and pays for the costs associated with owning the property.

If a landlord and a tenant have a dispute, the tenant has the ability to abate rent which can impact the ability of the borrower to pay the debt service. As well, due to the shorter nature of a commercial lease and mortgage, a typical commercial mortgage can be impacted by real estate market downturns, fluctuating rental rates, supply and demand in the marketplace, interest rate increases during refinancing, tenant viability and sometimes, in the case of multi-tenant properties, vacancies from varying underlying lease maturities.

DB: The majority of CTLs in the market are structured to be fully amortized over the term of the loan and the lease, thus focusing the credit risk on the investment grade tenant.

What are the main benefits of a CTL?

DB: When properly structured by an experienced investment team, a lender may achieve a uniqueness premium in the form of an enhanced yield, which can offer a better risk-adjusted return than if they had gone to the public markets and purchased an unsecured public corporate or government bond or a mortgage security issued by the tenant. This is because with a CTL, the lender receives the same predictable cash flow stream that they would have received if they had bought the public bond of the tenant, but they receive the added benefit of the collateral in the form of the first mortgage on real property. A lender may also achieve better diversification through exposure to the broad set of IG names offered in the CTL market, limited only by the number of corporate names and levels of government participating in the leasing of real property, which is extremely broad.

BM: CTLs provide a lender with a plethora of terms, both short and long. However, longer term loans are the norm and provide a benefit to both the borrower and the lender. As the principal on the CTL amortizes over the life of the loan, the equity value of the underlying property collateral increases. So, while the visibility horizon on the credit profile of the tenant may decrease with time, this is countered by the increase in the equity value of the underlying property securing the investment. This might seem similar to the commercial mortgage market, but recall that the terms in the commercial mortgage market are shorter resulting in a property that is constantly being re-levered.

What type of lender should consider CTLs?

DB: CTLs appeal to IG fixed income lenders seeking to enhance yield without sacrificing quality. The asset class provides opportunities for lenders with duration targets across the curve. However, just like commercial mortgages, CTL investments are illiquid, so lenders need to consider their liquidity needs in choosing the term to maturity.

BM: This could be an attractive, unique investment for IG fixed income investors, especially in this lower for longer interest rate environment. Lenders seeking to broaden the diversification within their portfolios may find CTLs desirable as they provide access to sectors and issuer names not well represented in the public corporate indices. As we know, concentration risk can be a big issue for institutional investors in the Canadian fixed income market. Through TDAM's two Private Debt pooled fund trusts, investors can gain access to CTLs and other unique yield enhancing fixed income investments including infrastructure and power, renewables and private securitization.

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