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Rising Trends: Credit Tenant Loan (CTL) Financing

Our Corporate Capital Markets team is active on a broad range of real estate and credit-based capital solutions for planned or existing assets across North America and, increasingly, globally. This activity puts us at the forefront of capital markets trends for real estate. A current trend relates to the use of Credit Tenant Loan (CTL) lease financing for planned or existing assets, especially for larger construction projects. Corporate users increasingly choose CTL-based lease financing as an alternative to self-funded corporate ownership, and developers and real estate owners increasingly prefer CTL financing for single-tenant assets with longer term leases. As example, over the past few years over $5 billion of properties leased to one of the world's largest ecommerce/technology companies have been financed with CTL debt. This trend is expected to accelerate for several reasons, including:

Dislocation and disruption in traditional markets for real estate mortgage debt. Property-level debt markets are largely dormant today. When traditional debt financing can be found it is expensive and/or inefficient compared to CTL financing rates for companies with qualifying credits. CTL financing can provide 100% of the funds to build, buy, or monetize properties compared to low levels of leverage from traditional mortgage financing. Many new projects today are specialized (e.g., manufacturing, R&D, etc.), compounding challenges for traditional mortgage debt, while CTL financing is largely indifferent to specialization, asset type, or market. The CTL structure allows strong credit companies to better leverage their credit strength from a lease; traditional property financing provides less pricing leverage to strong credit lessees. The trend of using CTL financing will build upon itself as more lessee's and borrowers become familiar with the structure.

Greater flexibility for reporting outcomes and other corporate or borrower objectives. The adoption of ASC 842 has diluted the long-held corporate preference for operating leases under prior lease accounting. CTL financing can be structured to achieve operating leases, finance leases, or financings. Certain reporting outcomes may be less impactful to financial covenants in other corporate borrowings or credit ratings and CTL financing generally doesn't require financial covenants. The strongest trend we see among corporate clients is to use CTL financing in finance leases on new projects or acquisitions. This form of finance lease provides the lessee with a right to purchase at the end of the lease for a nominal amount—something that isn't available at reasonable economics with traditional investor debt and equity structures for real estate. Benefits under IFRS 16 are not dissimilar.

Benefits of lease financing over direct corporate funding. For new construction, lease financing avoids recognition of expense or balance sheet capitalization until after the construction period. Once the lease commences, rent payments comply favorably with corporate limitations on Capex compared to the impact under direct ownership funding—limitations we see from almost every business today. This is true for any form of lease financing, but is most efficient with CTL-based structures. CTL-based solutions can also be used to fund equipment or other costs not typically included in leases using traditional debt and equity. Structuring for finance leases benefit EBITDA-sensitive companies.

Pricing efficiency of CTL financing compared to short term borrowing. CTL financing typically utilizes long term leases. CTL loans, which often have maturities matching the lease term, provide an efficient form of long-term fixed rate financing to the lessee. Today's inversion of the yield curve for U.S. treasuries favors long-term fixed rate debt over short-term debt. CTL financing also taps potentially new capital sources for corporations.

CTL lending provides strong relative value for lenders, which will expand allocations and attract new lenders. By most estimates, there are 60 to 80 CTL groups in North America. Six to eight of these lenders can manage documents and the administrative process for construction projects. Once one or more of these lenders leads a construction project, other CTL lenders gain comfort participating in a syndication. CTL loans are a product of regulations promulgated by the National Association of Insurance Commissioners, which governs life insurance companies in the U.S. Lenders and investors in Canada and some parts of the EU have mirrored the CTL structure for their own investments. Growing popularity of the CTL product is driving interest from other EU institutions and from Asia, expanding the availability of CTL-financing to meet rising borrower demand.

CTL financing requires investment grade credit and, for efficiency, longer term leases. Retail properties, such as those leased to national pharmacy retail chains, or big-box home improvement retail chains, have long been capitalized with CTL financing. Until recently, office and warehouse properties were in a "risk on" environment and enjoyed strong investment and debt markets. Companies generally prize flexibility and could get similar or even better economics under a shorter-term lease with a traditional investor compared to a longer-term lease using CTL financing. The investment and debt markets are no longer so bullish for these assets. Manufacturing was typically owned and funded by the corporate user.

The corporate occupier market is evolving to understand that there are capital options other than a traditional developer/investor lease or self-funding. An important driver behind this evolution was the capitalization of leases under ASC 842. This pushed real estate decisions higher up into organizations and in doing so created the need for more rigor and analytics supporting decisions. A by-product of this is a desire to evaluate other financing alternatives to own or lease in concert with the prioritization of enterprise-level objectives. The result is that strong credit companies increasingly choose credit-based lease financing solutions like CTL-based lease financing structures and synthetic leases in situations where they might have otherwise self-funded in the past.

Corporate Capital Markets provides capital markets advisory and execution expertise for planned or existing single-tenant assets on behalf of corporate occupiers, developers and owners.

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