

NET LEASE ADVISOR



1ST QUARTER 2006

Your Source for Investment Real Estate™

CALKAIN IS MOVIN' ON UP... NORTH

CALKAIN COMPANIES OPENS ITS FIRST EXPANSION OFFICE

Calkain Companies is growing with the institution of its first expansion office. The Boston metro office opened in January 2006 with the understanding that it will have a better medium to properly service clients within the northeast region. Choosing Boston was no accident as Calkain recognized the large number of developers and investors needing an experienced and professional firm to assist with their asset acquisitions and dispositions, as well as consult on their existing portfolios.

Calkain felt that a physical presence in the Boston area would better aid the growing number of real estate investment trusts, private and public equity firms, institutional clients, as well as professionals focusing on private market assets. From disposition and acquisition strategies to valuation and complex financing structures, Calkain will be offering a unique set of services tailored to fully support our national clients as they manage their investment decisions.

Joel Kahn, Managing Director of Calkain Institutional Advisors, will lead the Boston area office from Nashua, NH, a metro suburb. While the initial focus will be on institutional clients, the northeast office will also house a private markets division in order to complete the full spectrum of Calkain's services.

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EMERGENCE OF ENVIRONMENTAL DUE DILIGENCE

AN INVESTOR SHOULD UNDERSTAND WHAT IS UNDERNEATH THEIR ASSET

Over the past few decades, changes in environmental laws have impacted real estate owners and real estate transactions to the point of creating a new industry, that of environmental due diligence experts. When structuring an acquisition, sale, lease, or financial transaction, the parties involved need to know whether the real estate is contaminated and what effect the contamination may or may not have on the economics of the transaction. Buyers need to assess the potential costs, developers need to know if the contamination will displace their plans and lending institutions need to protect their investments.

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EMERGENCE OF ENVIRONMENTAL DUE DILIGENCE

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The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) has also had an enormous influence on the development of the due diligence industry. Under CERCLA an “owner” or “operator” of a facility where a hazardous substance has been deposited, stored, or placed is a potentially responsible party (PRP). Past court rulings have found that a PRP’s liability is absolute and retroactive¹.

Purchasing or leasing a property includes the risk of acquiring the liability for environmental conditions possibly caused by previous owners. Cleanup costs and managing impacts of contamination vary but are almost always unwelcome. Environmental problems can be significant enough to affect the market value of a property. The solution to these problems is a properly conducted Phase I Environmental Site Assessment (ESA). An ESA, although generally limited in scope, can provide indication of past and existing environmental conditions. The objectives of an ESA are to assess the probability of environmental concerns associated with current and past uses of the site and adjacent sites, and to determine the requirement for further investigation or remedial action.

One primary purpose of an ESA is to satisfy a requirement to qualify for the innocent landowner defense under the CERCLA, and to help quantify potential environmental liabilities that may impair the value of the property. The American Society for Testing and Materials (ASTM) standard was developed to define the customary practice for conducting a Phase I ESA. It should be noted that ASTM standards do not have the force of law, but help to fill the void left by the lack of guidance from the U.S. EPA and Congress. The EPA has been taking steps to better define standard practice, and as a result on October 21, 2005, All Appropriate Inquires (AAI) was signed into law. AAI defines what steps need to be taken to declare that a Phase I ESA is AAI-compliant for the purposes of qualifying for CERCLA liability protection. The recent AAI regulation defines and qualifies who may be considered an Environmental Professional (EP) and aspects of an acceptable Phase I in accordance with ASTM 1527.

While there are many different protocols offered by the environmental industry, the following activities are performed in conformance with AAI/ASTM Standard Practice E1527-05: (1) records review, (2) site reconnaissance, (3) interviews and (4) an evaluation report².

The purpose of a *records review* is to obtain and review records that may help identify recognized environmental conditions in connection with the subject property. The review includes several ascertainable federal, state and local databases; various historical sources such as land and title records or fire insurance maps; property tax files; topographical maps; aerial photography and/or city directories.

The objective of the *site reconnaissance* is to obtain information that indicates the likelihood of identifying recognized environmental conditions in connection with the property. During a *site reconnaissance*, the subject property is visually and physically observed, both the exterior and interior. The periphery and general site setting of the property is observed, as are the structures and adjacent entrance/exit paths and adjoining properties. This type of observation is completed to determine whether paths exist that may have historically acted as disposal routes for hazardous waste and to form indications of past usages — both on site and in adjoining sites. Geological and topographic research is conducted during the reconnaissance to determine the possible migration of hazardous substances. The site is also inspected for stained/discolored areas or distressed vegetation which may have been caused by a petroleum spill, odors which may be the result of a questionable activity or storage, pits and lagoons, storage tanks and monitoring wells, etc.

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The interior accessible common spaces and a sampling of tenant spaces are observed during the reconnaissance to determine current activities and possible past use of hazardous materials. It should be noted that ASTM does not require analysis, neither visually nor through testing, for the presence of asbestos containing materials (ACM), lead-based paint, radon, mold or lead in water. However, many industry scopes do require a visual determination or comment on the likelihood of substance presence. Many environmental due diligence firms will comment on the possible existence of such materials based on age of construction and/or site usage.

The last step of *site reconnaissance* involves the environmental professional conducting interviews to determine historical and current usage for the site as well as for the adjoining properties. The new AAI/ASTM 1527-05 states interviewing requirements for major occupants and those using, storing, treating, handling or disposing (or likely to have used, stored, treated, handle or disposed) of hazardous substances; neighbors of subject sites if abandoned; previous owners and state and/or government officials.

The final activity is the culmination of the gathered information into an *evaluation and report*. The *report* includes an opinion of the environmental professional stating the impact of any recognized environmental condition. It also includes findings and conclusions with support documentation as well as a statement to show that the *report* was completed in accordance with ASTM Practice E 1527 or stating any deviation or gaps in the *report*. After preparation, the *report* is then ready to be issued to all interested parties.

In conclusion, the Environmental Phase I is now a significant piece of the AAI ruling and should not be considered only a necessity of lenders, as a quality Phase I can have a substantial effect on investment decisions with regard to the property. So be sure to choose and qualify environmental consultants carefully. ■

By: D. T. Spinosa, EBI Consulting

¹Aspects of Real Estate Transactions. 1995. American Bar Association.

²ASTM Designation: 1527-93; 1527-00; AAI/ASTM 1527-05.

CHOOSING THE RIGHT LOAN

EVALUATING THE LARGER PICTURE ULTIMATELY BENEFITS AN INVESTOR'S OVERALL YIELD

The first question most often asked by borrowers is, "What is the best interest rate?" For most borrowers, at least initially, that seems to be the only important variable when comparing and choosing a loan program.

At first glance that seems reasonable. Doesn't the lowest interest rate for a loan result in the smallest mortgage payment? Doesn't the smallest mortgage payment mean that the investor is paying as little as possible to borrow money? Is choosing an appropriate loan program for your net leased investment really as simple as comparing interest rates? The answer is no. Per the below case study, a lower interest rate does not always equate to a smaller mortgage payment.

Before beginning to answer the "interest rate" question, a good understanding of a borrower's investment objectives is critical. Other than having a strong desire to purchase an investment property, many times borrowers haven't even considered an overall investment strategy. An investor should have a plethora of questions that should be considered early in the loan process.

What amount of equity does the borrower have or need to invest? Does the borrower plan to hold the property for a short period of time or for a long period of time? Is this transaction a 1031 exchange? What are the borrower's thoughts regarding prepayment penalties? How does a recourse or non-recourse loan influence the investors' objectives? Does the borrower want or need to maximize cash flow from the investment? Is a shorter amortization period preferred? Would the borrower like to consider a maximum leverage loan, i.e., 85%+ LTV, using a "Credit Tenant Lease" loan program designed for transactions with investment grade tenants?

These are the types of questions that need to be addressed at the outset of the commercial loan process. By examining the answers to these questions the borrower will define specific investment objectives which will in turn determine which loan programs are appropriate to consider and compare.

Therefore, the "investment objective" should first be considered when choosing a loan program... not the "interest rate" question.

Once it is determined which type of loan program is needed a lending professional can gather relevant quote data from a variety of lending sources in order to compare the available options. Because the borrower has defined specific investment objectives by this point, the loan quotes provided will be compared on an equal basis.

It is at this point that interest rates should be examined along with all other aspects of a loan quote, such as, loan term, loan-to-value, amortization, debt service coverage ratio, prepayment penalty, recourse, timing, fees, closing costs, etc.

CASE STUDY:

An investor contracted to purchase a net leased investment property (fast food restaurant.) Before the purchase, the buyer was solely concerned with the interest rates currently available.

The investor had his assistant call the mortgage professional with instructions to provide a loan quote with "the best interest rate available, keeping in mind that cash-flow is of the utmost importance". Through further discussions and evaluation with the loan advisor the investor chose loan terms and a higher interest rate that ultimately satisfied his overall investment objectives.

Discussions with the investor yielded crucial information that the borrower planned to own this property for a maximum of 2-3 years. The mortgage professional was able to provide him with three "short term" loan options. Varying interest rates and terms were presented to the borrower in a manner that allowed him to see the ultimate benefits and consequences of each scenario.

The "investment objective" should first be considered when choosing a loan program... not the "interest rate" question.

Additionally, it was learned that maximum loan amount was also very important to this borrower. Therefore, a 2-year adjustable rate, interest-only loan requiring 25% equity was included in his options because a 75% loan-to-value is a very competitive product type for a net leased "special-use" restaurant property.

The borrower recognized the minimal risk posed by the 2-year adjustable rate program given that he plans to sell the property in a short period. He was also able to achieve his investment objectives of maximum loan dollars and a no prepayment penalty. The borrower was also willing to pay a small premium for the interest-only option. In the end, the borrower selected option #3 (in the following table) despite the fact that the interest rate is 80 basis points higher than the first two options. It should also be noted that the loan program with the highest interest rate actually provided the highest return on investment.

Many factors are evaluated when discussing options for a loan on a net leased property. Finding a loan professional that is able to facilitate the assessment and valuation of the particular investment and finance options for the purchaser will, in the end, secure financing that allows them to achieve their investment target.

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CHOOSING THE RIGHT LOAN

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	OPTION #1	OPTION #2	OPTION #3
Term:	3-years fixed	3-years fixed	2-years adjustable
Amortization:	25-years	20-years	Interest-Only
Loan-to-Value:	65%	70%	75%
Interest Rate:	6.45%	6.45%	7.25%
Prepayment Penalty:	1% for Life	1% for Life	NONE
Annual Rent:	\$188,790	\$188,790	\$188,790
Cap Rate:	10%	10%	10%
Acquisition Cost:	\$1,887,900	\$1,887,900	\$1,887,900
Loan Amount:	\$1,227,135	\$1,321,530	\$1,415,925
Equity Contribution:	\$660,765	\$566,370	\$471,975
Annual Debt Service:	\$98,969	\$117,769	\$102,655
Net Operating Income:	\$89,821	\$71,021	\$86,135
Closing Costs (approx):	\$25,000	\$26,000	\$34,000
Return-on-Investment:	13.10%	11.99%	17.02%

By: Jack D. Sides, III, Vice President of BMC Capital, LP in Dallas, TX.

CALKAIN IS MOVIN' ON UP... NORTH

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Joel has been critical to the advancement of Calkain's growth into the financial epicenters of the industry. He has integrated demographic modeling, an in-depth review of physical characteristics, supply and demand factors, with a financial pro forma as a basis in projecting short and long term returns with a sound exit strategy. Additionally, Brett Pagani, Calkain's newest Associate and recent MBA graduate, will support Kahn and the northeast office in both sales and market research. ■

INSIDE CALKAIN

David Sobelman – Was promoted to Vice President of Calkain Realty Advisors and recently had a cover story published in Northeast Real Estate Business covering 1031 Exchanges.

Amy Bishop – Recently joined Calkain Companies as Market and Research Analyst.

Brett Pagani – Recently joined Calkain Institutional Advisors as Associate.

Doug Hall – Recently joined Calkain Companies as Financial Manager.

PNC Bank

Location:	Washington, DC
Space Size:	4,110 Square Feet
Lease:	10 years
Lease Structure:	NNN
Commencement:	May 2006
Options:	2 – 5 Year
NOI:	\$267,150
Escalations:	3% annually
Price:	\$5,088,571
CAP Rate:	5.25%

One of the few NNN properties in the middle of the Nation's Capitol. This S&P rated A company has signed a 10-year lease in a ground floor retail condo in a newly constructed luxury residential building surrounded by some of the areas best known landmarks.



Photo of actual site

Arby's

Location:	Bradenton, FL
Building:	3,304 Square Feet
Lease:	23 years
Lease Structure:	NNN
Commencement:	January 2004
Options:	4 – 5 year
NOI:	\$161,365
Escalations:	5% every 5 years
Price:	\$2,305,214
CAP Rate:	7.00%

Located directly off of Interstate 75 in the fastest growing area of the Florida Gulf Coast. Brand new construction in a very high traffic area with tremendous visibility.



Photo of actual site

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