

The Tenant Is Not the Property

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Abstract

The value of leased properties is significantly influenced by the creditworthiness of tenants, often overshadowing the physical attributes of the property itself. This article examines how tenant credit ratings and lease terms can cause identical properties to have vastly different values. The analysis covers the concept of credit tenants, bondable leases, and the methodologies used by rating agencies like Moody's, Standard & Poor's, and Fitch. Through data analysis, the article illustrates the impact of credit ratings on capitalization rates, emphasizing the need for appraisers to distinguish between the intrinsic value of real estate and the additional value derived from lease agreements.

Introduction

The market value of a leased property may hinge more on the creditworthiness of the tenant than on the physical attributes of the property itself, all other things equal. This phenomenon, where nearly identical properties can have significantly different real property values based on the tenants' credit ratings and lease terms, underscores a fundamental truth: The property is not the tenant, and the tenant is not the property. If tenants with different credit ratings took over each other's lease obligation, the value of their respective leased interest might change to reflect their respective credit ratings. This disparity arises from the lease contract rather than the inherent qualities of the real estate. The presence of a credit tenant can elevate the value of a leased fee interest, enhancing its value due to the tenant's perceived financial reliability, yet it has no direct impact on the intrinsic value of the underlying real estate. This concept challenges traditional views and highlights the nuanced interplay between real estate and real property rights, revealing an oddly controversial yet critical aspect of property valuation.

First, let's be clear on the meaning of terms used throughout this article. *Real estate* is defined

as “[a]n identified parcel or tract of land, including improvements, if any.”¹ *Real property* is defined as “1. An interest or interests in real estate. 2. The interests, benefits, and rights inherent in the ownership of real estate.”² A fundamental understanding of the differences between these terms will enhance the context provided throughout the balance of the article.

Also important in the discussion here is the term *credit tenant*. Traditionally *credit tenant* refers to a tenant in a commercial real estate context whose financial strength and creditworthiness are strong enough to secure financing for a landlord or developer and drive significant desire and pricing on these investments. Credit tenants are typically large, well-established corporations with high credit ratings (at least BBB—see Exhibit 1) from agencies such as Moody's or Standard & Poor's. The presence of a credit tenant in a property can be a pivotal factor in the decision-making process for lenders and investors because credit tenants are considered less risky investments for lenders. “Understanding a tenant's financial strength is key to assessing the quality of the income stream. Even nearly identical properties leased to single tenants with varying credit ratings can have drastically different values if one tenant has a strong credit rating and

1. Appraisal Institute, *Dictionary of Real Estate Appraisal*, 7th ed. (Appraisal Institute, 2022), s.v. “real estate.”

2. *Dictionary of Real Estate Appraisal*, 7th ed., s.v. “real property.”

the other does not. Long-term leases to a weak tenant can be worthless and may even adversely affect value.”³

What Are Credit Tenants?

“There are but so many ‘national credit’ tenants to go around. Once landlords get past the roughly 35% of national retailers that rating agencies dub investment grade, the pickings get slimmer and the credit decisions more crucial.”⁴ This statement highlights that credit tenancy has been a critical determinate for decades. Historically, the definition of a credit tenant has been relatively stable, centered on the tenant’s ability to meet their lease obligations consistently and on time. This reliability was often underpinned by a strong balance sheet, consistent revenue streams, and a high credit rating. The creditworthiness of a tenant was a key factor in the valuation of leased fee interests in commercial properties and in the structuring of lease-backed securities.

A *credit tenant* is defined as “[a] tenant in a retail, office, or commercial property with a long history in business, strong financial statements, or a large market presence that could be rated as investment grade by a rating agency. Because of the likelihood of honoring their leases, credit tenants are considered less risky to lease to, and developments with credit tenants as anchors are considered less risky investments.”⁵ A companion definition is that of *investment-grade tenant*, which is defined as “[in] commercial real estate, any tenant that has an S&P rating of BBB– or better or a Moody’s rating of Baa3 or better.”⁶

A *bondable net lease* is defined as “a lease in which the tenant assumes nearly all of the obligations of ownership of the property, therefore making lease payments net of any offsets or deductions and net to the lessor or owner. In other words, the tenant pays rent for the entire term of the lease

regardless of what happens to the building, e.g., condemnation. Also called a *bond-type lease*.”⁷ *The Appraisal of Real Estate* notes that “[a]n extreme form of a net lease is sometimes referred to as a *bondable lease* (or sometimes as an *absolute net lease* or a type of triple net lease).”⁸

According to *The Appraisal of Real Estate*, bondable leases, also known as absolute net leases or triple net leases, shift most risk from the landlord to the tenant. Tenants in these leases are responsible for all expenses, including structural repairs, and even continue paying rent after casualties or condemnation. This type of lease is most often associated with credit tenant leases, where the tenant’s strong financial standing and creditworthiness effectively guarantee the lease obligations, making it a low-risk investment for the landlord.⁹

A credit tenant and/or a bondable lease can significantly reduce the risk for the landlord (owner of the leased fee estate), can increase liquidity, and often can remove significant management responsibilities. This reduced risk is reflected in lower capitalization rates or discount rates applied to the leased fee position compared to similar properties with less secure tenants or lease structures.¹⁰ Real estate investment trusts (REITs) often target properties with long-term leases to credit tenants as part of their investment strategies. This preference for credit tenants stems from the reduced risk and stable income stream they offer, aligning with the REIT’s objective of providing consistent returns to its investors.¹¹

While the definition of *credit tenant* outlines the elements to consider, the ability to fully understand the context is diminished by the construction of relying on rating agencies’ analyses of a tenant. If that is the ultimate deciding factor, an in-depth discovery of the ratings agencies processes is more critical.

3. Appraisal Institute, *Evaluating Commercial Leases: The Tenant and Terms Both Matter* (seminar 2018), 91.

4. Steve McLinden, “Landlords Scrutinize Tenants’ Finances More Closely,” *Shopping Centers Today*, November 2006, 48–49.

5. *Dictionary of Real Estate Appraisal*, 7th ed., s.v. “credit tenant.”

6. *Dictionary of Real Estate Appraisal*, 7th ed., s.v. “investment-grade tenant.”

7. *Dictionary of Real Estate Appraisal*, 7th ed., s.v. “bondable net lease.”

8. Emphasis in original. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed. (Appraisal Institute, 2020), 418.

9. *The Appraisal of Real Estate*, 15th ed., 418.

10. *The Appraisal of Real Estate*, 15th ed., 423.

11. *The Appraisal of Real Estate*, 15th ed., 126.

Moody's Credit Rating Criteria

Moody's rates a variety of industries, sectors, and government agencies and bonds. It follows a prescribed process for each sector with variations as necessary.¹² In general its process includes a framework that consists of analysis of the scale, business profile, profitability, leverage and coverage, and financial policy of a company to arrive at a "scorecard-indicated outcome." Other considerations may be included before the final assigned rating is applied.

For example, the retail and apparel sector encompasses "operators of grocery stores, department stores, drugstores, auto dealerships, home improvement stores, value stores, apparel, footwear and fashion accessory stores, big-box retailers and mass merchandisers."¹³ The methodology seeks to incorporate all material credit considerations and is forward looking to the extent possible. Each of the enumerated factors is assigned a weight and evaluated through subfactors, reflecting their influence on the subject company's credit rating.

1. **Scale (15% weight):** The scale of a business is crucial as it highlights the company's market depth, customer diversity, and cost advantages. Larger companies often enjoy competitive benefits like better buying power and pricing strategies. This factor is quantitatively assessed using total revenue.
2. **Business Profile (20% weight):** This factor considers the market characteristics and position of a company. Features such as barriers to entry, demand elasticity, and exposure to consumer preferences play a role in determining a company's stability and competitive edge. Retail and apparel entities with strong market positions and geographic diversity are better positioned to sustain customer interest and manage operational challenges. The evaluation here is qualitative, based on market characteristics and the company's competitive positioning.
3. **Profitability and Efficiency (10% weight):** Profitability is essential for sustaining cash flow

and competitive status. High profitability often indicates strong competitive advantages and stable market share. This factor is assessed through the stability of revenue and earnings, considering historical performance and comparisons with peers.

4. **Leverage and Coverage (40% weight):** This factor focuses on a company's financial leverage and its ability to manage debt, crucial for long-term viability and competitive positioning. Metrics such as Debt/EBITDA, RCF/Net Debt, and (EBITDA-Capex)/Interest Expense are used to measure the company's debt serviceability and financial health.
5. **Financial Policy (15% weight):** The company's financial strategy is assessed based on management's risk tolerance and commitment to maintaining a robust credit profile. Historical actions, liquidity management, and responses to economic and industry shifts are considered. This factor also evaluates management's strategies for growth, such as mergers and acquisitions, and their impact on the company's financial standing.

In addition to these core factors, the scorecard may also consider other financial controls, corporate governance, environmental factors, and regulatory risks, which may vary in importance across different companies and scenarios.

Overall, the scorecard methodology is designed to provide a comprehensive assessment of a retail and apparel company's creditworthiness, considering both quantitative and qualitative factors that reflect the complex dynamics of the industry.

In addition to overall company ratings, Moody's also has a methodology related to rating credit tenant lease and comparable lease financings. For these it investigates four key factors in rating credit tenant obligations which include tenant credit quality, the lease obligations, the structure of the transaction, and the "dark value" (alternatively known as "vacant possession value" or VPV).¹⁴

The tenant credit quality is based upon Moody's deriving the probability of a default under the

12. Moody's Ratings, Rating Methodologies, <https://bit.ly/3SCSxHP>.

13. Moody's Investor Service, *Rating Methodology Retail and Apparel*, 1, <https://bit.ly/3FckDGO>.

14. Moody's Investor Service, *Rating Methodology: Moody's Approach to Rating Credit Tenant Lease and Comparable Lease Financings* (June 24, 2020), 2, <https://bit.ly/3F9pybD> (registration required). VPV in this context is a market value based on the special assumption that the property is vacant and generates no cash flows as defined in Moody's Investor Service, *Moody's Approach to Rating EMEA CMBS Transaction* (May 17, 2021), 9, <https://bit.ly/3YKqnOJ>.

tenant's nonterminable lease, which generally equals the tenant's senior unsecured debt rating (or equivalent).

In reviewing the structural features of the lease, they look for or evaluate whether a bondable lease unconditionally obligates the tenant to pay rent in an amount sufficient to pay the debt service in a timely manner and fully amortize the principal of the bonds. In addition, the bondable lease must allow for payment of all costs associated with occupying, operating, and maintaining the property, without any setoffs.¹⁵

Another critical element is whether the landlord is a special-purpose, bankruptcy-remote entity.¹⁶ This is a special form of ownership whose structure is meant to protect against the risk of the landlord's bankruptcy interrupting the lease stream. This is a crucial mechanism for ensuring the security and predictability of payments to bondholders. The landlord's business purpose is strictly limited to owning and leasing the property and issuing the debt. This narrow focus helps to reduce operational risks and prevent financial difficulties in other areas of business from affecting the lease payments. There are additional elements to be considered, including whether any transfer of the property by the landlord is also limited to another single-purpose, bankruptcy-remote entity. This requirement ensures that the property remains within a controlled environment, minimizing exposure to external financial risks.

The last consideration of the structure is the "dark value" of the real estate collateral. Per Moody's that simply means the value of the vacant property assuming rejection of the lease by the tenant in a bankruptcy action.

Standard & Poor's Credit Rating Criteria

Standard & Poor's (S&P) uses a similar methodology in rating companies and organizes the analytical process to consider all relevant issues. The company's business risk profile is reviewed to evaluate its financial risk profile. From there, six factors are analyzed that are deemed relevant to the eventual rating. These six issues are diversification/portfolio effect, capital structure, financial

policy, liquidity, and management and governance. Comparable ratings analysis also take place.¹⁷ Standard and Poor's has separate criteria for rating credit-tenant leases, including the landlord obligations, the lease terms, and the termination rights.

Landlord obligations are critical to the analysis. There must be a determination of whether the transaction is credit-tenant centric meaning the performance of the obligation is based on the tenant's lease payments or whether the transaction is property-centric where the performance is based on the underlying real estate collateral.

The analysis of a single-tenant credit tenant lease transaction starts with an analysis of whether the lease payments on the underlying lease on the real estate securing a loan and any applicable corporate guarantees reflect the credit tenant obligation. Specifically, S&P expects the credit tenant to be responsible for all operating, real estate tax, and insurance expenses under the lease. Additionally, they consider the lease term, with an expectation that its term runs at least the term of the fully amortizing loan's term in order not to consider refinancing risk.

Finally, much like the considerations from Moody's, the presence of lease outs or condemnation outs that could break the link to the tenant are generally viewed as unfavorable. These lease outs typically permit the tenant to abate lease payments or terminate the lease if the property suffers a casualty or condemnation event. The notion that a tenant could exercise its right to terminate under a lease out following casualty, condemnation, or other termination events could indicate that the tenant believes the value of the real estate has diminished. The ensuing vacancy may result in a decline in the S&P Global Ratings value due to the cost in leasing up the property, as well as the fundamental changes to the market that caused the tenant to vacate the property in the first place.

Fitch Ratings Credit Rating Criteria

Fitch Ratings' credit rating methodology integrates both qualitative and quantitative factors.

15. Moody's, *Rating Methodology: Moody's Approach to Rating Credit Tenant Lease and Comparable Lease Financings* (June 24, 2020), 3.

16. A "bankruptcy-remote entity" is a special legal structure designed to minimize the risk of being affected by bankruptcy proceedings. When landlords own their property as private individuals or through small partnerships, their personal assets are directly linked to the property.

17. S&P Global, "Criteria/Corporates/General: Corporate Methodology," January 7, 2024, <https://bit.ly/4jRcc2M>. See also Nasdaq, "What Is the Standard & Poor's (S&P) Rating Scale?," September 9, 2024, <https://bit.ly/43v9Lgu>.

The agency assesses the business and financial risks associated with an issuer, considering a blend of historical data and forward-looking projections. Typically, these projections span a three-to-five-year horizon, corresponding to one economic cycle, to gauge the issuer's performance relative to its industry peers.¹⁸

In its detailed assessment, Fitch looks closely at sector-risk and country risk. This involves evaluating the inherent challenges and opportunities within an industry—such as competitiveness, capital intensity, and cyclical volatility—as well as the broader economic and financial landscape in which a company operates.

The financial analysis focuses on profitability, financial structure, and the issuer's capacity for financial flexibility. This includes an examination of how well a company can manage its debt and whether it possesses the resilience to withstand economic downturns without compromising its credit standing.

According to Fitch Ratings, in credit-tenant lease transactions, there are four key criteria for determining whether the transaction can be linked to the issuer default rating (IDR) of the tenant/lessee, including whether the lease is bondable or triple net (NNN) and all lease termination and abatement rights are quantifiable and mitigated by additional structural features. A bondable lease does not allow termination, abatement, or offset rights at any time, and the lessee is responsible for all costs associated with operating and maintaining the property. Second, the criteria require the property is constructed and there are no obligations of the landlord that if not met would allow the tenant to abate rent or modify or terminate any lease term. Third, the lease payments are fixed, and payment of any additional rent is unnecessary to meet debt service obligations. The base rent should include the payment of all real estate-related costs, including taxes, insurance, maintenance, utilities, ground lease payments, and special assessments. Finally, in the event of condemnation or casualty, the lease provides that all related proceeds from insurance or condemnation are applied to the principal balance of the rated loan/notes, and the lessee must continue to pay subsequent base rent payments that fully amor-

tize the remaining loan balance by the maturity date. A *credit tenant* is defined by Fitch Ratings as a tenant whose lease structure and creditworthiness allow the transaction to be linked to the tenant's issuer default rating, rather than the property's leverage characteristics.¹⁹

Summary

The definition of *credit tenant* has become more nuanced in recent years, reflecting changes in the broader economic landscape. Landlords and investors now focus on a tenant's overall strategic position and ability to navigate uncertain economic conditions, rather than focusing solely on static financial metrics or credit ratings. The definition has evolved from a narrow focus to a more comprehensive assessment of a tenant's financial stability, operational resilience, and strategic adaptability in the face of changing market dynamics. Also, credit tenants have evolved into the inclusion of private companies with successful business operations, like Chick-fil-A and In-N-Out Burger.

Commercial Real Estate as an Investment Class

Following World War II, commercial real estate emerged as a significant investment class, notably gaining prominence after the implementation of the Employee Retirement Income Security Act of 1974 (ERISA). That legislation redefined real estate investments, allowing pension plans to include certain real estate as permissible investments. The credit rating played a crucial role in aligning the investor's perspective with that of other investment asset classes. The triple-net lease structure further facilitated this transformation by eliminating most landlord responsibilities and shifting the focus from location to tenant creditworthiness. This made the investment comparable to other securitized instruments. As a result, there was a surge in capital into the investment-grade real estate sector. To cater to the needs of institutional investors, the market expanded to include various investment opportunities, such as single-tenant properties with triple net (NNN) leases to credit-worthy tenants, featuring extended

18. Fitch Ratings, *Corporate Rating Criteria—Effective 3 November 2023 to 6 December 2024* (November 3, 2023), 1, <https://bit.ly/4dgpCo>.

19. Fitch Ratings, *Single- and Multi-Name Credit-Linked Notes Rating Criteria* (December 18, 2023), 13, <https://bit.ly/43eIXRA>.

lease durations.²⁰ These types of triple-net leases lower the purchaser's risk, making it an attractive option for institutional investors. These leases allow investors to allocate funds to real estate while minimizing the management risks commonly linked with real property ownership.²¹

Credit Rating Summary

For additional analysis and visualization of the data, information from Moody's, Standard & Poor's, Fitch Ratings, and other sources were used to develop the matrix in Exhibit 1. The tier-grade descriptions generally follow accepted categorizations of investment grade and non-investment grade categories, albeit each user might have slightly different naming conventions. A numeric proxy value was applied for each rating shown for the ten categories.

Dataset Analysis

A review of net leased transactional data can assist in demonstrating the effect of credit ratings. The following analysis includes data obtained from CoStar Group from January 2020 through March 2024. Additionally, information was taken from quarterly reports published by The Boulder Group.²² Over the period from Q1 2020 through Q1 2024, 710 office, industrial, and retail transactions were reported in these sources. While not all inclusive, the information provides a convenient sample dataset to consider. From these sales, all office, industrial, and ground leased properties were excluded. Further limitations were imposed on those transactions leased to tenants that did not hold a credit rating from major agencies. Finally, deals were also eliminated from the dataset if the remaining lease term could not be determined. The resulting subset contained 486 retail property transactions with tenant credit ratings and remaining lease terms known.

Description of Dataset

Exhibit 2 shows a summary table of the descriptive statistics for the dataset, providing a broad overview of key numeric variables. Other descriptive statistics will follow.

Descriptive Statistics Summary

- **Capitalization Rate:** The average capitalization rate is approximately 5.5%. The range of capitalization rates is from 3.40% to 8.7%, indicating a wide variance in potential returns, possibly influenced by factors such as tenant creditworthiness, lease terms, and other factors.
- **Remaining Lease Term:** The average remaining lease term is about 12.7 years, with leases ranging from 2 to 25 years.
- **Numerical Credit Rating Proxy:** The credit ratings have a mean value of 4.4. Ratings range from 2 (high grade—AA+, AA, AA-, Aa1, Aa2, or Aa3) to 10 (default—D, C, or D). (See Exhibit 1.)

State Data

The dataset sales were in forty-five states with Florida, California, and Texas having the most sales per state. The dispersion is shown in Exhibit 3.

Visualizations of Dataset

Exhibit 4 shows a histogram that reflects the overall composition of the sales dataset regarding the number of transactions that fall into each numeric proxy category. This shows that there were no sales in the Prime (AAA), Substantial Risks (CC), and the Extremely Speculative (C) categories. The remaining categories have several sales transactions with investment-grade tenants represented in 311 of the transactions or roughly 64% of the deals.

In addition to the categorization by credit rating, the graph in Exhibit 5 demonstrates the average capitalization rate for the sales based on years remaining on the lease. There is a demonstrable trend showing the shorter the remaining lease term, the higher the capitalization rate, except for those transactions with longer than twenty-one years left on the terms. This relationship is not unexpected as the risk of renewal, markets changes, etc. are more pronounced the shorter the remaining term. The Exhibit 5 dataset depicts the deviation in the last category of data points—

20. See Leslie P. Sellers and Paula K. Konikoff, "Valuation Methods and Dark Big-Box Theories," *The Appraisal Journal* (Summer 2019): 165–179.

21. For a fuller discussion, see Leslie P. Sellers and Paula K. Konikoff, "Big Box Divided," *Valuation* (Third Quarter, 2018): 20–23.

22. "The Boulder Group is a boutique investment real estate service firm specializing in single tenant net lease properties," from "About Us" on the Boulder Group website, www.bouldergroup.com.

Exhibit 1 Tier Grade Matrix

Tier Grade	Standard & Poor's	Moody's	Fitch	Numeric Proxy
Investment Grade				
Prime	AAA	Aaa	AAA	1
High Grade	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-	2
Upper Medium Grade	A+, A, A-	A1, A2, A3	A+, A, A-	3
Lower Medium Grade	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-	4
Non-Investment Grade				
Lower Grade	BB+, BB, BB-	Ba1, Ba2, Ba3	BB+, BB, BB-	5
Speculative	B+, B, B-	B1, B2, B3	B+, B, B-	6
Highly Speculative	CCC+, CCC, CCC-	Caa1, Caa2, Caa3	CCC	7
Substantial Risks	CC	Ca	CC	8
Extremely Speculative	C	C	C	9
Default	D	C	D	10

Exhibit 2 Summary Table of the Descriptive Statistics

	Sale Date	\$/SF	Cap Rate	Credit Rating Proxy	Remaining Term
Mean		\$772	5.5%	4.4	12.7
Median		\$592	5.3%	4.0	13.0
Minimum	Jan-24	\$55	3.4%	2.0	2.0
Maximum	Apr-24	\$4,484	8.7%	10.0	25.0

Exhibit 3 Dispersion of Dataset Sales

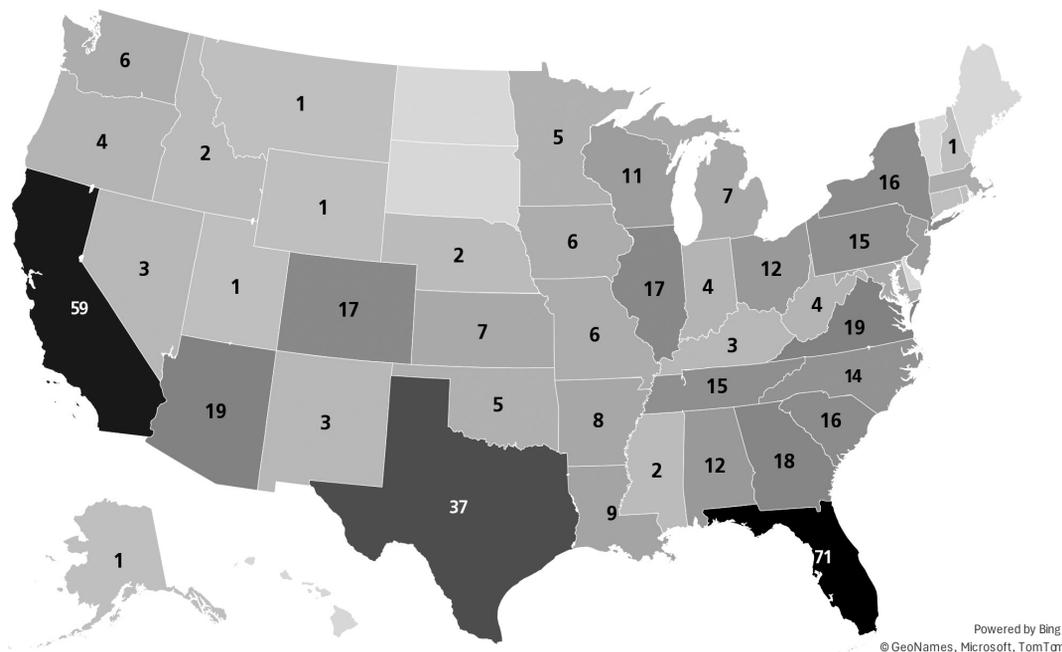
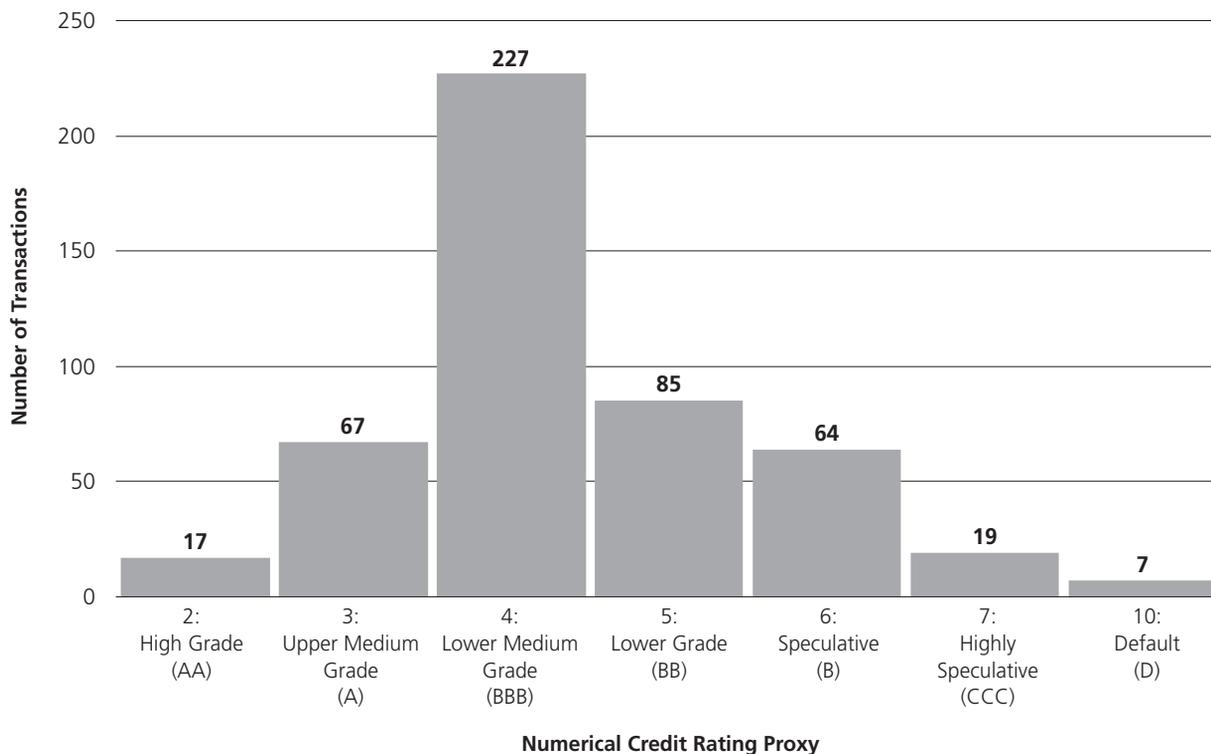


Exhibit 4 Number of Transactions by Numerical Credit Proxy

leases with 21 plus years remaining on their term. Several factors could explain this deviation.

- **Diminishing Marginal Benefit of Additional Lease Years.** Investors may perceive that beyond a certain lease length (e.g., 20 years), the additional years do not significantly reduce risk further. The initial years of a lease carry the most significant risk mitigation, and beyond a certain point, the value added by extra years diminishes. This could make investors less willing to accept lower cap rates for extremely long leases.
- **Inflation and Rent Escalation Concerns.** Longer leases can expose landlords to inflation risk if rent escalations are fixed or insufficient. Over 20 years, the cost of living and market rents may increase significantly, but if the lease terms don't allow for adequate rent adjustments, the real income from the property could effectively decrease over time. Investors might demand higher cap rates to compensate for this potential loss in purchasing power.
- **Tenant Creditworthiness and Lease Terms.** Properties with very long lease terms might attract tenants with lower credit ratings who demand longer leases for stability. If the tenants in the 21 plus years category are perceived as higher risk, investors would require higher capitalization rates to offset this risk.
- **Property and Location Characteristics.** The properties with leases longer than 20 years might be in less desirable locations or might be specialized properties with a narrower market appeal (e.g., single-purpose facilities). This could make it harder for the properties to re-lease or sell in the future, leading investors to seek higher capitalization rates.
- **Lack of Flexibility.** Extremely long leases can limit a property owner's flexibility to respond to market changes. If market rents increase significantly, the owner cannot adjust the rent until the lease expires, potentially leading to lost opportunity costs. This inflexibility might prompt investors to demand higher capitalization rates.
- **Market Saturation and Investor Sentiment.** There could be an oversupply of properties with very long leases, or prevailing market sentiments might favor shorter-term leases due to

Exhibit 5 Average Cap Rate vs. Years Remaining on Lease

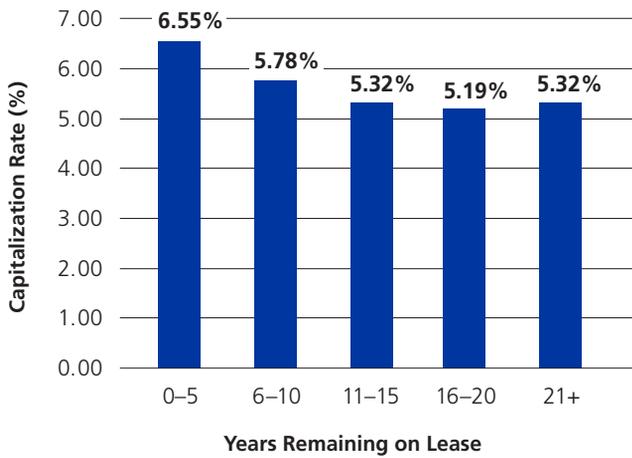
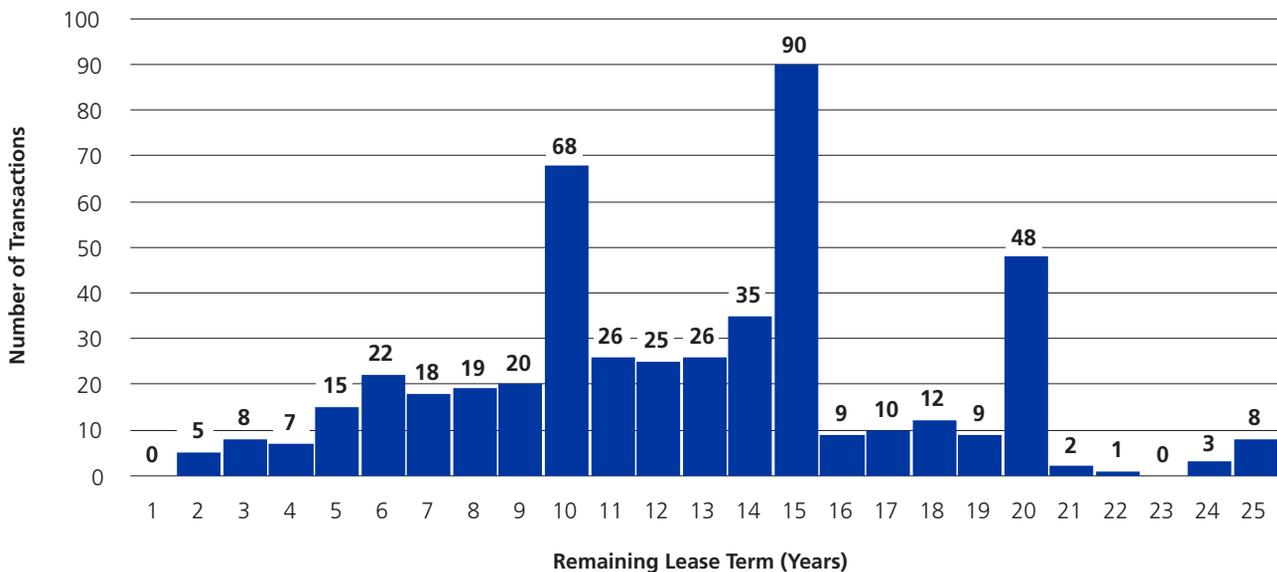


Exhibit 6 Transactions per Remaining Lease Term



economic forecasts, leading to higher capitalization rates for the 21 plus years category.

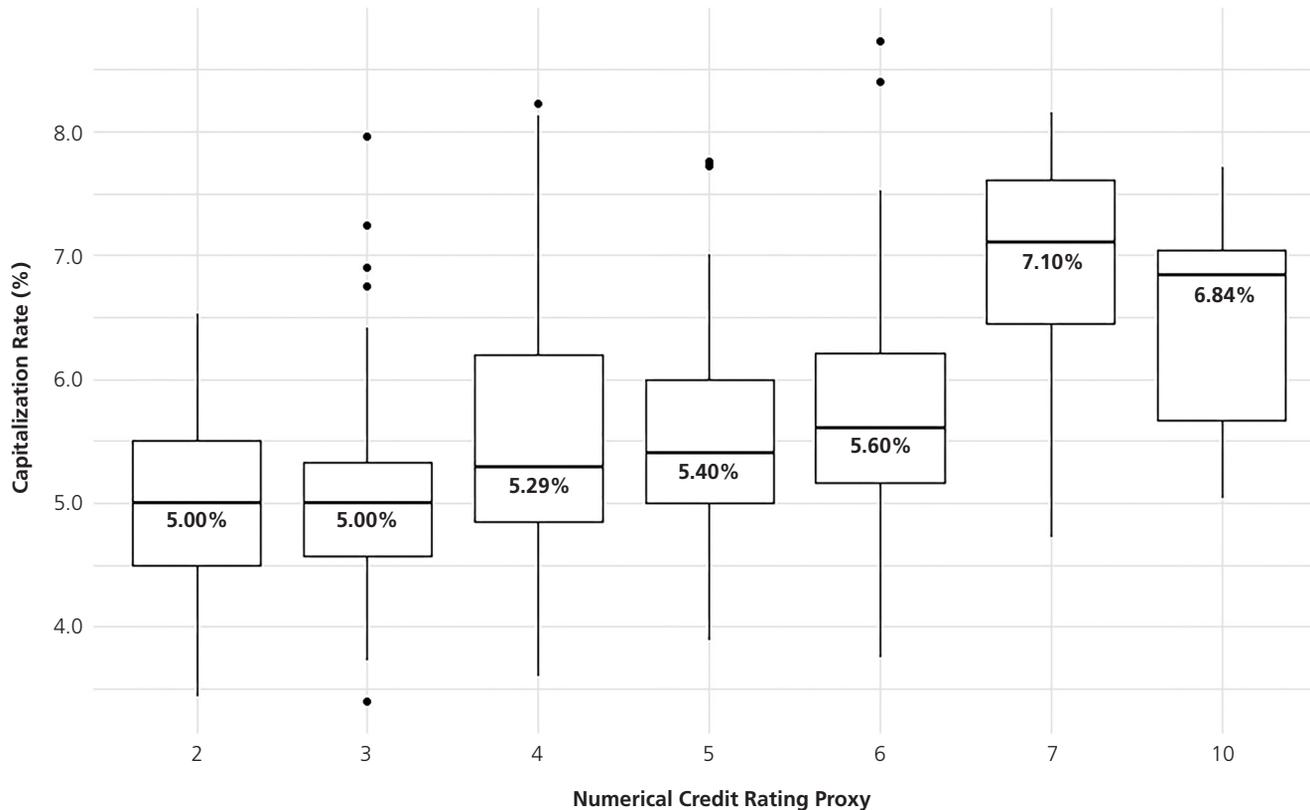
- **Sample Size and Data Variability.** The number of properties in the 21 plus years category might be smaller than in other categories, making the average capitalization rate more susceptible to anomalies or outliers.

Exhibit 6 shows the number of transactions compared to the remaining lease term.

Exhibit 7 uses a box and whiskers plot (aka a box plot) to display capitalization rate distribution by numerical credit proxy. The graphical representation is based on the five-number summary: minimum, first quartile (Q1), median, third quartile (Q3), and maximum. The following explains what each part of the box plot represents:

tribution by numerical credit proxy. The graphical representation is based on the five-number summary: minimum, first quartile (Q1), median, third quartile (Q3), and maximum. The following explains what each part of the box plot represents:

- **Box.** The central box of the plot shows the interquartile range (IQR), which is the distance between the first quartile (25th percentile) and the third quartile (75th percentile). This box contains the middle 50% of the data.

Exhibit 7 Capitalization Rate Distribution by Numerical Credit Proxy

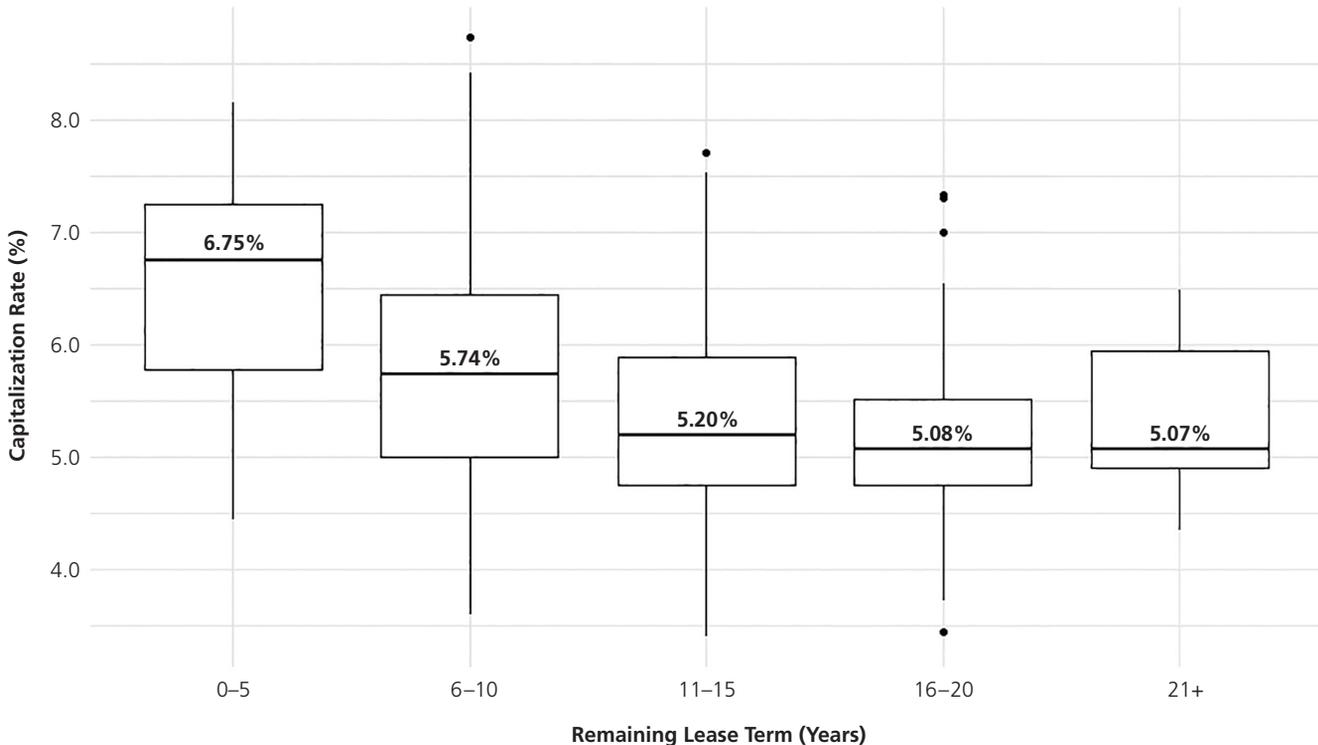
- **Median Line.** Inside the box, a line is typically drawn at the median (second quartile), dividing the box into two parts where the bottom half contains the second 25% of the data and the top half contains the third 25% of the data.
- **Whiskers.** Extending from the box are lines called whiskers. These can vary in representation but often extend to the smallest and largest values within 1.5 times the IQR from the first and third quartiles, respectively. Data points outside this range are considered outliers and are often plotted as individual points.
- **Outliers.** Points that lie beyond the ends of the whiskers are outliers and are plotted individually. This highlights unusually high or low observations that may require special attention.

Box plots are useful for giving a quick snapshot of data distribution and for identifying outliers, making them valuable for exploratory data

analysis. Exhibit 7 is a representation of the capitalization rate distribution by credit rating (numerical proxy).

The box and whiskers plot illustrates the capitalization rate distribution by numerical credit rating proxy. It offers valuable insights into the relationship between tenant creditworthiness and investment yields in the form of capitalization rates. Here are some key observations:

1. **Variability Across Ratings.** The capitalization rates exhibit variability across different credit ratings, suggesting that investors may price the risk associated with the tenant's financial stability into the yields they expect from real estate investments. The remaining lease term also plays a significant role, which is illustrated in Exhibit 8.
2. **Trend in Median Cap Rates.** There appears to be a general trend where higher credit ratings (lower numerical proxies) are associated with lower median capitalization rates. This is consistent with the principle that more-creditworthy tenants are considered

Exhibit 8 Capitalization Rate Distribution by Remaining Lease Term

less risky, thereby commanding lower yields.

- 3. Outliers and Spread.** The presence of outliers, especially in categories with higher credit ratings, indicates there can be significant deviations from typical capitalization rates. These could be influenced by factors such as property location, lease terms, or specific tenant circumstances.
- 4. Risk vs. Return.** The spread of capitalization rates within each credit category indicates the diversity in return expectations within similar credit cohorts. This spread might reflect differences in property types, lease structures, or local market conditions, even among tenants with similar credit ratings.

These observations can help appraisers and investors understand how credit ratings influence the returns expected from real estate properties and can guide investment strategies based on risk tolerance and return objectives.

Focusing more granularly on how lease term correlates with capitalization rates, another plot has been provided (Exhibit 8) that allows a check if there is a pattern or trend related to

lease term. Because the remaining lease terms for the dataset range from 2 years to 25 years, the data has been grouped into five-year increments to aid in presentation.

The visual comparison of capitalization rates to the remaining lease term provides insights into how the length of the lease impacts investment yields that are critical in making informed real estate investment decisions. Here are some key observations:

- 1. Shorter Lease Terms (0-5 years):**

- This category generally shows higher median capitalization rates, indicating a higher yield. This could be attributed to the higher risk perceived by investors due to the uncertainty of tenant retention and/or property repositioning post-lease expiry.
- Wider interquartile range suggests significant variability in capitalization rates, possibly influenced by tenant credit quality.

- 2. Medium Lease Terms (6-10 years and 11-15 years):**

- These groups typically exhibit a decrease in median capitalization rates compared

to the shortest-term category. The reduction in capitalization rates can be associated with the increased stability provided by a longer lease commitment.

- The spread of capitalization rates is narrower than in the shortest lease-term category, indicating less variability and potentially more predictable returns.

3. Longer Lease Terms (16–20 years):

- This group continues to show a trend of decreasing median capitalization rates for the longer lease terms.
- The interquartile range is the narrowest even accounting for the outliers in this category.

4. Very Long Lease Terms (21+ years):

- The capitalization rates for long lease terms are among the lowest, reflecting the premium investors place on long-term income security. These investments are often viewed as bondlike, with stable returns over extended periods.
- The slightly wider interquartile range of capitalization rates in this group indicates more variability, possibly aligning with some concern as the remaining lease term is quite long.

The visualizations underscore the inverse relationship typically seen between lease term length and capitalization rates, with longer lease terms generally associated with lower capitalization rates. This trend highlights the trade-off between risk and return, where longer leases reduce income variability risk, thus lowering the expected return. This analysis suggests that while longer leases are generally valued for stability, the nuances of individual transactions can lead to a complex relationship with capitalization rates.

Concluding the exploration of credit tenant leases and the interplay of credit ratings with real property valuation, it becomes evident that these components are not isolated variables but part of a complex matrix influencing the value of these investments. The analysis has delineated how credit ratings directly impact capitalization rates and, consequently, investment strategies. Furthermore, the lease terms, especially in bondable or triple net leases, underscore the significant shift of operational risks to the tenant, which inherently stabilizes the income flow and reduces the perceived risk for property owners and investors.

However, while these elements are critical, they do not exist in a vacuum. The nuanced dynamics between the physical characteristics of real estate and the financial robustness of its tenants through lease agreements demand an integrated synthesis to fully appreciate and navigate the multifaceted landscape of commercial real estate investment. In the subsequent section, there is a deeper exploration into how these interconnected elements coalesce to affect the valuation of leased properties. This synthesis will not only enhance understanding of individual factors but also illuminate their collective impact on market values and investment decisions, ensuring a comprehensive framework for real estate appraisal and investment analysis.

The Tenant Is Not the Property

In valuing leased fee interests, it is imperative to distinguish between the physical attributes of the real estate and the creditworthiness of its tenants. This distinction underscores a critical yet often misunderstood aspect of property valuation: the tenant is not the property.

When evaluating similar properties, stark contrasts in valuation can arise not only from differences in their physical characteristics, but from the credit ratings of their tenants and the terms of their leases. This valuation shift is attributable to the intangible benefits conferred by the lease agreements themselves, rather than any tangible qualities of the property.

Exhibit 9 illustrates the potential impact of these factors. It shows four paired sales where in each pairing, the primary difference is the credit rating proxy and underlying lease terms implied within the capitalization rates. Each pair is in the same city, with similar remaining lease terms and dates of sale. The buildings are generally similar in size and year of construction. The primary difference in each paired transaction is reflected in the credit rating proxy. In each pair, the superior credit rating proxy represents a measurably lower capitalization rate as well as measurably higher price per square foot indication. The real estate is quite similar in each case, the difference being the tenant. It should be noted that there are potential locational differences between some of these comparisons (urban versus suburban) or preferred submarket over a less desirable submarket. Other mitigating factors are likely as

Exhibit 9 Selected Pairs of Sales Reflecting Capitalization Rate Difference vs. Credit Rating

Pair	Tenant Name	City	State	\$/SF*	Cap Rate	% Change in OAR	Remaining Lease Term	Date of Sale	Credit Rating Proxy†
A	Rite Aid	Fresno	California	\$116	7.02%		15	Dec-2023	10
B	CVS Pharmacy	Fresno	California	\$568	6.40%	-8.83%	15	Nov-2022	4
C	Burger King	Greenville	North Carolina	\$580	5.25%		11	Jul-2023	5
D	Starbucks	Greenville	North Carolina	\$1,139	4.85%	-7.62%	10	Dec-2022	4
E	Pick 'n Save	Milwaukee	Wisconsin	\$196	6.37%		7	Jul-2022	4
F	Whole Foods	Milwaukee	Wisconsin	\$436	5.50%	-13.66%	10	Feb-2021	2
G	Rite Aid	Orrville	Ohio	\$226	7.51%		8	Nov-2022	7
H	CVS	Orrville	Ohio	\$423	5.51%	-26.63%	15	Jan-2023	4

Source: CoStar Group and the Boulder Group

* \$/SF of building area included for illustration, but noted figure is partly influenced by differences in the floor area ratio

† Credit rating proxy at time of sale

well and might be identified if a more granular analysis was undertaken. Nonetheless, the presented points are directional and generally show that the tenant's credit rating can have an impact on the lease rate achieved, even though the underlying real estate may not be significantly different.

A creditworthy tenant may enhance the value of a leased fee interest, as the financial stability of the tenant lends greater security to the income stream from the lease. However, this enhanced value does not alter the value of the fee simple interest in the property—the inherent value of the real estate remains unchanged. The benefits derived from having a financially solid tenant are intangible and tied to the lease contract.

This nuanced understanding challenges conventional views on property valuation and highlights the intricate interplay between the physical real estate and the rights encapsulated within lease agreements. Properties that are commonly leased to credit tenants are diverse in their nature, ranging from a small Starbucks operation to a large Amazon fulfillment center with many

other types in between as noted in this article. These property types are often not inherently special-purpose properties limited to the current tenant's use. It is not uncommon for a property to be converted for a different user or use over its economic life. Properties have characteristics that enhance or detract from their adaptability for a subsequent user. These include standardization of construction materials, floor plan and configuration, and adequacy of parking and accessibility.

There are numerous instances where similar single-tenant properties have been successfully converted to accommodate new tenants or entirely different uses. This adaptability may mitigate the risks that may be associated with properties originally designed for a specific user. Some examples include the following:

- A former Rite-Aid in East McKeesport, Pennsylvania, that was converted to a Clean Express Auto Wash.²³
- Former Walgreens location in Houston, Texas, converted to a Now & Forever convenience store.²⁴

23. Andy Peters, "Why the Local Drugstore Could Become a Plasma Collection Center, Restaurant or Even a Dog Park," CoStar News (September 24, 2024), <https://bit.ly/3Fcljko>.

24. Peters, "Why the Local Drugstore Could Become a Plasma Collection Center."

- A former Rite-Aid in Alpharetta, Georgia, was converted to a restaurant-dog park called Off Leash.²⁵
- A former Walmart in McAllen, Texas, converted to use as the McAllen Main Library.²⁶
- Former Kmart location in Austin, Minnesota, converted into the offices of Hormel.²⁷
- A Giant Foods supermarket in Reading, Pennsylvania, was converted to a Berks Community Health Center.²⁸

Literature Review

The conversion of use underscores the essential principle that while the quality of tenants can influence the perceived value of leased properties, the intrinsic value of the real estate itself remains distinct and unaffected.

In his *Valuation* article, William J. Barrett amplified this point, stating, “Generating an opinion of value for an interest in real property is familiar territory for many valuation professionals. Assignments become trickier when the interest to be valued is a lease or a property that’s subject to a long-term lease, because leases grant the right to use real property and establish a set of personal obligations. Unlike interests in real property, which are durable rights that normally survive the bankruptcy of the owner, leases are delicate things, and their existence may depend on the continuation and solvency of a tenant.”²⁹

The Appraisal of Real Estate clarifies the role of leases, stating “A lease never increases the market value of the real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract, and even though the rights may legally ‘run with the land’, they constitute a contract rather than real property rights.”³⁰ This should be self-evident, but despite this statement in *The Appraisal of Real Estate*, the role of leases

and tenants is at times subject to confusion. The tenant’s credit is an inherent attribute of the tenant as opposed to a characteristic of the real estate itself.

An *Appraisal Journal* article on this topic, “Is Excess Rent Intangible?”³¹ explores the nature of excess rent in valuations, emphasizing its status as an intangible asset. That article begins by defining excess rent as the amount by which contract rent surpasses market rent at the time of appraisal. This distinction is crucial as it frames excess rent as a product of the lease agreement rather than of the physical property itself. The article argues that while real estate can produce market rent, any rent above the market level—excess rent—is derived from the lease contract, making it an intangible asset. This perspective is reinforced by standard definitions and appraisal principles, which state that excess rent results from favorable lease terms (from the landlord’s perspective) rather than the inherent qualities of the real estate.

The article also highlights that excess rent should be capitalized separately at a higher rate due to its inherent risk and shorter lifespan compared to market rent. This recognized and accepted treatment ensures that appraisers accurately reflect the additional risk associated with excess rent, which ceases to exist once the lease expires or is otherwise terminated. The implications of excess rent for property valuation are explored. Similar to *The Appraisal of Real Estate*, it explains that excess rent, while enhancing the income stream from a property, does not increase the market value of the real estate itself. Instead, it represents an intangible benefit tied to the lease agreement. This distinction is vital for appraisers who must identify and potentially value these intangible components separately to provide a credible appraisal.

Finally, the article concludes that excess rent

25. Peters, “Why the Local Drugstore Could Become a Plasma Collection Center.”

26. Kurt Kohlstedt, “Ghost Boxes: Reusing Abandoned Big-Box Superstores Across America,” <https://bit.ly/3YMI9C8>.

27. Kohlstedt, “Ghost Boxes.”

28. Eric Althoff, “Adaptive Reuse Leads to New Community Health Center in PA,” HC&O News (February 1, 2021), <https://bit.ly/4jYWeUs>.

29. While quoted directly, the use of the word “personal” must stem from a more generalized sense of the word as lease obligations could easily be the responsibility of a corporation or other legal entity beyond a single person or persons. For a fuller discussion, see William J. Barrett, “Value Proposition,” *Valuation* (Second Quarter, 2016): 19–23.

30. *The Appraisal of Real Estate*, 15th ed., 415.

31. Stephen D. Roach, “Is Excess Rent Intangible?,” *The Appraisal Journal* (Spring 2016): 121–132.

(and the value that results therefrom) is an intangible asset created by the lease contract, not by the real estate. This understanding is essential for accurate property valuation and compliance with appraisal standards, ensuring that the value of excess rent is appropriately recognized and capitalized.

Integrated Synthesis

The valuation of leased properties is complex, intertwining the physical attributes of real estate with the financial and contractual aspects of lease agreements. The discussion on excess rent elucidates how contract rent above-market levels is a byproduct of the lease terms rather than the property itself. This concept aligns seamlessly with the understanding of credit tenancy in commercial real estate.

Excess rent as an intangible asset derived from lease agreements necessitates a higher capitalization rate due to its transient nature and higher risk. This underscores the need for appraisers to distinguish between the intrinsic value of the underlying real estate and the additional value brought by lease terms.

Credit tenants, typically characterized by their strong financial standing and reliable income streams, lower the perceived risk for investors. This reliability is often reflected in lower capitalization rates for properties with credit tenants, as investors will accept lower yields in exchange for reduced risk.

Credit tenants frequently enter into bondable leases, transferring nearly all ownership obligations and risks to themselves. This arrangement not only assures consistent income for landlords but also enhances the investment appeal of the property, as evidenced by lower capitalization rates.

Integrating these perspectives reveals a nuanced understanding of property valuation. The excess rent generated from favorable lease terms can elevate the value of a leased property, but this value is tied to the lease contract's intangibility. All one must do is look to the authority of a bankruptcy court to reject, forgive, or alter leases to understand the nature of these assets. If forgiven, rejected, or altered, the underlying real estate has not changed, but the value of the real property may change significantly. Concurrently, credit tenants enhance the property's appeal and stability, leading to lower capitalization rates. Together, these elements illustrate the critical

interplay between lease agreements, tenant creditworthiness, and property valuation in commercial real estate.

Conclusion

The market value of a leased property is profoundly influenced by the creditworthiness of its tenants, a factor that can overshadow the physical attributes of the property itself. This phenomenon, where nearly identical properties can exhibit vastly different values based on the tenants' credit ratings and lease terms, underscores a fundamental truth in real estate valuation: the property is not the tenant, and the tenant is not the property.

Credit tenants, typically defined by their strong financial standing and high credit ratings, bring a level of reliability and stability that can significantly elevate the value of a leased property. The presence of credit tenants reduces the risk perceived by investors, which is often reflected in lower capitalization rates. Bondable leases—common among credit tenants—transfer nearly all risks and obligations to the tenant, providing landlords with a consistent and predictable income stream. This risk transfer further enhances the investment appeal of properties with credit tenants.

The valuation of leased properties, therefore, must account for both the tangible aspects of the real estate and the intangible benefits derived from lease agreements. Excess rent, defined as the amount by which contract rent exceeds market rent, exemplifies this principle. It is an intangible asset resulting from favorable lease terms, necessitating capitalization at a higher rate due to its higher risk and transient nature. Appraisers must understand the intrinsic value of the real estate and the value conferred by the lease contract to ensure accurate and credible valuations.

The valuation of leased properties is inherently multidimensional, influenced not only by tenant credit ratings and lease terms but also by a range of other factors, including location, property type, and market segment. While this article emphasizes the role of tenant creditworthiness and lease structures in driving property value, appraisers should consider the broader matrix of attributes that collectively shape real estate valuation outcomes. Property-specific characteristics, such as location, size, and market positioning, can con-

tribute substantially to value differentiation, independent of tenant credit quality or lease durability. Integrating these dimensions into appraisals may lead to more nuanced and accurate assessments, particularly in diverse or fluctuating market environments.

The substantial impact of tenant type, market segmentation, and regional variations also could be an area for further study. Narrowing sample groups based on tenant categories, such as quick-service restaurants or drugstores, could illuminate how specific industries interact with real estate market dynamics. Additionally, more granular location analysis, particularly by state or metropolitan area, may yield insights into how geographic factors influence capitalization rates and property values.

As the landscape of leased property valuation continues to evolve, it is essential for appraisers to adapt to these complexities and consider a spectrum of factors that influence value. By embracing a more comprehensive approach, appraisers can provide clients with valuations that not only reflect the tangible aspects of

the property but also account for the intangible influences of lease agreements and tenant financial strength. Future studies that explore these facets could significantly advance appraisal practices, offering a robust framework for analyzing the layered interactions that define the real estate market.

The interplay between lease agreements, tenant creditworthiness, and property valuation is intricate and essential. Credit tenants transform the financial landscape of a leased property investment, significantly affecting its market value. As the real estate market continues to evolve, understanding these dynamics becomes increasingly critical. This nuanced approach to property valuation not only aligns with current market realities but also ensures that the intangible elements contributing to a property's value are appropriately recognized and capitalized. The principle remains clear and irrefutable: the property is not the tenant, and the tenant is not the property.

SEE NEXT PAGE FOR ADDITIONAL RESOURCES >

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Additional Resources

Suggested by the Y.T. and Louise Lee Lum Library

Appraisal Institute

Lum Library Knowledge Base information compilation [Login required]

- Business valuation
- Economic indicators
- Economic data
- Property interests
- Taxation and assessment