Deals

Blue Owl's Zahr: The net lease specialist going big

On the verge of closing the firm's first real estate mega-fund, Marc Zahr's next challenge is deploying the capital into the still-maturing sector.

Peter Benson - 2 days ago

Marc Zahr arrives at parent company Blue Owl's offices at 399 Park Avenue in New York straight from the airport, having flown in from his hometown of Chicago. While unfailingly gracious, the executive is slightly reserved at the start of his interview with *PERE*. But one topic of conversation causes him to immediately liven up: net lease.

In forming Chicago-based net lease specialist manager Oak Street in the final quarter of 2009, Zahr says he took a leap of faith by focusing on what was then a relatively unknown strategy.

"We were coming out of the global financial crisis," he recalls. "At the time, I didn't know it was the best time to start a real estate firm where there were no other private equity or large asset managers doing single-tenant triple net lease funds."

The scale to which Oak Street has grown would not have been easy to predict. The firm – rebranded as Blue Owl's real estate platform as of July this year – now has more than $25.9 billion of assets under management. The platform is nearing the final close of its first mega-fund, having raised $4.6 billion at press time and expecting to hit the $5 billion hard-cap on Oak Street Real Estate Capital Fund VI, the sixth offering in its closed-end value-add fund series, by the end of the year.

Blue Owl will be one of only 20 managers to ever have raised a real estate mega-fund, according to *PERE* data. But it is the only firm on the list to have done so for a non-traditional real estate equity strategy.

The firm's real estate platform has come a long way since raising its first fund, the $20.4 million **Oak Street Partners RE Fund I**, in 2011. Its first institutional fund, **Oak Street Real Estate Capital Fund II**, closed above target on $136.4 million in 2012, backed by investors including the Municipal Employee Retirement System of Michigan, according to Zahr.

After raising two successively larger funds that both exceeded their original hard-caps, the firm entered the $1 billion club with the $1.25 billion **Fund IV** in 2017. The vehicle had an original target of $750 million and a hard-cap of $1 billion. Then Oak Street went on to double that equity haul with the successor, **Fund V**, closing on $2.5 billion in March 2020, per *PERE* data.

Oak Street also launched an open-end institutional vehicle, **Blue Owl Real Estate Net Lease Property Fund**, in 2019 and has since raised $4 billion for that strategy.

Zahr chalks up Blue Owl's fundraising success simply to track record. Against a net return target of 12-14 percent, the first three funds, now fully realized, have delivered a net IRR on a weighted average basis of 25 percent, he says.

Multiple areas of expansion

Despite the exponential growth of the firm's flagship fund series, Zahr had his eye on further expansion for Oak Street. More specifically, he was seeking to grow through a merger and acquisition deal, and hired investment bank Berkshire Global Advisors to manage the process. "We had gotten to a size and scale where there were a number of other things that we wanted to grow into," Zahr says. "Having the right partner and the right infrastructure would have allowed us to do it substantially faster."

In December 2020, Oak Street sold a 15 percent stake to Petershill Partners, a publicly listed unit of **Goldman Sachs Asset Management** making minority investments in alternative asset managers. Shortly after the sale, Blue Owl was established with the combination of minority stakes from private equity firm Dyal Capital and direct lending firm Owl Rock. Zahr spent the next year meeting with the newly formed Blue Owl team.

A year after Oak Street's minority stake deal with Petershill was completed, Blue Owl bought Petershill out of the minority stake and merged with Oak Street.

Post-merger, one key area where Zahr is seeking to scale the real estate business is raising capital through Blue Owl's private wealth channel. The real estate platform first ventured into the private wealth capital space in September 2022, launching its non-traded private real estate investment trust, Blue Owl Real Estate Net Lease Trust. *PERE* understands the vehicle has raised $2 billion in subscriptions to date.

That vehicle has allowed the firm to expand in other ways, too. Using capital from the REIT, Blue Owl made its first European real estate investments in the UK and Germany this year, buying industrial properties in those countries. The REIT is the only vehicle through which Blue Owl can currently invest in real estate outside of the US, but the firm is in early discussions to raise dedicated institutional capital for real estate investments in Europe.

Blue Owl's real estate business has also invested in Asia-Pacific on a club deal basis. The APAC region is a key growth area for the firm in terms of geographical expansion, Zahr says.

Pressure to deploy

In raising its first mega-fund, however, Blue Owl's real estate platform will also face considerable pressure to deploy. The net lease market has become increasingly competitive, with large, diversified firms like Ares Management and KKR having bolstered their capabilities in the space. Peers like Angelo Gordon and ElmTree Funds – the latter of which is targeting $1.25 billion for a fund launched this year – have had a sizable presence in the sector for many years.

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> ***believe it's mission critical and we believe that people need to be in the asset" Marc Zahr***

"With a $5 billion fund that has buying power at least twice that figure, Blue Owl will have its work cut out," says Scott Merkle, managing partner of SLB Capital Advisors, a data firm focused on the net lease space. Noting the average size of a sale-leaseback transaction last year was $7 million, he adds: "An investor needs a lot of smallish deals, or a handful of chunky transactions, to really move the needle."

Deployment is further challenged by the fact transaction volume fell off a cliff after a very active 2021 and 2022. Q2 2023 sale-leaseback activity rose 8.3 percent in the US to $5.1 billion from the previous quarter, but investment volume was less than half of the $10.4 billion recorded in Q2 2022, according to data from SLB Advisors.

"From a demand standpoint, net lease investors are hungry to deploy capital but exceedingly cautious in this current risk-off environment," Merkle says. "On the supply side, many existing owners of net lease properties are slow to transact as they want yesterday's cap rates, which broadly impacts availability of net lease investment opportunities."

He adds that the decline in transaction activity is also partly due to a corresponding decline in corporate events, like a merger or acquisition, where sale-leaseback deals typically follow. However, Merkle notes that sale-leaseback is "among a menu of capital-raising alternatives" for corporate owners.

Nonetheless, several net lease firms have proven their ability to put out capital even during challenging market conditions. Some of the larger net lease REITs, such as Agree Realty, Realty Income, Vici and WP Carey, all deployed north of $1 billion in 2022, according to Merkle. In November, San Diego-based Realty Income, the largest net lease REIT, announced its plan to acquire Dallas-based rival Spirit Realty in a $9.3 billion transaction.

As for Zahr, he does not expect to see more transactions of the same scale as the firm's $15 billion take-private of listed net lease REIT Store Capital with Singaporean sovereign wealth fund GIC, given the rarity of such an opportunity. "If there were other single-tenant, multibillion-dollar investment-grade-rated REITs in the marketplace that we could buy at a seven-plus cap rate, I'd be backing up the truck right now," he says. "They just don't exist."

However, he predicts large-scale opportunities could still come from companies seeking to capitalize on large real estate portfolios on their balance sheets. Fund VI's significant size will allow for transactions of up to $3 billion with a single company – which most firms with sale-leaseback and net lease strategies would not be capable of executing.

"When you think about going to a company sourcing a $1 billion, $2 billion-plus-type sale-leaseback transaction, the pool of competitors shrinks dramatically," Zahr says.

Harsh Hemnani, an analyst of net lease and ground lease at research firm Green Street, also points to shrinking competition in the sector. "Through most of 2021, cheap debt costs enabled highly levered private buyers to enter the net lease market and lock in double-digit cash-on-cash returns," Hemnani says. However, many of those private buyers have since exited the market because high debt costs have compressed levered returns, he notes.

Continuing education

As the fundraising landscape has evolved, so has the education of the industry in net lease.

For one longtime US pension fund investor that asked not to be named, the first time the organization invested in the sector was when it committed to Blue Owl's third real estate fund.

The investor's head of real estate says getting approval for the initial investment required multiple brown bag lunch sessions with the investment committee to explain why the investment belonged in the pension fund's portfolio.

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>
> ***US pension fund investor***

What ultimately convinced colleagues was that a net lease investment had the characteristics of a bond, but was backed by a physical asset.

"Instead of investing in a FedEx corporate bond with a tenure duration, what if you can buy a logistics asset leased to FedEx at a meaningful spread to the corporate bond?" they mused. "If you're telling me there are 400 basis points of spread between the corporate bond and the cap rate on the same risk profile asset, but it's an asset instead of a bond, then I would say that makes a whole lot of sense."

That pension fund has been a first-close investor in all of Blue Owl's subsequent real estate funds. What the investor now wants to see, however, is how the firm will deploy such a massive amount of capital into the net lease space.

"Am I comfortable with the fund size increase? No," the investor says. "Have I been proven wrong over time? Absolutely."

For Zahr, the education of investors continues. However, his focus has shifted from an explanation of the lease structure, which most investors now understand, to debunking some of the misconceptions about net lease. That net lease does not perform well in an inflationary environment is one such example. Zahr contends that net leases mitigate the risks posed by rising costs by passing them onto the tenant.

Another misconception about net lease in an inflationary environment is that rent growth cannot be captured with lease turnover because the leases are long term.

However, escalators in contracts have grown as well, Zahr explains. Before the Federal Reserve hiked rates last year, Zahr says most deals would pencil to 12-year leases with 1-2 percent escalators. Now, the firm is seeing deals with 15- to 25-year lease terms with 2-3 percent escalators.

These risk mitigants enable a net lease strategy to weather today's market challenges. "The ability to finance a longer-duration lease becomes a lot easier, even in difficult environments," Zahr says. "If you've got 15-20 years of contractual rent, while the expenses are covered you can ride out a lot of market volatility in that time period while you're taking that income stream and putting it in your pocket."

An evolving strategy

Blue Owl's real estate strategy has always been direct sale-leasebacks, which involve buying properties off a company's balance sheet and then leasing them back to the company

Blue Owl's leases are structured as triple net leases, meaning the tenant pays all the taxes, insurance and maintenance costs of the property. They are also longer in duration, usually signed for over 12 years.

Typically, triple net leases can be found on industrial, retail and office properties. Around 80 percent of the firm's current portfolio is in industrial properties or essential retail, Zahr says. Essential retail includes grocery-anchored strip centers as well as tenants like pharmacies and auto part retailers. Zahr says Blue Owl will also look at medical office.

"Will we do an office building? Yes, if the credit quality is fantastic, if we believe it's mission critical and we believe that people need to be in the asset," Zahr says. Blue Owl's sale-leaseback strategy will evolve slightly with Fund VI. The firm will partner with developers early in a project for build-to-suit properties on which Blue Owl will then execute a triple net lease with the tenant. Such a deal provides the developer with capital, while a tenant in place reduces the risk for Blue Owl. The firm does not develop itself, choosing to help capitalize development projects as opposed to taking development risk, Zahr notes.

Fund VI's strategy will also differ from that of its predecessors in terms of the types of tenants targeted. Until now, the firm has focused exclusively on investment-grade tenants. But because of dislocation in the credit market, more opportunities are emerging with non-investment-grade tenants, Zahr says, noting the risk-adjusted return on such investments has begun to look favorable.

In fact, Blue Owl and GIC's $15 billion take-private of Store Capital involved non-investment-grade tenants, Merkle points out. He thinks it makes sense for Blue Owl to be expanding into that part of the net lease market for a very simple reason: the non-investment-grade market is substantially larger than the investment-grade one.

"There are thousands and thousands of businesses out there and a large percentage of them happen to own the properties they're operating out of," Merkle says.