FINANCIAL ADVISORY

Should I Buy Net Leased Properties or Apartments?

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

As my regular readers know, my business focuses on partial interest properties. Most of my investors are buying these interests as replacement properties for tax-deferred 1031 exchanges. I do have many clients who make new, or "cash" investments for income and growth potential as well. Over the years, when recommending properties, I have focused my attention on two asset classes: Net Leased Properties and Apartment Properties.

While reviewing my offerings, many investors will ask "which do you prefer – Net Leased or Apartments?" My answer is "we're looking for what's best for you, and that will depend on what YOU desire from your investments." After a conversation, we will then decide if the investor wants net leased properties, apartments, or maybe some of each.

WHAT ARE NET LEASED PROPERTIES?

Net Leased properties take their name from how their leases are written. Tenants of such a property will sign a lease that pays their landlord rent "Net" of most or all expenses. This means that, in the case of a Triple-Net-Leased property, the tenant will pay ALL the expenses of the property – including maintenance, property taxes and insurance – before paying the landlord his rent.

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Sometimes an apartment investor will tell me he earns "$6,000 per month" from a 4-unit property. My follow up question is "But what is your NET income – after all your expenses?" (This often decreases the figure substantially.) With Triple Net Leased properties, your gross rental income IS your net income.

BENEFITS OF NET LEASED PROPERTIES

One obvious benefit of Net Leased Properties is the insulation of the landlord from increases in expenses. If property taxes, insurance, electrical rates go up – that's all the tenant's problem: the landlord keeps getting the same cash flow.

A second benefit of Net Leased Properties is that the landlord has a good sense of what his income will be on that property. If, for example, he buys a CVS Pharmacy where CVS has signed a 20-year lease with 2% annual rent increases then he knows what he will receive every year for the next 20 years – as long as CVS stays in business. (Only bankruptcy can release a company from its' lease obligations.) For this reason, buyers of Net Leased Properties must look closely at who the tenant is.

BENEFITS OF APARTMENTS

All of my readers know what apartments are. The benefits of apartments are that – if we are buying in growing metropolitan areas – people will always need a place to live. Tenant turnover costs are minimal (limited to some new paint and carpet) and, in the absence of rent control laws, there is no cap on how high rents can climb. As we learned from my article last month, "Where Appreciation Comes From," our appreciation potential comes from rising income.

TRIPLE NET VS. APARTMENTS

With apartments, an investor doesn't have the same surety of income as with Net Leased Properties. Under a Net Lease, as stated earlier, a company (hopefully a large one) has put in writing what they will pay every year for several years. With apartments, we don't know for sure that rents will rise every year – they could fall in a tough economy. The real risk, I have found, to income from apartments is an unexpected increase in expenses: maybe the property needs all its A/C units or windows replaced. Us residential landlords are familiar with this risk: How many of your

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I have completed over three hundred 1031 exchanges for investors.
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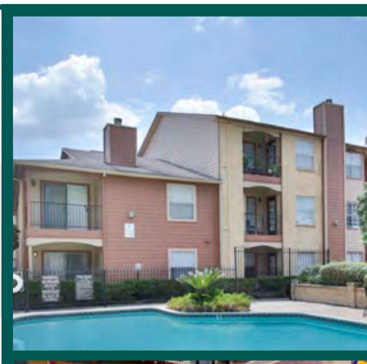

Investing in real estate, with or without use of a 1031 exchange, carries the risk of losing your principal, income or tax benefits. Additionally, the IRS has issued inflexible guidelines for completing tax-deferred 1031 exchanges. Failure to follow these guidelines could lead to a loss of tax benefits. 1031 Exchanges can involve significant fees. This does not constitute an offer to buy or sell any security. Investments may be illiquid in nature and those seeking to dispose of their investments early may be unable to do so. Securities offered through Emerson Equity LLC. Member FINRA/SIPC, MSRB registered. Advisory services offered through Emerson Equity LLC an SEC registered investment advisory. Emerson Equity LLC and Specialized Wealth Management are unaffiliated.

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properties were making good money until that water heater blew up? (or some other problem arose.)

On the other side of this argument, Net Leased investors are giving up appreciation potential in exchange for their surety of income. We remember, again, that appreciation is driven by increasing rents. We could, in theory at least, double the rents in our apartments over the next 10 years. With Net Leased properties, our tenant is stuck paying their contracted rent during economic downturns – but that same rate is "capped" if market rents rise.

Does this mean that we will get better appreciation from Net Leased Properties? No. I mean that our appreciation under a Net Lease is limited, while with apartments it is not. It is certainly possible to earn more in appreciation with a net leased property than from apartments – in certain situations.

WHICH IS BETTER FOR ME?

The answer to this question depends on what you are looking for. Some of my clients are in their 80's, and are planning for this to be their "last exchange." They are less concerned with appreciation and more concerned with steady income. Some of my clients are younger and would like to see good appreciation, as they plan to do more exchanges in the future. Some of my youngest clients have bought Net Leased, however, and I just had a 90-year-old investor buy an apartment property.

"Which asset class is better for me?" is really a question best answered in a conversation rather than in a "one size fits all" article. This month's column is a good start to get you thinking about the pros and cons of each; now we'll just need to decide which one suits you best. If you have any questions, my office number is (877) 313-1868.

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1031 Exchange Risk Disclosure:

- *There is no guarantee that any strategy will be successful or achieve investment objectives;*
- *Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;*
- *Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;*
- *Potential for foreclosure – All financed real estate investments have potential for foreclosure;*
- *Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.*
- *Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;*
- *Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits*

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Tax Advantaged Investments

What Is.. Your Investment Property's *Cash on Cash Return?*

Would you put your money in a bank account at a low interest rate? Probably not, but many investors are doing just that with their investment properties. Although property values have increased dramatically, income has not for many investors.

Try This- Calculate your Cash on Cash return.

Yearly Income - _______(subtract) Expenses ______(subtract) loan payments _______

= Annual Cash Flow ______________

Now, estimate your property's value___________ (subtract) Loan Balance__________

= Your Equity Value ______________

Now, divide your Annual Cash Flow by your equity value, and you get your

Cash on Cash Return % _____________ .

Want to increase your properties' income potential? Call Chris Miller at **877-313-1868** today!