Investments:

Triple Net Leased Investments

Part 1 of a 2 Part Series

Triple Net Leased properties can limit a landlord's exposure to rising expenses. This has made it a popular asset class for real estate investors. I write an article about this asset class about properties about once every two years, and spend a lot of time talking about them. This month's article will be a "refresher," of sorts, on the subject. A good conversation about the main points will take up a bit of room, so I'll need to split this article across two months.

This month, I'll explain what Triple Net leased properties are and discuss some of their key features.

What Are Triple Net Leased Properties?

Triple Net Leased properties, in the real estate investment world, refer to properties with a specific kind of lease. In a true triple net leased property; the <u>tenant,</u> or the lessee, (not the landlord, the lessor) will pay ALL the expenses of a property. The tenant will pay utility bills, maintenance expenses, insurance costs and even annual property taxes. The term "triple net" refers to the landlord receiving income net of all these costs: **net** maintenance, **net** insurance and **net** taxes.[1]

The opposite of a triple net lease is called a Full Service Gross lease. In such a lease, the landlord will pay <u>all</u> expenses. (some apartments; where the tenant isn't billed separately for utilities, are considered full service gross.)

Single tenant retail properties are often leased "triple-" or "double-net." (We will talk about the similar "double net lease" next month. Think about your local Walgreens, Starbucks or Burger King. These are all, very likely, triple or double net leased.

Tenant Quality

When reviewing potential triple net purchases, the first thing an investor should ask is "who is on the lease?" Who is responsible for making the payments on the lease? It's not always the company listed on the sign in front. Fast food restaurants, for example, are very often leased by a franchisee, and not by the parent company. I often have investors tell me that they are looking at buying a "Burger King property." My first question is always "who is on the lease?" The answer I often hear is "Burger King corporate,

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I assume." This is a bad assumption to make. The majority of fast food restaurants in this country are operated by franchisees. My neighbor, Steve, could go and buy his own McDonald's franchise. Steve is a smart businessman, and certainly intends to make good on his lease obligations; but he doesn't have as much money as McDonald's corporate. If Steve opens a McDonalds and goes out of business, he may not have enough money to pay rent. In this case, Steve's landlord would have trouble collecting his income.

Lease Term

A Lease's term describes how long a tenant can occupy a property. This is important because a tenant's renewal of a lease is never guaranteed. Your tenant may have the best credit in the world, but that won't mean anything if their lease expires next year and they move out, leaving you an empty building. An ideal lease would be one with a AAA rated tenant signing a 50 year lease with 10% annual rent increases. As a landlord, you'll likely need to compromise on some of these points. Remember also that you can buy a fast food restaurant in Kentucky with a ten year lease – but what will you do if that tenant moves out 10 years from now, and you have an empty restaurant. How will you make the mortgage payment? Who will you call to find a new tenant? How will you market this property on the other side of the country?

Rent Increases

I have seen 70 year leases (including renewals) to big tenants with zero rent increases. Such a lease wouldn't be very desirable to an informed investor.

If, in 1946, the average annual income was $2,600, the average home cost $5,150, and a new car cost $1,1252; $10,000 of annual rent would go a long way. It won't go very far today.

When shopping for a triple net leased investment, you'll want to make sure that provisions for rent increases are included in the term or, at the very least, in the options. These rent increases will drive the value of your property higher, and maintain the buying power of the income the property pays you. (By keeping ahead of inflation.)

Renewal Options

In any lease, the tenant may have a renewal option. This option allows, but does not require, the tenant to renew their lease by extending it a number of years. These renewal options are sometimes presented as a benefit to a new landlord. In reality, these options can only help the tenant. The lease renewal option is really just a put that the tenant owns to limit future rent increases.

Although a lease option may call for a 10% rent increase upon renewal, this likely won't cause a tenant to pay above market rent. In such a case, the lessee would simply negotiate new terms with the lessor and create a new lease. For example; if the tenant is currently paying $10,000 per month rent, and the market rate is $10,000, they would never sign an option agreeing to pay $11,000. They would simply re-negotiate a new lease starting at $10,000. On the other side of the fence; if the market rate has now risen to $15,000 per month, the tenant can simply exercise their option and pay only $11,000.

It's rare that a credit tenant will sign a lease without options to renew. If a large company is making an investment in a new location, they'll want to know that their access to the property is protected for the long term. Renewal options aren't necessarily "bad." An understanding of how they work is, however, crucial to making wise triple net leased investment decisions.

Next month, I'll conclude this 2 part series on Triple Net Leased properties. If you have any questions, please call me at (877) 313-1868.

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Part 2 of a 2 Part Series

Last month's article was the first part of a two part series. This month is the final installment of the module covering Triple Net Leased investments.

Triple Net Leased properties have long been attractive to investors for their many benefits, including a limited exposure to rising expenses. I write an article about this asset class about once every two years. I spend a lot of time talking about these investments, so I think it's time for a refresher.

NNN vs. NN

When reviewing a triple net leased investment; the first question that you need to ask is "is this a true triple net leased investment?" Often a "triple net" property is really just a "double net" one. What's the difference between triple and double net? You may recall from last month's article that a true "triple net leased" owner receives his rent "net maintenance, net insurance and net taxes." In a double net leased property, the owner is often responsible for some maintenance of the property – just the roof and the parking lot, for example.

Why would somebody agree to buy a double net leased property knowing that they'll need to pay some expenses? The answer to this question is one heard often about investments: money. A double net leased property is likely to cost less than a comparable triple net leased one. Additionally – since the tenant is avoiding potential costs – the landlord will likely receive more rent. A double net leased property, therefore, can offer *more* income for *less cost.* In many cases – such as ones where the investor's hold period is shorter than ten years, and where an existing roof and parking lot are in excellent condition – opting for a double net lease can make a lot of sense.

Location Quality and What Will You Do if the Tenant Moves Out?

These two questions - what are the property's surroundings like, and what will you do if you have to re-tenant the space? – are different but closely related. If a tenant were sure to stay in one place forever, and to keep increasing their rent, an investor wouldn't care that there are only 100 residents within 10 miles of the property. In the real world, however, a tenant's renewal is *never* guaranteed. Buying a Kentucky Fried Chicken with 10 years left on their lease may make sense for now, but what happens if that KFC decides to move across the street to a brand-new building in 10 years? How will you market the property and find a new tenant?

Exit Strategy: How Will You Sell In The Future?

As I often suggest; before buying a property, an investor should have an idea of when he will sell it. When performing a "sell forecast" for a Triple Net Leased property, a good indicator to start with is the lease term. Just as you are looking for a nice long term lease; the investor you will sell to in the future is as well.

If your tenant's existing lease expires in 10 years and contains 5 year renewal options, you may want to sell in 5 years to avoid the risk of them moving out upon expiration. In this way, a potential buyer of your property still has five years of rental payments before he needs to worry about the tenant renewing. Alternatively, you could sell in 10 years – after the tenant renews – with 5 years still remaining on the lease.

Which option is better: sell in 5 years with 5 lease years remaining, or sell in 10 with 5 years remaining?

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The next question you should ask is “What sort of rental increases are provided for in the lease?” As I often emphasize, an investment property’s value is based on the income it generates. If you buy a property today with $100,000 of income and sell it 5 years from now with $100,000 of income, you will likely lose money due to transaction costs. If, however, the property earns $110,000 five years from now, you could sell it at a profit based on that. Where, and for how much, your rental increases are will best determine the proper time to sell your property.

This two part article has summarized some of the major criteria I evaluate while helping my clients purchase Net Leased Investments. These articles, I hope, have allowed my readers to learn more about this asset class and helped make them wiser and more successful real estate investors. Of course: if you have any questions, please call my office at (877) 313-1868.

Happy New Year! I hope that it is a great one for you.

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