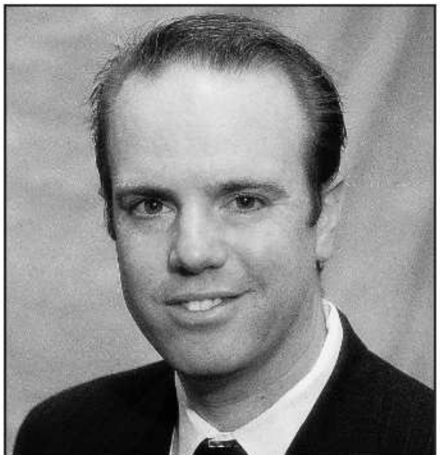

By Christopher Miller

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Net Leased Properties

What Net Leased Properties Are

Net leased properties get their names from how expenses are treated; rent is paid to the landlord "net" (tenant pays) certain expenses. In any kind of net lease, the tenant will generally pay all operating expenses, such as electricity, gas, and water. Property taxes and insurance are also the tenant's responsibility in a "double net," or NN, lease. A "triple net," or NNN, lease will pass all responsibilities and expenses to the tenant – even maintenance of the building. The net leased properties that I come across – with long-term leases and credit tenants – will typically have either double net or triple net leases, so that's what this article will focus on.

Why NN rather than NNN?

You may ask "Why would I buy a NN leased property when the NNN one means that I have less responsibilities?" The answer is "it may make more financial sense." With a gross commercial lease, the landlord pays all expenses – even electricity. For this reason, the rent is higher; since that money has to come from somewhere, after all. If a tenant accepts a NN lease, he gets a significant "discount" on his rent, while an NNN tenant pays even less. An investor buying properties must weigh income, location, lease terms, tenant strength, and many other variables to find his best acquisition target.

What I Look For in Net Leased Properties

As I mentioned above, there are many factors you should examine before buying property. There's not just one very important thing to look for; there are several. Some things that I always like to look for in net leased properties are:

Good Leases With Rising Rents

I have proclaimed this fact repeatedly in many articles over the years: rising rents lead to rising property values. Since investors buy properties based on their income generation potential, they will pay more for

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a property that pays a higher rate of income. Just as you raise your apartment's value by raising your rents, commercial landlords do the same.

Some triple net leased buildings have flat leases – and 50 (or more) years of options that could lock in the same low rent until the 2080's! This is not a good property to buy. (I would say "obviously," but somebody out there is buying them.) A flat lease of 10 or even 20 years may be acceptable if you can raise rents upon lease expiration – and if you are comfortable with a longer hold period with flat income. Any longer than that, and your property value could be stuck at the same rate for decades. Remember, too, that inflation will eat away the purchasing power of that rent over a long period of time so that your income isn't just staying the same – it is slowly shrinking.

Good Tenants

A company may be committed to a building under a lease for 10 years or more, but a landlord needs to make sure the tenant can stay in business that long. I prefer to look for strong credit tenants with a national presence – many stores in many states. I'll want to see a company that is growing in revenue, employees and in numbers of locations and I will want to choose a tenant in an industry that I'm optimistic about

Pay Attention to Renewal Options

Almost two years ago, I wrote an article entitled "When Buying Real Estate, that 'Positive' Feature Could be a Negative One." Paragraph one discussed lease renewal options and why they are a bad thing for landlords. This is because a lease renewal option functions in much the same way that a purchase option for a stock does. If market rents increase, the owner of that option (in this case, the tenant) benefits by leasing space below the market rate. So – if he's paying $10 spf now and market rent is $14 psf; but he holds an option for $11, he will exercise his option to renew his lease at that lower rate. If market rents fall to $9, rather than exercising that $11 option, he'll just negotiate with you to re-lease at the lower rate. So the option is really an *upper limit* on what the tenant will pay in the future – it is only valuable to the tenant. It is okay to include options in a new lease or to purchase a property encumbered by options; just make sure that the options contain sufficient rental increases. In this way – if the tenant stays put and exercises those options – you can still get your rent increases in.

Location

As with any real estate transaction, you can hope for the best – but should plan for the worst. I prefer net leased properties in major metropolitan areas. I have seen properties listed before that have 3,000 people living within a 10 mile radius that have an average income of $18,000 per year. If the current tenant has financial trouble, or even if they just vacate at the end of the lease term, it is hard to imagine many other tenants having interest in such a property. I have been talking a lot recently about the United States' continually growing population. Between the 2010 census and today, it is estimated that *our country added 2.6 million residents annually*. This means we need to build the equivalent of Chicago (the 3rd largest city in the U.S.) across our country every year. I prefer to buy property in the growing cities that more of these new residents are moving to.

Net leased properties can be a good way to seek predicable income from your next investment property. *If you have any questions about them, I would be happy to discuss it with you.* The toll-free number at my Tustin office is 877-313-1868

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