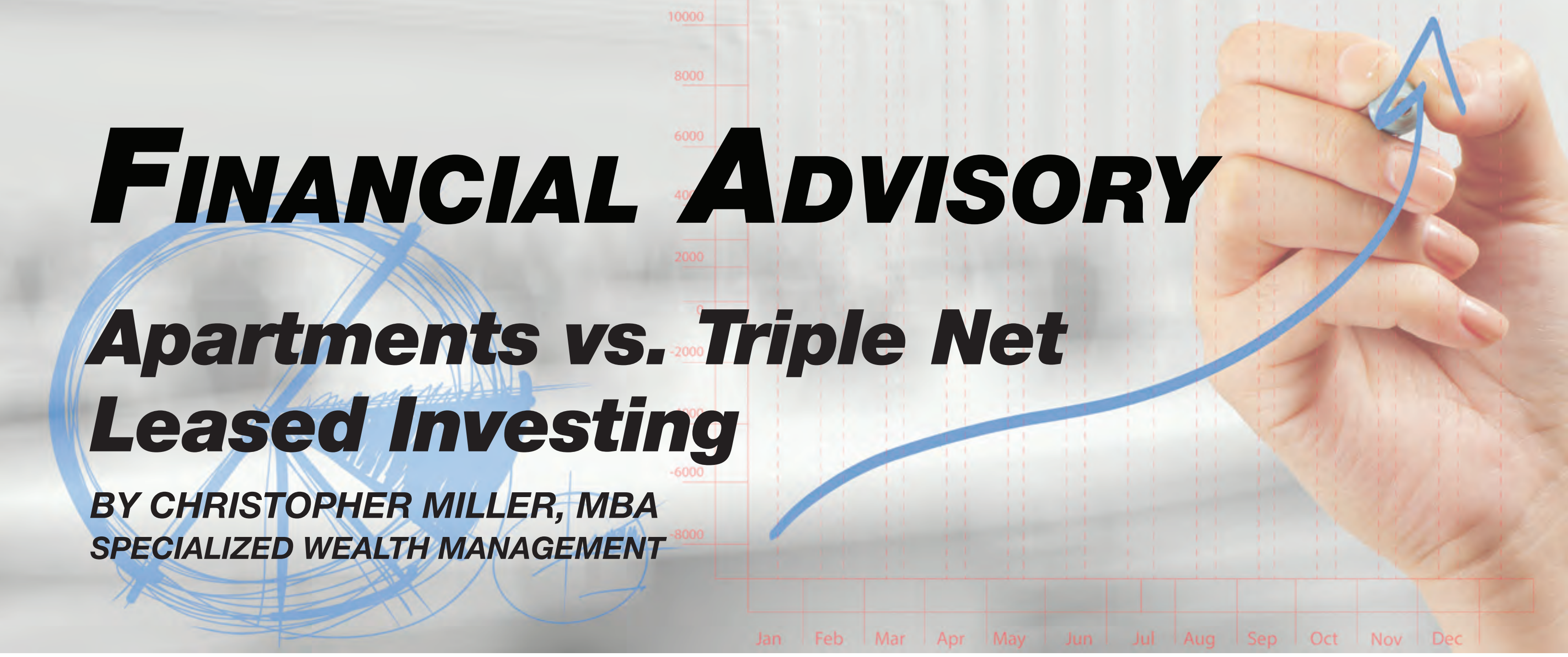

FINANCIAL ADVISORY

Apartments vs. Triple Net Leased Investing

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Over the years, my business has started to focus mainly on two asset types: Apartment properties in growing metropolitan areas and single-tenant, triple-net-leased (NNN) properties with long term leases and credit tenants. Which property is best for you to buy? Well, that depends on what your wants and needs are. This month, we'll explore the pros and cons and the differences between each asset type.

First, let's describe these investments as I and my investors typically buy them:

APARTMENT PROPERTIES

Over the last 20 years, when evaluating apartment properties, I have moved my focus to complexes with between 250 and 350 units that are located in growing metropolitan areas. A growing population is key to my review process: I always say that I think we have a better chance of success as investors if our pool of potential customers (apartment renters) is growing every year.

TRIPLE NET, OR NNN, LEASED PROPERTIES

"NNN" or "triple net" is real estate lingo that is used often, but rarely defined in a way that is easy for investors to understand. The terms "triple net" or NNN are abbreviations for the phrase "Net taxes, net insurance and net operating expenses." Or – the property owner is receiving his rent net these three expenses – he doesn't pay them at all. The tenant in an NNN lease will pay not only rent, but also real estate taxes, insurance and operating expenses including maintenance on the property. NNN leases can therefore protect landlords from rising costs since those charges are paid directly by tenants. An NNN lease is the opposite of what is typically called a "full-service gross" lease – where the landlord pays ALL expenses, including utilities.

BENEFITS OF APARTMENT PROPERTIES

"Everybody needs a place to live." Apartment Properties, especially when compared with retail or office buildings, can be easier to re-rent and have much lower costs associated with tenant turnover. If we own apartments in areas without rent control laws, our income growth potential is – in theory, at least – unlimited. Apartments are typically rented with a one year lease, and then are rented month-to-month afterwards. We, therefore, (again – in non-rent controlled areas) have ultimate flexibility to raise rents

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in response to inflation or academic growth, or when asking problematic tenants to leave.

Since investment real estate is valued based on the income it produces – the higher potential for income growth can also mean higher potential for value growth. It is, in theory, possible for apartment rents to grow substantially over the next 10 years. If this happens, it is then possible for apartment owners to enjoy substantial appreciation as well.

My tax-savvy investors also know that apartment properties can be depreciated over 27.5 years – versus 39 years for other commercial property. Remember that we can only depreciate improvements value (and not land). Let's assume we value the properties' improvements at 80% of their value and that we are looking at two $2.5 million offerings – one is an apartment property and one is an Auto Zone. Our depreciation deduction for the apartments will be (80% X $2,500,000) / 27.5 = $72,727 every year. Our deduction for the AutoZone works out to be (80% X $2,500,000) / 39 = $51,282. With the apartments, we can enjoy tax deferral (potentially forever) on an extra $21,444 every year until 2051. That's a nice benefit.

BENEFITS OF NNN LEASED PROPERTIES

Companies that agree to sign NNN leases are often much larger than most real estate owners. CVS Pharmacy or Bank of America doesn't want to run into any problems on account of their landlord not paying property tax or insurance bills. These tenants will, instead, agree to pay them directly.

Investors like Triple Net Leased properties because, if everything goes well, they know exactly what their income will be every year of the lease. If Amazon, for example, signs a lease expiring in 2037 with annual rent increases; there is a contract that says in black and white exactly how much the company will pay their landlord every year. Even if Amazon moves out of the property entirely, that rent is a legal obligation of theirs – as long as they are still in business. NNN properties can therefore offer stable income to their owners – if we buy building leased by stable companies.

POTENTIAL DISADVANTAGES OF APARTMENT PROPERTIES

As opposed to NNN properties, we don't know what the rent will be every year for apartments. Will rents decline next year? Will unexpected expenses arise that could temporarily cause our spendable cash flow to decrease? Apartment investments lack the "crystal ball" of a lease that can show us what our income will look like 4 years from now.

When you lived in apartments, did your rent ever go down? I think that the potential for more growth 4 years from now outweighs the uncertainty of not knowing what our income will be then.

POTENTIAL DISADVANTAGES OF NNN LEASED PROPERTIES

As I often say, the good news with NNN leased properties is that as long as your tenant is in business – you know exactly what you'll be receiving as rent every year. The bad news with NNN leased properties is that you know exactly what you'll be receiving as rent every year. As I mentioned earlier, investment properties are valued based on the amount of income that they generate. Higher income can lead to higher values. If we have a lease with 3% annual rent increases, (a decent lease), that has the effect of putting a "cap" on our appreciation.

Of course, NNN leased properties have, as discussed earlier, less depreciation benefits on an annual basis than apartment buildings.

WHICH PROPERTY TYPE IS BEST FOR YOU?

Does this mean that NNN leased properties will not appreciate as much as apartments? No. In theory, however, apartment properties have the potential to grow more. Does that mean that apartments will grow more? No again – just because we don't have a crystal ball to look at market conditions 7-10 years from now when we sell.

I have found that NNN leased property buyers tend to be more focused on income than on appreciation. A few years ago, a client of mine told me "Chris, I don't know if I'll still be around 10 years from now – but I do know that I can use income today." My apartment buyers may like the higher growth potential, or they are just more comfortable with apartments since that's what they have owned their whole lives. Some of my investors will do what I call "combo exchanges:" They will buy 1-3 apartment properties AND 1 or two NNN offerings in the same 1031 Exchange. In this way they are diversifying their portfolio by property, geographic location AND asset type.

Which asset type is right for you and your 1031 Exchange? If you would like to discuss, my toll-free office number is (877) 313-1868.