

# FINANCIAL ADVISORY

## NNN Properties – How to Seek Appreciation Through Tenant Enhancement

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**R**ecently, I've written about how Triple Net Leased properties with long term leases to credit tenants can provide the potential for more secure income. I've recently been working with some managers who buy "value-added NNN" seeking additional appreciation potential as well.

All investment properties are valued based on the potential income stream that they generate. This month, we will explore how we can potentially increase our property value by increasing the value of that income stream.

### VALUATION OF NNN LEASED PROPERTIES

The value of an NNN leased property is based on many factors, of which one is "tenant quality." Would you pay more for a one-location "Rocco's Hardware Emporium" with a 20 year lease or a Home Depot with the same lease terms in the same city? How about a Sears compared to a Target (with the same 20-year leases)? Why would you pay more for the Home Depot or the Target store? You would probably pay more because Home Depot and Target represent better tenant credit quality. The leases on each of these properties represent a

*Please turn to page 64*



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## FINANCIAL ADVISORY

Continued from page 63

future stream of cash flows, but the landlord has a much better chance of collecting those cash flows from Home Depot or Target than from smaller or less financially stable companies. Rocco may be an upstanding citizen, but he simply doesn't have the financial strength that Home Depot does.

### THE IMPORTANCE OF CREDIT RATED TENANTS

If Home Depot decides that their store is not profitable, they are still stuck paying the rent for another 20 years even if they decide to close the store. This is because Home Depot is a credit rated company. Just as if one of us stopped making mortgage payments, Home Depot defaulting on a lease would ruin their credit rating. This would dramatically increase their borrowing costs. Paying \$3.5 million per year rent for an empty store for the next 20 years is much less expensive than the costs associated with a lower credit rating would be. Rocco's, on the other hand, only has one location so closing that location means they are out of business. Good luck collecting the next 20 years of rent from a bankrupt company.

### HOW CAN I INCREASE THE VALUE OF A LEASE?

#### Method 1 – Put a Stronger Tenant in Place

Let's change the above scenario a little bit and say that I just bought the building that houses "Rocco's Hardware Emporium." Rocco's only has 1 year left on their lease, so other buyers were scared off by this fact – I was able to purchase the building at a great price. What if I knew that the Home

Depot wanted to expand into my city and, better yet, I have contacts over at The Home Depot's real estate offices? In this case, I could decline to renew Rocco's lease and sign a new 20-year lease with The Home Depot. This could increase my value substantially.

#### Method 2 – Buy a Property with a Tenant Expected to Grow in Financial Strength

In this second example, our tenant strength will improve without us doing anything. We are simply buying a property with a tenant who is expected to grow.

A great example of this is Tesla. Does Tesla make the best electric cars and is it destined to become the largest automobile manufacturer in the world? That's all up for debate, but I am confident that Tesla is a major American automobile manufacturer now, that the company will continue to grow as alternative electric cars are introduced, and that it will be a larger company 10 years from now.

Tesla's unique no-dealer business plan gives the company the opportunity of open their own Tesla-branded service centers. Tesla has also recently started opening their own Tesla-branded collision repair shops as well. All of these facilities are leased by Tesla with rent payments secured by the corporation.

In 2022, Tesla earned \$6.2 Billion of revenue from their "Services and Other" category in 2022 that includes these centers, and the company is

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expanding nationwide to grow this revenue stream. If we buy a “one of 32” Tesla body shop today and it is “one of 250” in 2033, this could greatly increase Tesla’s perceived value as a tenant and therefore our value.

**Method 3 – Put a Stronger Lease in Place**

A third way to increase our value is to just improve the lease itself. Imagine that I own a Sonic Drive-In restaurant. If their lease expires next year, I could renew that lease for another 20 years, perhaps at a much higher rate. Like many fast food restaurants, Sonic is mostly franchise-owned. If our current tenant operates 3 Sonic restaurants and is purchased by an operator of over 100 restaurants, this too could increase our value.

In the cases above, we’ve secured a longer series of cash flows from a credit tenant by extending the lease or we have “upgraded” our tenant when it was absorbed by a larger and stronger company. Each of these scenarios are more attractive to potential

buyers and can help us achieve a higher value for our property.

**HOW I DO THIS FOR MY INVESTORS**

My investors can buy triple net leased properties in 3 ways: 1. We can purchase a property outright in a “traditional real estate brokerage” transaction. 2. We can buy a partial interest of a larger property with a tenant such as Tesla, Federal Express or Amazon. 3. We can invest in a partnership that specializes in “value add opportunities” for triple net leased investments. The investment method I recommend for you will depend on the nature of your investment, (1031 exchange, just investing some excess cash, long term financial planning), and what your goals are.

This month, we have explored how NNN properties could offer excellent growth potential if we buy correctly. Do you want to know more? Call my office toll-free at (877) 313-1868 and let’s discuss.

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