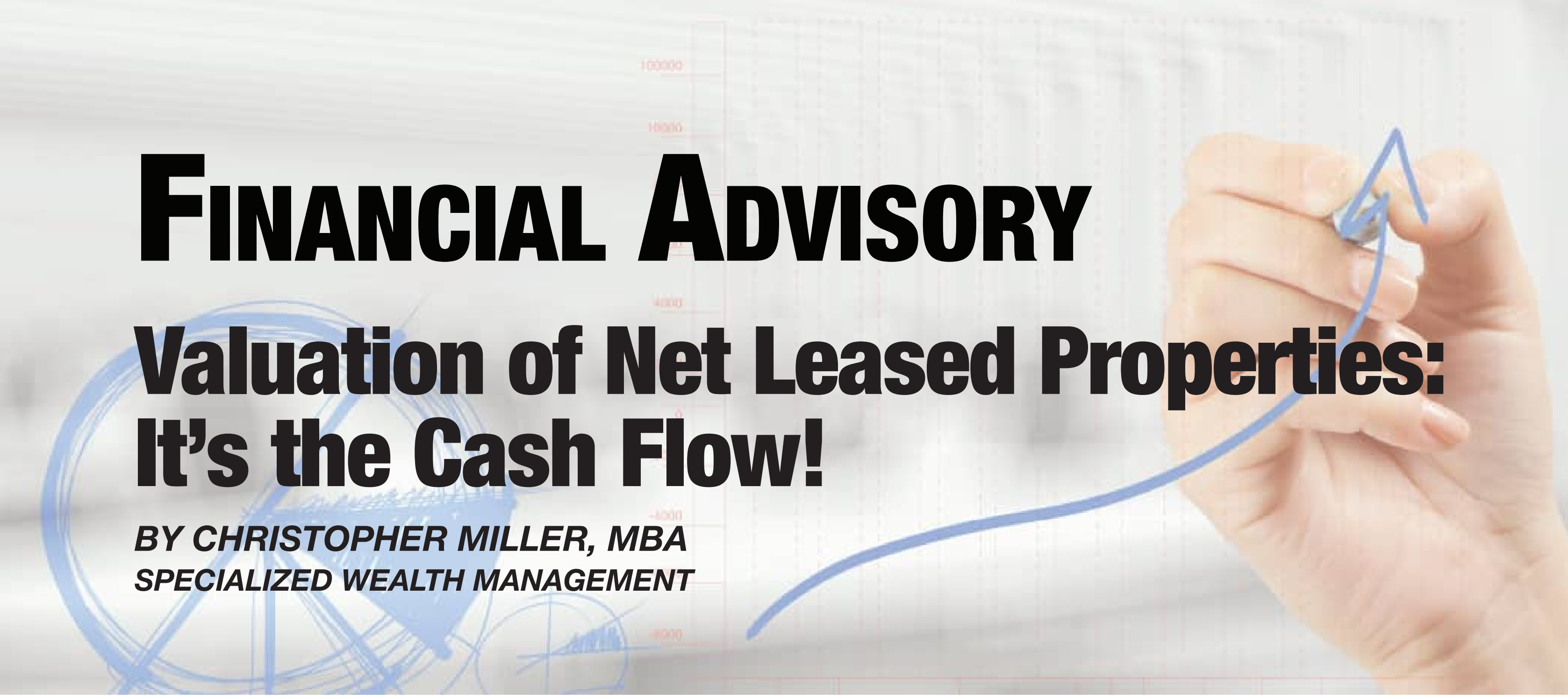

Financial Advisory

Valuation of Net Leased Properties: It's the Cash Flow!

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This month, we will explore how Net Leased (NN or NNN) properties are valued. Like all investment properties, their worth is strongly influenced by the amount of cash flow they generate. Net Leased Properties' sales prices will additionally be affected by 1. The credit quality of the cash flow generated and 2. The length of time that cash flow will be generated.

CREDIT QUALITY OF CASH FLOW

The credit quality of your cash flow will come from the credit quality of your tenant. Let's consider two hypothetical 100,000 square foot warehouses that are next door to each other. One of these warehouses is occupied by Amazon while the other houses Crazy Joe's electronics. Although I've never heard of Crazy Joe before, it turns out that he sells $200 million worth of electronics per year, a figure that is growing 10% annually, and his company earns $20 million of annual profit. Although Crazy Joe's is indeed a successful business, Amazon earned $30 Billion of profit in 2023 on $574 Billion of sales. If both tenants have 5 years remaining in their leases at the same terms (rental rate, increases, options), the Amazon property will be worth more due to credit quality: Although both are substantial companies, the probability of receiving rent payments for the next 5 years is much higher with Amazon than with Crazy Joe's.

DOES THE CASH FLOW INCREASE?

Inflation will always be a threat to cash flow producing investments. If a stream of cash flows is not growing, then the actual purchasing power of those income is shrinking as inflation decreases its real value. The vulnerability that a series of payments has to inflation can therefore negatively affect the value of those cash flows.

Apartments can have inflation protection built in. Inflation often leads to rising rents, which in turn leads to rising values through increased cash flows. Net leased properties, on the other hand, features rents set by contract. If inflation begins to rise, we as landlords can not raise rents to compensate, as we are bound by the terms of our contract.

Rental increases built into leases can positively affect the value of a net leased property. Let's alter our above example slightly and say that our two neighboring 100,000 sf warehouses are BOTH occupied by Amazon. Both properties have 20 years remaining in their lease term. Building A has annual 1% rent increases, while Site B has 10% increases every 5 years. Because its series of cash flows is growing more, with the same credit quality, Site B will be more valuable.

HOW LONG WILL THESE CASH FLOWS CONTINUE?

Remaining Lease Term is an additional important number to consider when evaluating a Net Leased property. If our tenant Amazon's lease expires in 2025, this could negatively affect our value. What if Amazon decides to move to another property? While 100,000 sf warehouses may be relatively easy to re-lease in our market; our value will likely decline if we can't find a replacement tenant with Amazon's high credit quality.

If Amazon's lease doesn't expire for another 10 or 15 years, a buyer may feel more secure in that stream of income and therefore more willing to pay a higher purchase price.

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OPPORTUNITY TO ADD PROPERTY VALUE BY ENHANCING TENANT VALUE

Just as a replacement tenant with lower credit quality can negatively affect our value, we can increase value by upgrading our tenant quality – replacing our current tenant with a stronger one can increase our value without even raising rent!

For example, a real estate fund manager that we work with specializes in this kind of value creation. I'll use a hypothetical example to illustrate this concept: This manager will look for a well-located "Bob's Hamburgers" with a short remaining lease term and – upon expiration of this lease – attempt to replace that tenant with a McDonald's franchised by an operator with 100 locations. If our manager can successfully complete this plan, they have very likely greatly increased the value of a property – just by changing the tenant!

A series of cash flows is valued by 1. The dollar value of those cash flows 2. How long those cash flows are scheduled to continue and 3. The likelihood that those cash flows will indeed continue and be collected. Similarly, our Net Leased Properties are valued by 1. The rent they collect. 2. The length of our lease terms and 3. The credit quality of our tenant.

If you have any questions, please call my office toll-free at (877) 313-1868.

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