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Investors find triple-net deals appealing

SALE-LEASEBACK FINANCING

PART 2

ADVANTAGES TO LANDLORDS

In the second of a two-part series, Miami consultant ***JONATHAN S. HORN*** *looks at the attractions of triple-net lease deals to real estate investors. Part one appeared in the March 30 edition of the* Dallas Business Journal.

GREATER METROPLEX — Whether an investor is in need of a relatively safe or a smart depreciation vehicle, net-leased (NNN) properties offer the benefits of a corporate bond-type vehicle and traditional real estate ownership.

The popularity of such transactions looks set for an extended run, thanks to recent stock market gyrations and the Federal Reserve Bank's unflagging resolve to cool the economy.

Commercial property ownership under a NNN lease agreement has emerged over the past decade as a popular and effective strategy in real estate investing. *Business Week* has called triple-net lease real estate "a smart idea ... for risk-averse investors seeking a steady source of income."

Banks, trusts, pension funds, REITs and other conservative investors are probably the best candidates for these types of investments. All share homogeneous objectives: safe, passive, real-estate investments designed to provide predictable, advantageous annual income, tax-reduction benefits and the opportunity for significant, long-term gain.

A triple-net lease investment provides an opportunity to own real estate without the hassles associated with management and leasing. Such transactions generally require a long-term investment ranging from $1 million to more than $100 million.

NNN properties are traditionally priced on the cap rate, which varies depending on the tenant's financial strength. For example, a new franchisee might be considered the highest risk, while a multibillion-dollar corporation with an investment rating (S&P, Moody's, NAIC) would be the lowest risk and earn the lowest rate for the investor.

A NNN lease is considered a passive investment, since little or no investor/landlord responsibility is required. The single tenant agrees to pay all costs associated with the property use and occupancy, including real estate taxes, insurance, improvements and maintenance for 10 to 25 years.

As a result, the investor can invest in markets beyond his own immediate location without the day-to-day involvement required of a multitenant lease.

Commercial tenants also can be viewed as "positive renters." Unlike apartment renters, for example, they are unlikely to abuse the property and then relocate, leaving the owner to refurbish and find a new renter. Commercial tenants have a vested business interest in ensuring a location is well-maintained and attractive to customers.

Because of their regular, safe returns, NNN properties can be likened to long-term company bonds in the form of real estate lease documents. However, they also provide the conventional real estate benefits of tax deductions and appreciation.

Net-leased investments are usually categorized in one of three ways:

Retail refers to big-box users such as discount variety stores, department stores, theaters or home improvement stores, as well as small-box users like restaurants, convenience stores or drug stores.

Industrial includes facilities used for distribution, manufacturing or research and development.

Office refers to a single user, such as an oil company or pharmaceutical company, occupying a facility as the sole tenant.

The focus in recent years has been on the retail category, perhaps to the detriment of the office and industrial categories, which may offer opportunities worth investigating.

Pricing on net-leased projects is based primarily on the tenant's credit, the lease and the location. Although each of these variables plays a part, it is the combination of all three that determines a purchase price — with credit being paramount.

Tenant's credit

■ Since many net-leased projects are based solely on a tenant's credit, it is important to evaluate the financial strength of a prospective tenant both on its own merit and in industry terms. Consider long-term stability during good times as well as bad.

■ Tenants considered "investment grade" by a recognized rating agency usually command a premium.

■ Tenants with junk bond — non-investment grade — ratings or minimal net worth typically provide a higher return.

Lease

■ Lease length is a primary factor in determining the sale price. Primary terms of more than 15 years are preferred, but 10 years are sufficient in IRS Section 1031 tax-deferred exchanges and similar cases.

■ "Bond-type" triple-net leases, or forms of these where the tenant is responsible for the roof, structure and parking, trade at a premium.

■ "Double-net" leases, where the landlord is responsible for the roof and structure, produce a higher yield and usually include a reserve taken for any potential repairs.

Location

■ NNN leases are credit driven, making location a secondary factor.

■ Investors often willingly pay an extra premium for well-located properties.

The combination of credit, lease and location can lead to a higher premium with a lower yield for investment-grade credit or a higher yield for a non-investment-grade credit.

Yield on a triple-net lease property is composed of three components, beginning with the cap rate. This is the annual lease payment as a percentage of the total purchase price of the property.

The second component is the dollars sheltered from federal income taxes. A portion of the cost of the property is allocated to the building and the balance is allocated to the land. For tax purposes, the owner may depreciate the cost of the building over a designated period. Thus, the portion of the annual return which is no greater than annual depreciation is sheltered from Uncle Sam.

The final component is the compounded annual appreciation rate as a percentage of property cost, since well-maintained real estate traditionally will appreciate substantially in the long-term.

On the positive side, a lease also can be written to provide the opportunity for rent increases as a hedge against inflation. Another hedge may be in establishing a minimum lease payment plus a reasonable percentage of the tenant's sales above an established annual base.

Overview of investor benefits

The primary benefits of NNN investments to the investor/landlord are as follows:

■ Security of both the tenant and the real estate;

■ A hassle-free transaction with minimal costs;

■ Annual high-interest cash return on a passive investment;

■ Property depreciation shelters a portion of the annual cash return from tax;

■ The value of the real estate frequently appreciates during the lease term;

■ Minimal risk occurs with investment grade tenants;

■ The opportunity exists for higher cash returns from less-than-investment-grade tenants;

■ The investor does not pay for property insurance, maintenance, improvements or taxes; and

■ The investor can cashout, often with a profit, by selling the property; or can hold the property, allow it to further appreciate and lease it again at a higher rate to the original tenant or a new tenant when the lease term expires.

The market for net-leased real estate investments is strong. The availability of attractive financing coupled with minimal landlord responsibilities creates highly desirable commodities, especially for investors desiring a property for an IRS Section 1031 tax-deferred exchange.

Corporations facing critical crunches in credit and capital, as well as wary — and weary — investors looking for more conservative, long-term opportunities, could find a common safe haven in well-conceived, sale-leaseback financing with triple-net leasing.

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