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NET-LEASED SINGLE-TENANT RISKS

Thorough due diligence and market intelligence helps to quantify NNN investment potential.

by George L. Renz, CCIM

Net-leased single-tenant is the most sought-after property type for investors seeking lower management-intensive products, fewer owner costs, and stable monthly incomes. While net-leased single-tenant properties have always been favored by individual investors, in many markets today, the competition for NLST product is stiff. Private investors compete against institutional investors such as real estate investment trusts, insurance companies, and pension funds for investment-grade assets. Those properties are leased by tenants that have received a credit rating of BBB- or higher from credit rating agencies such as Moody's and Standard & Poor's. Many investors see investment-grade NLST product as an alternative to bonds, producing a steady return with very little risk.

Institutional investors stick to investment-grade assets, usually in choice locations in primary markets. However, private investors often have a greater number of options — and decisions to make — when considering NLST investments. The choices may be confusing, particularly to investors who are used to owning multi-tenant properties.

The Basics

NLST are considered the most passive of real estate investments, meaning the owner has the fewest responsibilities for the property. NLST properties are often called triple net or NNN leases, which means the tenant pays for property taxes, insurance, and maintenance.

Often, the biggest objection private investors have to NLST properties is the prospect of relying on a single tenant. Many investors find comfort in multi-tenant cash flow — one vacancy does not eliminate income. In fact, clients often ask, What is the likelihood that the tenant will actually pay rent over 10, 15, 20 or more years?

An analysis of 100 NLST deals answers the question. Out of 100 transactions with locations nationwide ranging in value from $322,000 to $9 million, only six tenants filed bankruptcy or did not pay rent. The breakdown:

- Of 70 investment-grade and national tenants, no investment-grade tenants defaulted and only one national tenant defaulted;
- Of 30 franchisee, regional, and local tenants, five defaulted.

As is evident from these results, the tenant's creditworthiness and investment in the property are key to long-term success.

THE 1031 FACTOR

In order to defer capital gains taxes, investors will often opt to use a 1031 exchange to sell an existing asset and buy a net-leased single-tenant property. A 1031 exchange under Section 1031 of the Internal Revenue Service tax code allows property owners to defer taxes on gains realized from a sale. Investors must meet specific time frames and rules order to qualify under 1031 regulations. For inexperienced investors, understanding IRS requirements for a qualified 1031 exchange and NLST properties can be overwhelming. Utilizing an experienced investment real estate professional and a certified public accountant to identify the properties and tenants best suited to help the investor meet their goals is essential.

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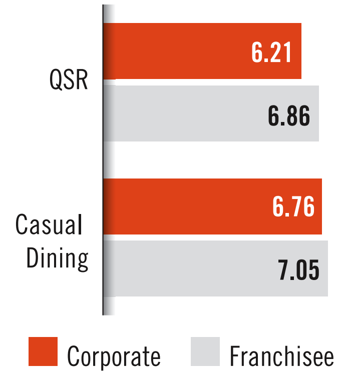
Corporate vs. Franchisee Guaranteed Leases

2014 NNN restaurant capitalization rates (%)



Source: Calkain Cos.

In comparing two options for a NLST investment, on average, a national credit tenant with 15 years remaining on a 20-year lease at a well-located, newly remodeled building is very likely to pay rent. Given the company has invested a great deal of expense and effort into building out the property to meet its brand standards, there is also a high probability it will renew its lease.

A local, regional, or franchisee tenant with one year remaining on a five-year lease has little incentive to renew if the building is worn or dated or if the location has seen a change in demographics that has negatively impacted that business type.

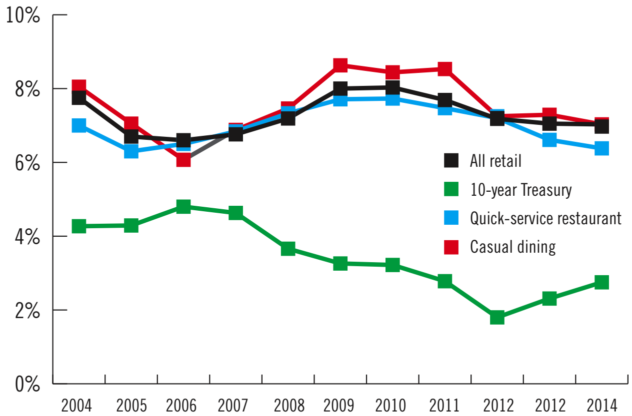
Due Diligence

Obviously NLST investments have other risks beyond the payment of rent during the lease term. The best way to minimize risks in acquiring NLST properties is to complete a thorough due diligence. That starts with the most vital question: Does the property have a true net lease? While many properties are advertised as triple net, some leases hold owners responsible for items such as snow removal, roof replacement and repairs, building maintenance and repairs, parking lot surfacing, and the like. A true NNN lease is one in which the tenant is responsible for property taxes and insurance, building maintenance and repairs, and *all* other costs. Obtaining a copy of the lease and having it reviewed is crucial for potential buyers.

Along with knowing what is in the lease, due diligence includes inspecting the property as well as evaluating the land and improvement values. Vacancy, default, or nonrenewal of a lease can quickly bring a landlord to the realization that the property is worth little without a tenant. This factor can be mitigated by evaluating the raw land and building value prior to purchase.

For example, the purchase price for a non-specialized building, such as an auto parts retailer, might be $2,500,000. The dark or vacant price of the property (the lot plus improvements) might be $1,875,000 with the extra $625,000 being added in as the purchase price of a 20-year net lease. The physical attributes of the property such as

Net Lease Retail Cap Rates vs. 10-Year Treasury



Source: Calkain Cos.

building type and the local market dictate the value of the property.

Financial evaluation is also critical for non-credit tenants such franchisees and local businesses. However, a franchisee operator may be corporate backed. When a store is described as corporate that means that the location's credit is that of the corporate parent. In either case, creditworthiness of the guarantor should be assessed.

Local and regional tenants are often considered a higher risk due to a number of limitations, mostly financial. Often a local tenant will have a shorter lease term, no proven track record, no back-up corporate entity to support them, low to no financial backing or cash reserves, and little improvement investment in the property. Some investors are attracted to "local" tenants, which offer a higher return as a trade-off for higher risk. For other investors, the interest lies in the specific property, area, or market.

Re-leasing appeal should always be considered. Is the property well located in a thriving market, flexible in user/tenant appeal? Assess the interior build-out: Is it so specialized as to only value the current user/tenant, such as a fast-food chain? What would be the rough cost

THE 2014 NET LEASE MARKET

by Winston Orzechowski and Gareth Watson

As of September 2014, net lease transactions have totaled roughly $32.5 billion from 32,000 transactions. This is a slight increase over 2013, where through the same time period transactions totaled roughly $30 billion from 29,700 transactions. For all of 2013, net leases transactions totaled $42.7 billion from 41,000 deals. Institutional investors have increasingly invested in net lease properties and net leases have become a fully incorporated part of the commercial property portfolio. At the same time, high net worth investors continue to flock to the net lease market to preserve and grow their wealth.

Of all net lease property segments, retail banks have averaged the lowest capitalization rates over the course of 2014 — averaging 5.50 percent. Net lease investors are attracted to the high credit rating and long leases offered by these assets. Dollar stores are another highly popular segment. They offer investors a higher return with cap rates averaging 7.68 percent for 2014 (compared to 7.88 percent for 2013). Dollar stores are also one of the few tenants to be vigorously expanding. Furthermore, tenants such as Dollar General offer fully triple net 15-year leases, which makes them much more appealing. Pharmacy tenants such as CVS and Walgreens have always been popular with net lease investors and remain so today. With good credit, long leases — which now sometimes feature increases — and strong locations, pharmacies also trade at low cap rates, with Walgreens averaging 6.15 percent and CVS, 6.26 percent for 2014. The quick-service restaurant segment is also in high demand: for example, McDonald's QSRs trade for some of the lowest cap rates on the market, 4.67 percent. QSR properties are often well located and feature a relatively recession resistant product.

Nearly every net lease investment product experienced record pricing growth and cap rate compression throughout 2014 thus far. Competition among net lease buyers has increased with more people entering the market, looking for net lease properties as a solid alternative investment form. Institutional investors such as real estate investment trusts have increased their exposure to the net lease market and they remain a very popular wealth-producing asset for high net worth investors. Net lease activity levels in secondary and tertiary markets have also increased throughout 2014. Investors who were priced out of the primary markets by competition have shifted their focus to secondary and tertiary markets. Investors can find investment-grade tenants such as Dollar General and Advance Auto Parts available in secondary and tertiary markets at around $1 million.

Going forward, the net lease market will continue to see strong demand and limited supply. Net lease development increased in 2014, and we expect that to continue well into 2015. Cap rates will likely continue their compression in early 2015; it is yet to be seen if that compression will level off as higher interest rates and increased development affect the market. However, cap rates will remain low in 2015 and buyers will still be paying premiums for net lease properties.

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NNN Cap Rate Trends

Average cap rates (%) for main net lease sectors

Sector	9/2014	9/2013	9/2012
ALL RETAIL	**6.94**	**7.58**	**7.21**
Bank	5.40	5.85	6.23
Quick-service restaurant	6.05	6.86	7.12
Restaurant	6.89	7.71	7.39
Pharmacy	6.47	6.80	6.93
Dollar store	7.15	7.85	7.96
Convenience store	6.63	6.69	6.93
Automotive	6.72	7.33	7.23

Source: Calkain Cos.

to retrofit the property for re-leasing? What is the zoning and is the building fairly flexible in location, size, and type to be suitable for a number of users? What is the local market expectation for landlord responsibilities? Would landlords in that area and market need to provide retrofits or cover other expenses going forward?

Each of these questions should be addressed prior to purchase. Retrofits for re-lease on a generic retail box such as an auto parts retailer or drugstore can often be completed for very little. Properties that are more specialized or have significant internal build-out can be expensive to retrofit and take time to re-tenant.

Potential NLST investors should also consider the low capitalization rate environment that exists for NLST properties today in some markets. Properties that are being purchased now at a low cap rate, with low or no rental increases, are not likely to reward the investor with a high future sale price return, especially when inflation is calculated. In the case of local tenants, the lease should be more modestly weighed and the emphasis of the purchase should be upon the physical potential and value of the property.

Risks associated with NLST deals are similar to those of any other income-producing real estate, but the significant risks are fewer. But fewer major risks does not eliminate the need for thorough due diligence and review of the investment prior to purchase. To understand risk and select the right investment property, a complete due diligence review prior to purchase should consider vacant or dark property value, lease length, the area's economy, tenant type, and the credit rating of the lease guarantor.

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