

Triple-net threat

Understanding single-tenant NNN investments

By Larry Bogle

As the saying goes, "It may be too good to true." Let buyers beware this could apply to single-tenant NNN (net net net) investments, the latest phenomenon in the real estate investment market.

Single-tenant NNN investments are so prevalent these days, they've become a specialty niche in the brokerage world. Real estate investment trusts have been gobbling them up.

By definition, a single-tenant NNN investment is a single property, occupied by a single tenant, under a lease agreement that mandates the tenant to pay all expenses. Some investors view single-tenant NNN investments as a way of getting a check in the mail each month without being involved in the operation of the property.

Although it may sound simple, potential investors need to evaluate single-tenant investment opportunities carefully before signing on the dotted line. The following are some of the major points to consider.

1. Tenant stability: The financial strength of the tenant determines the security of the investment and the ability to obtain attractive financing. A lease signed by a franchisee may or may not be guaranteed by the parent company and, sometimes, a subsidiary or holding company is formed.

2. Lease term: Some leases provide for early termination or allow the tenant to "go dark" and continue to pay the rent. If the leased property is part of a larger shopping center, the tenant may be able to cancel its lease if the anchor tenant vacates.

3. Lease rate: Prospective purchasers should compare competitive lease rates for the area in the event the tenant fails and the property needs to be re-leased. This is especially true if the property is a special-use building and if major improvements or modifications need to be made for a new tenant.

4. Sub-leasing: If the tenant has the ability to sublease, it is important that the landlord

approves the qualifications of any new subtenant. If percentage rent is a part of the lease, this may affect your total overall return if the subtenant does not maintain the same level of sales. There could also be restrictions that prohibit leasing to certain tenants in the event you need to re-lease the property.

5. Property maintenance: The largest items of contention are the roof, the structural integrity of the building and the HVAC system. These may be considered capital improvements and some leases provide for the landlord to maintain or replace these items. Even though the lease may be net/net/net, there could be a provision for the landlord to pay common area maintenance charges, which are reimbursed by the tenant.

6. Expense pass-through: Some leases limit a tenants' liability to pay for an increase in real estate taxes or insurance due to a sale of the property. Many leases provide for the landlord to furnish liability insurance

in addition to the tenant's coverage. Insurance clauses need to be reviewed closely, especially those provisions allowing the tenant to cancel the lease in the event of partial destruction of the property.

7. Construction type: This could affect the landlord's liability regarding the HVAC equipment and the roof. If it is a new property, there is usually a one-year warranty on the structure. The roof and HVAC extended warranties are usually available from subcontractors and will vary from five to 10 years.

8. Sale/lease-back: If there is an option for the seller/tenant to buy back the property, the Internal Revenue Service may consider the transaction to be a loan and not a true sale. It is

also important to verify comparable lease rates in the area to make sure the property's value is not being inflated by artificially-high lease rates. When the lease term expires, your ability to re-lease the property will be determined by market demand for the area.

9. Financing: Financing single-tenant properties can be quite difficult. The credit of the tenant, the length of the lease and the lease rate will determine the type of loan you can obtain. The property you are buying may not appraise for the purchase price. A real estate appraiser could apply a higher capitalization rate or allow for vacancies and reserves for replacement. Interest rates may also fluctuate during the time you apply for the loan until the date the loan is actually funded. If you do not lock in a rate when you apply for the loan, the interest rates could change dramatically and affect your rate of return on the investment.

10. Comparative analysis: Buying a net leased property is no different than buying any other real estate. You will need to review all the documentation and do an inspection of the property. The old adage of location, location, location still applies.

Most investment decisions involve common sense, but others — especially single-tenant NNN investments — require judicious research. Potential investors are well-advised to employ the help of a real estate attorney or a competent real estate broker who is thoroughly familiar with commercial leases.



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