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Investment Newsletter – December 2009

Investing in Triple Net Leased Commercial Real Estate – Why and How

Many individuals think of houses or apartments when they think of real estate investing, but commercial properties offer good returns without the management headaches or risks of residential property; these should be considered by all investors with total investable assets of $300,000 or more. Triple-net, or NNN, refers to a commercial building with one or more long-term (5-30 years) leases under which the tenant pays all expenses of the property. Thus the owner receives a rent check that is: 1) Net of operating costs (maintenance, repairs, utilities, etc.), 2) Net of insurance, and 3) Net of property taxes. Some leases, called "absolute" triple-net leases, even make the tenant responsible for structural repairs.

This month's newsletter explains why these investments are attractive and shows you how we can go through the process of finding a good property and evaluating its risk versus returns.

Why Invest – Good Returns for Low Risks without the Hassles

NNN property investments are very similar to buying inflation protected bonds - but with higher returns and less liquidity. Single tenant properties are mostly management free. You have a long term tenant who pays you a net rent and they manage and pay all property expenses. This is ideal for retirement income and requires about as much attention as a bond. But there are two big advantages compared to bonds.

First, the income relative to risk is higher. If you buy a well located property with rents at, or below, market rents, there is little chance of suffering a major loss - even if your tenant defaults. Worst case is you lose several months of rent before finding a new tenant. If the tenant has multiple locations and a decent balance sheet, then you've got risks roughly equivalent to an investment grade bond. Investment grade bonds generally yield 7% or less at the end of 2009 but these have no adjustment for inflation. This brings us to the second advantage. A triple-net property can match or exceed the yield of investment grade bonds *and* provide increases throughout its life (rent increases). Over the long run, the value will reflect increases in rents caused by inflation. Therefore you should get an inflation adjusted return of capital – assuming the property was properly maintained. In contrast, most bonds do not protect the purchasing power of your capital. Inflation protected treasury bonds yield under 1% - more than 5% less than a NNN property.

NNN Avoids Psychological Risks

As explained in the September 2009 newsletter, one of the biggest investment risks for individuals is the impact of emotions on investment decisions. Herding instincts work against us when we watch stock market prices – i.e. when we see what everyone else is doing. People naturally want to buy when everyone else is buying and sell when everyone else is selling – which means buying high and selling low. One way to resist this urge for financial self destruction is to hand over your assets to an advisor to manage (Berkeley Investment Advisors!). Another way is to avoid looking at the market price movements while you hold the investment. This is hard for most to do with stocks but not so hard with real estate given that there are no market prices for your particular property that you can observe. Even if you did observe a price drop in a similar property and panic, the difficulty of selling real estate would provide you with time to come to your senses. The opinion of an ill-informed high frequency trader may cause you to sell your gold right before it runs up another 20%, but his opinion as to the value of your land leased to McDonald's won't affect you in the slightest.

Evaluating NNN Property Risks

The two most important risks we must look at are: tenant default and re-leasing at the end of the lease term (or default). There are two things to look at in assessing the chance of a tenant default. First is the strength of the tenant's financial statements. We look at the balance sheet to see that the company's assets and liquidity can easily support its debt, and we look at the income statement to see which direction the company's operations are taking the balance sheet – better (profitable) or worse (unprofitable). In bankruptcy, the court decides whether to cancel a lease obligation or not depending on whether a location produces or uses cash. In other words, a tenant in bankruptcy may still not default if your location is profitable. Thus, you want to determine if the location is generating cash flow for the tenant. If the location contributes money towards debt repayments, lease cancellation is unlikely.

The profitability of the location is also an important factor in evaluating the re-leasing risk. If the property is located well and can generate profitable levels of customer traffic then it will be easy to re-lease or sell at the end of the lease. Besides operating results, we can look at vehicle counts on the streets passing the store, local demographics, and nearby land uses that produce customer traffic. For example we would like to see major shopping or movie theaters near a fast food restaurant, or a hospital next to a medical clinic. In contrast, a large retail store on a country road is risky – it could take a long time to get a new tenant at a reasonable rent.

There is also re-leasing risk when market rents are below the current rent on the property. In this situation you may find a tenant, but the rent will be lower than the current lease. Therefore, when buying, don't pay for rents above market. Such leases are particularly common in "sales-leaseback" transactions in which an owner-user sells the property and simultaneously leases it back. Public companies may sometimes do this for accounting reasons. Non-public companies always do it because their finances are deteriorating and they need to access cheap financing. They will inflate the rent to inflate the selling price. Economically, this is equivalent to buying property plus a junk bond; the distressed company gets extra cash now and pays your back in the form of higher rent over the term of the lease – if they survive.

Evaluating Lease Terms

Unlike apartment rentals, which tend to turn over yearly, commercial leases run for many years. Therefore commercial lease terms largely determine your cash flows and the risks to those promised cash flows. The following table summarizes what you want to see and what you should avoid in the key sections of a lease.

Section	Want	Avoid
Term & Renewal Options	Initial term of at least 10 years Prefer fewer options – 10-15 years of options is normal	Less than 5 years remaining. Many (>3) options at rents not adjusted for inflation or to market.
Rent Escalation	As frequent as possible, tied to inflation or sales growth.	Rent fixed for more than 5 years. Low fixed adjustments unlikely to keep up with inflation.
Early Termination & Notice	No way for tenant to break lease early. At least 6 months notice on renewal options.	Easy conditions for terminating lease early. Short notice period for renewal or termination.
Maintenance & Renovation	Complete tenant responsibility for all maintenance and repairs. Acceptable condition well defined and requirements for major renovation expenditures.	Major landlord responsibilities like roof, structure, parking lot. Lack of specific condition requirements such that tenant can let the property deteriorate.
Assignment	Landlord must approve in writing any lease assignment and can withhold permission if replacement tenant is inferior.	Freely assignable lease such that a weaker tenant can take over the lease without landlord permission.
Disclosures	Complete annual financial statements of the tenant or guarantor, plus quarterly income for the location.	Lack of financial reporting requirements.
Right of 1st Refusal	None if possible, or tenant only has right to accept the listing price before an offer is obtained.	Tenant right to match any purchase contract after signing.

There are, of course, other issues to watch out for. The investor or their advisor needs to read the entire lease to identify potential risks.

Financing

The financial crisis has reduced the number of financing sources greatly and underwriting standards are tight. It will not be easy to get financing for every property. Still, money can be found for good deals for buyers with good credit. There are a lot of variables that determine the leverage ratio and the interest rate. These loans will always require amortization of principal over 25 years or less. Rates can be fixed for as long as 10 years but usually a fixed rate for 5 years with an adjustment to the then current 5 year rate will be a better deal. For the kind of properties we like for investors, we expect to finance 70% of the purchase price and get a rate of 6.5% fixed for 5 years.

Evaluating Return on Investment

The financial crisis has pushed prices down and yields up on NNN properties. The yield, otherwise known as the capitalization rate (cap rate for short) is the net annual rents divided by the price. Currently cap rates on relatively low risk properties are in the range of 6.5% to 7.5%. These leases typically provide rent increases of 10-12% every 5 years. Buying a property outright (with no mortgage) provides a starting yield roughly equal to a low investment grade bond, but the property will also enjoy yield increases every 5 years. Leveraging the property with a mortgage for 70% of the purchase price will usually lower the cash return on investment but will increase the equity buildup portion of the return(which is not taxed). Assuming a mortgage for 70% of the purchase price at a rate of 6.5%, you would end up with 1st year cash yield of 2% on the equity invested. With leverage, this yield rises faster than the rise in rents and so does the owner's equity.

Inflation will tend to drive up market rents and eventually the property's rent. The property value may rise with market rents, or it may fall initially before recovering, – it depends on how long it takes for rents to increase under the lease terms. The June 2009 newsletter analyzes inflation's impact in more detail and how it interacts with lease terms. When held through to the end of the lease term, inflation will significantly boost returns since it reduces the real cost of the mortgage.

Analyzing longer term total return on equity, we see very good returns for a typical NNN property purchased at a 7% cap rate. If inflation and interest rates stay steady, the typical 2% annual rent escalations will provide 11% average returns on equity over the first 5 years. This is a very nice return for such a low level of risk and is far better than what would be available from any kind of bond investment.

Besides the attractive overall returns, there is "built in" retirement preparation: over time, as the mortgage is paid down, more and more of your return comes in the form of increased cash flow and less as unrealized capital gains. This is exactly what you want as you near retirement – automatic increases in investment income.

Conclusion

Triple-net leased commercial properties provide better returns than investment grade bonds for the same risk (or less) and these returns will tend to rise with inflation. The investor must give up liquidity to achieve this boost in return, but this is a great strategy for the long term portion of your portfolio. Many conservative investors will need such an investment to achieve their long term goals given the low returns available in the bond market today. Additionally the inflation protection will very be important over the next 10 years.

In order to take advantage of the opportunities available in this market, you need good up-front due-diligence and a clearly thought out strategy that fits your overall investment plan. Berkeley Investment Advisors can help find the right deal for you and explain the advantages and disadvantages of the various properties available.

Featured Property

Selling at a 7.2% cap rate, this Bridgestone-Firestone store in Brentwood California has a brand new 20 year absolute NNN lease. There is no management responsibility. The asking price is $1.25 million for this .78 acre parcel.

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