BREAKWATER 1031

What is a NNN Property?

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A NNN property is a property for which the lease agreement specifies that the tenant must pay all of the property's expenses, including real estate taxes, insurance, and maintenance. The term "triple-net lease" comes from the fact that the lease on a NNN property requires the tenant to pay those three property expenses. The tenant in a triple-net lease must also pay standard rent and utilities.

In simplified lease agreements, the landlord is responsible for paying some or all of the above property expenses. NNN leases are common with commercial properties like retail spaces, offices, and industrial buildings.

HOW A NNN LEASE WORKS

A NNN lease works by shifting more responsibility to tenants than in other lease agreement structures. A net lease in commercial real estate is an agreement where the tenant will pay some or all of the property's maintenance costs, taxes, and fees. Different kinds of net leases divide the property's costs between the tenant and property owner differently.

NNN leased investment properties place the burden of paying insurance, real estate taxes, and property maintenance costs squarely on the tenant for the lease's term. By agreeing to pay for these expenses, tenants assume more financial responsibility for the property's upkeep and gain more control over the maintenance and operational responsibilities of the property.

Triple-net investment properties can also enable tenants to avoid being overcharged for utilities, taxes, or building insurance, which the landlord might tack on to their rent. Because the landlord is free of the obligation to pay these property upkeep costs, they typically lower the rental payments for tenants.

WHAT ARE THE RESPONSIBILITIES UNDER A NNN LEASE?

Each party's responsibilities in a NNN lease commercial investment are rigidly defined. Each party must meet its obligations as outlined in the lease agreement or face potential consequences like legal action. Here is a brief overview of the responsibilities described in a triple-net lease:

LANDLORD

Landlords have fewer responsibilities in a NNN lease agreement, making triple-net investment properties potentially attractive to investors. Property owners must handle the following obligations for a NNN lease commercial investment:

- **Collecting rent:** While tenants pay utilities, insurance, and property taxes directly to the appropriate parties, they still owe rent payments to the property owner. Landlords are responsible for collecting rent from tenants on time each month.

- **Mortgage payments:** Property owners must pay the mortgage payments throughout the lease, which rental income will help offset.

- **Inspecting the property for proper maintenance:** Landlords want to ensure their properties are in good condition, including the structure and heating, air conditioning, and plumbing systems. Landlords may inspect their buildings periodically to see whether the tenant follows the maintenance contract.

- **Creating a maintenance contract**: Landlords may include a maintenance contract in the lease agreement to define the maintenance tasks the tenant must perform, the maintenance timeline, and other expectations.

- **Structural issues:** A landlord may still be responsible for covering any structural issues the property experiences, which include capital improvements such as replumbing a building or replacing an entire roof. These expectations should be outlined in the lease agreement. A net lease that places responsibility for the property's structure on the tenant is called an absolute net lease.

TENANT

Tenants bear a greater share of the financial responsibilities for a property under a NNN lease, including:

- **Rent:** Tenants must pay rent by the agreed-upon date each month. Since landlords don't have to cover the property's taxes, insurance, and maintenance expenses, rent payments are usually lower.

- **Utilities:** Building utilities like electric, gas, and water all fall under the tenant's list of obligations in a NNN lease. The tenant pays the expenses to their local utility departments.

- **Building insurance:** Tenants may also pay for liability insurance if someone is injured on the property. The tenant may also list the property owner on their insurance policy, protecting the owner in case someone is injured.

- **Property taxes:** Tenants must pay real estate taxes for the property. If these taxes increase over the lease term, the tenant is still responsible for paying them. However, landlords and tenants may agree to a cap that transfers the additional tax burden to the landlord if it reaches a certain threshold.

- **Maintenance costs:** It's also the tenant's responsibility to maintain the property by paying for upgrades, renovations, and repairs over the lease term. Maintenance tasks may include landscaping, maintaining the parking lot, and repairing plumbing or HVAC issues.

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Factors to Consider

The retail real estate industry is a class within the commercial real estate sector. While the commercial sector encompasses properties that include buildings and land, the retail industry is more specific. Retail real estate consists of establishments for public commerce like shopping, entertainment, and restaurant assets. Traditionally investors have targeted these properties because they provide greater opportunities for high returns than multifamily properties.

A well-connected or creative investor can potentially unlock hidden value that others would not be able to, potentially providing returns for investors.

VALUE THE IN-PLACE COMMERCIAL RENT ROLL

When first looking at purchasing a retail property, an investor must evaluate the quality of tenants currently in the property. Is the property filled with small “mom and pop” type shops or are there any quality tenants with an institutional- grade corporate-backed guarantee on the lease? A corporate tenant will always be more valuable as future income is guaranteed if the corporation remains in business. If the property does not have institutional grade corporate-grade tenants, it is up to the potential buyer to conduct even more due diligence on the current tenants.

Investors should be looking for a few key items: the current financial health of the operating businesses, the future viability of the business, and the trust in the owner/manager of the business. If an investor buys a property only to find out their new tenants are not able to pay their lease rents, the investor has a serious problem on their hands. A thorough review of the past rental payments and the tenants’ financials is key to help assure the stability of the asset. Another way commercial retail property owners can help mitigate their investment risk is by requiring their tenants to sign a personal guarantee on the lease which further commits the tenant’s responsibility to pay their commercial rent on time.

A potential investor must also weigh the impact of an anchor tenant. An anchor tenant, also known as a prime tenant, a draw tenant, or a key tenant—is the leading, featured, big-name business that rents a large portion of retail space in any given retail development. Anchor tenants are designed to draw people into your retail space which can then further increase sales to your other retail spaces. Sometimes the anchor tenant will be given a slightly lower lease rent to make the retail center more successful overall. Properties that have a high draw anchor tenant, like a Whole Foods Supermarket or Apple Store, will generally be more valuable because the anchor attracts tenants to the spaces around the anchor, further increasing the value of the asset in totality.

ANALYZE POTENTIAL OF THE PROPERTY

An investor in any retail property must analyze the current in-place rent for all in-place leases, future lease escalations, CAM reimbursements, vacant space, current market rent, and outlook for the market.

Valuing the in-place rent roll is very important because that will dictate how much debt one can receive on a property. When using conventional financing, a lender will typically only lend based on the in-place cash flow. Some real estate experts advise that investors should purchase properties with an in-place Debt-Service Coverage Ratio (DSCR) of at least 1.2. If the business plan is to increase rents on current tenants, lease vacant space, or build new space, an investor should wait until that income is realized to get additional debt financing on the property.

Future lease escalations must be considered when calculating a targeted return on a property. For instance, if the leases at a property do not grow and remain flat, an investor could start to lose money over time as operating expenses and real estate taxes increase. Therefore, the investor should pay less for the property upfront to compensate for the lack of future income.

One of the main ways to attempt to generate returns on a retail property is leasing vacant space. An investor must research the market and calculate what the market rent per square foot is at their property based on other signed leases in comparable nearby properties. The future development around a retail space may also increase the value of the property and timing can be everything. If an investor knows that a highly attractive tenant is taking space nearby a property that they own, it may be beneficial to wait until the neighboring tenant is in place to start their leasing. As the new tenant typically makes the area more attractive, other retailers may want to be in your location.

BUDGET PROPERLY FOR FUTURE LEASING COSTS

Depending on one's business plan, certain items need to be budgeted upfront to properly execute the plan like deferred maintenance, tenant improvement budgets, broker fees, free rent periods, and interest reserve. Depending on what shape the property is in, different deals will have different capital expenditure needs. Some properties might need the roofs replaced, HVAC updates, elevator upgrades, façade work, etc. This is work that needs to be done regardless of the occupancy of the building and are classified as immediate needs.

Tenant leasing costs will vary from market to market and will also be dependent on whether the market is favoring landlords or tenants.

If a new buyer is underwriting a deal that requires leasing up vacant space to a new retail tenant, they will negotiate on what scope of work will be acceptable to the new tenant. This could be as little as a "white box" which is essentially a clean blank canvas for the tenant to make their improvements on their own. Tenant improvement dollars can also be negotiated so that the Landlord will pay for any new buildout for the future tenant's use.

The new tenant will also potentially negotiate some sort of initial free rent period to allow them to get the business up and running. The landlord needs to account for the downtime and have enough money budgeted to pay for the new expenses the tenant is creating as well as debt service obligations. In addition to these expenses, landlords will usually hire a leasing broker to procure a tenant. Leasing fees can range anywhere from 2%-5% of the total lease amount and are negotiated before the broker begins working. The intelligent investor will know exactly what each of these items will cost before buying the property to raise enough capital to pay for the Capex, carry the operating expenses, and pay the debt service.

STRIVE TO INCREASE RETURNS WITH BEST LEASE OPTION

As an investor signs new leases with new tenants, they need to critically think about the structure in which they will write the terms. Lease structure can be crucial in determining if an investment will be successful or not. There is more than one way to cook an egg and writing a retail lease is no different. There are three main types of retail leases including gross leases, net leases, and modified gross.

- **In a gross lease, the tenant's rent covers all property operating expenses. These expenses can include, but are not limited to, property taxes, utilities, maintenance, etc. The landlord pays these expenses using the tenant's rent to offset the costs. As a result, the base rent is usually high but is the only expense to the tenant. Tenants incline to prefer this type of lease because they don't have to get involved in the day-to-day tasks of the building and the rent is fixed even if the expenses are not. For example: during the summer, rent will stay the same even though air-conditioning use increases energy costs.**

- **The net lease is a highly modifiable commercial real estate lease. The base rent for a net lease is lower than a gross lease, but the tenant also pays fixed operating expenses such as property taxes, insurance, and common area maintenance items. In a single net lease, tenants pay a set rent and a part of the property tax which would ordinarily be negotiated with the landlord. The landlord then pays building expenses, while the tenant pays utilities and other services directly. A double net lease is like a single net lease, except the tenant also pays a portion of the property insurance along with the property tax. The landlord pays for maintenance of the common area, but the tenant is still responsible for their utilities and trash services. The triple net lease includes property taxes, insurance, and common area maintenance, with the tenant paying for some or all of the costs of these three things on top of their base rent. It is one of the most common lease types.**

- **The third main form of commercial real estate lease is the modified gross lease (or modified net lease) and offers a great middle-ground for both tenants and landlords. The modified gross permits a larger range of negotiations when it comes to operating expenses. The base rent will subsequently be subjected to the terms decided upon by both parties like the gross lease. The distinguishing factor is that the lease amount remains fixed even if expenses rise or fall.**

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1031 Risk Disclosure:

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits