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NNN lease

In United States real estate business, normally the landlord, rather than the tenant, is responsible for real estate taxes, maintenance, and insurance. In a, "net lease" the tenant or lessee is responsible for paying, in addition to base rent, some or all of the recoverable expenses related to real-estate ownership. As the rent collected under a net lease is net of expenses, the base rent tends to be lower than rent charged under a gross lease.

Net lease types include single net, double net, and triple net leases, depending on the number of items they include. The term "net lease" often being used as a shorthand expression for any of these arrangements. The three most common expenses charged back in this fashion, often called the "three nets", are property taxes, insurance, and maintenance.[1] A triple net lease that includes the three nets is particularly common and is often abbreviated in writing as "**NNN lease**", but is still pronounced as "triple net lease".[2][3][4]

Contents

Variations of the NNN lease

Single-tenant net lease

NNN leased investments are generally leased to one single tenant and are thus referred to as STNLs or Single Tenant Net Leases. A NNN lease investment can however have two or more tenants, though it would not be considered an STNL investment. An example of this would be a Starbucks & MetroPCS which share a building under two separate NNN leases, or a retail strip center where all tenants are wrapped into one NNN lease. Both examples would be considered NNN leased investments; however they would not be STNLs. The risk of default is spread out over more than one tenant in such NNN deals (i.e. if either Starbucks or Metro PCS goes bankrupt, the other tenant continues to pay the rent due under their NNN lease). Such deals can appeal to investors seeking to spread risk, though the simplicity of collecting one rent check from one tenant is forfeited.

Double net lease

Another variation of the NNN lease is the NN lease or "Net-Net" lease which is pronounced "double net" where the "net" amounts generally are property tax and insurance.[1] Double net leases, like triple net leases, are usually, though not always, single-tenant arrangements, however, the landlord carries some extra financial maintenance obligation. The term "Net Lease" is tossed around loosely in the net lease industry, often used when referring to a triple or double net lease; however, there is a definite distinction between a triple net and a double net lease even though some brokers erroneously use the term "Net Lease" to describe both. Double net leased investments generally trade at a slightly higher CAP rate than triple net leased investments, because of the maintenance expenses which the landlord is responsible for. Brand new NN Deals with long-term builder warranties covering the roof and sometimes structure can be attractive to investors looking for a higher return.[5][6]

Risk

Though NNN leased investments are considered to be highly risk-averse investments, especially when leased to a national credit tenant, the landlord is still exposed to some financial risk. In the fine print of most NNN leases these risks are specified. For instance, who carries the obligation to rebuild after a casualty (natural disasters included) or whether the tenant must continue paying rent should the property be condemned? In other instances, certain risks (e.g. fluctuations in property taxes) cannot be completely accounted for in the initial contract, forcing the landlord to estimate these costs early on. In this scenario, if the landlord's accountant does not follow through with changing the invoices appropriately, it may cost the landlord thousands of dollars by the end of the taxable year. Although NNN lease investments carry relatively low risk, they require high levels of oversight for these reasons.[7]

In one variation of a NNN lease contract, the "bondable NNN lease" (sometimes referred to as a "true triple net" or "absolute triple net" lease), the tenant cannot terminate the lease or seek any rent abatements under any circumstances, a provision that mitigates some of the risk for the landlord.[8]

Benefits

For investors

NNN lease

Investors can benefit from NNN lease properties in a variety of ways. In NNN leases tenants take on the responsibility of major expenses such as HVAC and roof repairs keeping the operation cost lower for the landlord. Typically NNN leases have lower rent per square foot rates which increases the tenant pool when a landlord is ready to lease the property. For specific tenants, landlords will frequently modify leases allowing for greater flexibility and higher tenant retention.[9]

Absolute net lease

Most investors in today's net lease market prefer an investment that is truly passive, therefore, an absolute net lease is a requirement for many of these investors. Investors prefer to hold these assets long-term, which means there is likely some wear and tear maintenance, as well as a roof that will need to be replaced at some point. With an absolute net lease in, the risk of expenses associated with building maintenance shifts solely to the tenant, allowing the landlord to receive a 100% passive investment.[9]

NNN 1031 exchange

In its simplest form, a 1031 exchange is a tax deferral strategy for real estate transactions in which a property owner or investor sells one property and purchases another within a specific time frame. However, the transaction must qualify as a "like kind" exchange.[10]

For tenants

Often a NNN lease will offer a lower monthly rent than a gross lease since the tenant will be responsible for maintaining the building. In a NNN lease tenants are responsible for maintenance and repairs, therefore cost savings for expenses related to operating the building are passed on to the tenant instead of the landlord.[9]

Common misconceptions

A "bondable NNN lease", the most extreme form of a NNN lease investment, is often used incorrectly in the net lease industry when referring to NNN properties which are merely occupied by investment-grade tenants. The tenant's credit rating is a crucial factor which the lender takes into account in their decision to lend on a property and under what terms; however, it is not the characteristic which distinguishes a bondable triple net from a standard triple net lease investment. When evaluating the value of the credit tenant's credit, most brokers, and lenders, base their analysis on the credit rating garnered by one of the major credit agencies (Moody's, Standard & Poor's, Dunn & Bradstreet). Though these ratings are important, they don't always paint the most accurate picture of a company's overall performance and future viability. Some brokers offer the services of an in-house stockbroker and analyze the credit tenant's financials and stock performance when the tenant is publicly traded on an exchange. A great deal can be learned by examining the credit tenant's stock performance in comparison to other industry competitors. Other readily available metrics such as the P/E ratio, PEG ratio, and debt-to-equity ratio can be indicators of a credit tenant's financial health.

Components and values of single-tenant leases

The value of a net leased investment is determined by the value of the real estate, the value of the credit tenant, and the value of the lease itself.

1. In a standard NNN leased investment the landlord owns the land and building while collecting rent from the tenant. If the tenant chooses to leave or the landlord decides he or she wants a different tenant when the lease term is up, he or she still owns the building and land. Planned developments in the area as well as current and future demographic trends all affect the real estate's value. The value of the physical building should also be factored in when determining the real estate's value.
2. The second determinant of value is the quality of the credit tenant. This is generally determined by the tenant's current credit rating and past financial reports. Most investors use the Standard and

Poor's credit ratings. In order to qualify as an investment grade tenant, the company must be rated at lease BBB- by Standard and Poor's. Properties leased by credit tenants are in the highest demand and therefore command a lower capitalization rate than non-investment grade tenants.[11]

3. The third determinant of value is the lease itself. NNN leases are more valuable than NN leases because the landlord is responsible for some of the expenses in a double net lease. The length of the lease is also a determinant of value (20 years of guaranteed income will be worth more than say 10 or 15 year terms). Generous rental increases, also known as rent bumps, add value to the lease and protect the landlord against inflation. Some leases also have a percentage rent kick in if the tenant's gross sales hits a certain CAP. Most leases grant the tenant options to renew (several short term options put the landlord in a weaker position when it comes time to renew the lease). If the current rents called for in the lease are below market, the landlord has the opportunity to command higher rents when the lease term is up.

Net lease planning as an investment tool

NNN lease planning is a rich investment tool which provides the investor with many opportunities to navigate an ever-changing market. NNN lease investments are essentially inflation-protected bonds guaranteed by a credit tenant, rather than a state or local municipality. The tenant makes monthly payments to the landlord, while the real estate (and often rent bumps called for in the lease) provides the investor protection against inflation. . NNN lease investments provide similar tax advantages as tax-exempt municipal bonds, without forcing the investor to settle for lower yields or opening the investor up to a large capital gains hit.[12] If an investor were to purchase a bond in the secondary market and turn around and sell it for a profit years later, he or she would have to pay a capital gains tax on the profit, regardless of whether or not the bond is exempt from state income tax. This is not the case when investing in NNN leases because, although structured like a bond, they are still considered real estate investments and therefore can be depreciated in the same manner as similar income producing commercial real estate. The taxes on the income they generate can be written off or deferred over the life of the asset. The investor, of course, has to pay depreciation back when he or she sells, however, this too can be circumvented by evoking a 1031 exchange and trading into another like-kind property.[13][14] NNN leased investments are also financeable allowing the investor to leverage the credit of their tenant and the interest payments would also be a write-off. .[15]

Off-market NNN properties

An off-market NNN property is a NNN property that is available for sale, but not publicly marketed. Many investors and developers prefer off-market transactions for a variety of reasons, one of which is controlling the publicity of the availability of the property, which could create issues with other lease negotiations on other deals. There are several professional commercial real estate brokers that specialize in off-market NNN properties.[16]

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