REALTOR®Mag

Hunting for NNNs

Triple-net leases have their risks, but the biggest investor challenge is simply getting one.

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Your client just sold a small apartment building and is weary of the hassles of the landlord experience. While a capital gains hit is looming (tick-tock), the client sours on lackluster alternatives like parking the proceeds in a savings or money market account or risking it in the stock market.

These dynamics are fueling a surge in 1031 exchange buyers—both individuals and institutional investors—who are flocking to triple-net leases (NNN), which have all the perks and few of the downsides of being a landlord. Under the terms of triple-net leases, the tenant pays rent, property taxes, insurance, maintenance, and overhead; typical lease durations are 25 years. These dynamics, commercial brokers report, are creating a demand for exchange properties that they are struggling to satisfy.

The perceived safety of triple nets contributes greatly to their appeal. “Net-lease properties have bondlike attributes and, as a result, are more connected to the bond market and interest rates than other types of real estate,” says Gary Ralston, CCIM, CRE, with Coldwell Banker Commercial Saunders Ralston Dantzler Realty in Lakeland, Fla.

> **The New Residential NNN**
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> Although triple-net leases have been the exclusive domain of commercial real estate, the same low rates of return on fixed-income investments are spurring interest in structuring residential properties as triple-net leases.

It is these bondlike and passive landlord attributes that make triple-net leases appealing destinations for risk-averse investors—and especially alluring alternatives to 1031 exchange buyers—seeking to defer taxable income. And, as Ralston notes, “Leases in excess of a decade in duration bridge real estate and economic cycles.” And that’s a highly desirable sweet spot for many investors.

Jonathan Hipp, founder, president, and CEO of Calkain Cos. and coauthor of The Little Book of Triple Net Lease Investing, concurs. “There is a tremendous amount of capital sitting out there, and net leases are very attractive when looking at other fixed-income alternatives. A triple-net lease is really a corporate bond wrapped in real estate,” says Hipp.

Ralston cites the 1031 buyer as the biggest influence on the current triple-net market, in terms of demand and pace, noting that 1031 buyers must identify a replacement property within 45 days of the sale of the relinquished property. “Net-lease properties are easier and simpler to underwrite,” says Ralston, largely because the tenant is responsible for most expenses, including, in many cases, the roof and the structure of the building.

1031s Driving Cap Rates South

Geoffrey Faulkner, ccim, managing partner at NNNet Advisors in San Francisco, observes that cap rates are the lowest he’s seen in his career. “At the beginning of the year, everyone was wondering how they could go any lower, and the last two quarters, they have,” he says.

“It’s a tale of two property types. What’s driving cap rates down are the better credit deals with 10 or more years on them,” says Faulkner. “These are your household names—McDonalds, Wells Fargo, Walgreens. (In general, the higher the tenant’s credit rating, the lower the cap rate.) On the other side, deals that maybe have a bit of hair on them, whether it’s a lesser credit deal or shorter lease term, those are trading at a higher premium.”

Faulkner and California brokers are challenged by a lack of supply in part because the state’s NNN product is held by families and trusts. “The better West Coast product rarely trades,” says Faulkner, which means California 1031 exchange buyers are seeking higher yields outside the Golden State. As many as 50 percent of 1031 exchange buyers originate from California.

NNNet Advisors represented a California 1031 exchange buyer in the acquisition of a Christian Brothers Automotive in Sandy Springs, Ga., for $2.5 million. The lease had 14 years remaining on it and terms included a 15-year sale leaseback option. The company also represented the seller of a drive-through

Starbucks in Oklahoma City. This short-term lease (three-and-a-half years) fell out of contract a couple of times due to financing. “That’s what dragged out the deal. The price per square foot on a drive-through is very high. We had to comp that out,” Faulkner explains.

“I deal with buyers and sellers all over the country,” he adds, “and they always say, ‘I cannot compete with the California exchange buyer, because they will pay the most because they have to.’ ” Faulkner has noticed that institutional buyers and REITs that historically do not buy below 7 percent have settled for low cap rates. “Lately, I’ve seen them dip into the 6s, because they need to pay a dividend and their overhead.”

Deborah Vannelli, CCIM, director of net-lease sales for Upland Real Estate Group Inc. in Minneapolis, has observed the same scenario. “There have been quite a few 1031s, but even the 1031 buyers, as of late, have been competing with the family trust investors and the institutional buyers, and that’s primarily due to lack of product and demand. The institutional buyers and REITs need to achieve the goals they’ve set for Wall Street.”

Cap Rates on Triple Nets

In recent years, cap rates have trended down, averaging in the 5%–7% range last summer.

AVERAGE CAP RATES FOR MAIN NET LEASE SECTORS*

Net Lease Sector	July 2014	August 2014
All retail	6.95%	6.58%
Bank	5.63%	5.35%
Dollar store	7.88%	7.61%
Pharmacy	6.25%	6.29%
Automotive	7.08%	7.15%

**August 2014 Calkain Cos. Monthly Net Lease Trend Report*

Recent deals for Vannelli include a McDonald’s ground lease that the investor acquired from a developer: $1.6 million sales price, with a new 20-year lease that included 10 percent rent increases every five years and a 4 percent cap rate. “It is a ground lease so investors don’t have depreciation, but they definitely do have appreciation of the property, and the building would revert to their ownership at whatever time McDonald’s does not renew the lease. Many buyers prefer ground leases because the price point is lower, since they are not paying for the construction cost of the building. Even though it is a 4 percent cap rate, if they have rent increases every five years, it gives them a nice return overall.”

Vannelli points to the retailer “at the corner of Happy & Healthy” as a benchmark for NNN cap rates. “Walgreens is a good reference point throughout the years,” she explains. “For 20 years the stores have been selling pretty consistently, depending on location or timeline,” says Vannelli. Cap rates for the stores ranged from 8.25 percent to 9 percent in the 1995–1997 era, she notes, with the rates trending incrementally downward since then. The retailer’s high creditworthiness is coveted by triple-net investors, because regardless, the chain will pay its rent. Earlier this year, Vannelli closed a Walgreens with 18 years left on a triple-net lease at a cap rate of 5.85 percent. “Today, Walgreens is trading at a 5.5 percent cap rate. Investors who acquire a Walgreens treat it like a bond with real estate.”

Vannelli confirms that exchange buyers are driving down not only cap rates but also due diligence timelines. The high demand from all buyer types—1031s, family trusts, and REITs—drives higher prices and lower cap rates. Buyers of 1031 exchanges are tax-motivated and willing to pay more aggressive prices to ensure they satisfy their 1031 deadlines. Many triple-net lease properties have multiple offers with the investors offering a due diligence timeline of 14 days versus 21 or 30 days if paying cash for new construction properties. “Deals are closing at near or full asking price,” says Vannelli, “and some sellers will not provide a financing timeline because there are several cash buyers waiting for every 10 buyers that need financing.”

Triple-net Fundamentals

- When cap rates decline, listing prices increase
- Cap rates are an inverse measure of risk
- Cap rates track Treasury interest rates
- Longer lease terms mean lower cap rates
- Tenant’s creditworthiness + lease term affect the cap rate

Another recent sale for Vannelli was a Caribou Coffee with seven years on the lease term and rental options with rent increases. The buyer, a 1031 investor with financing, put 50 percent down. “The 6.5 percent cap rate worked because interest rates were low. The investor felt comfortable that the tenant would renew beyond the seven-year term,” she says.

The strong demand for triple-net lease properties keeps Vannelli prospecting—reaching out to developers and tenants she’s had relationships with for the past 10 to 15 years, as well as constantly calling developers of new properties. Not surprisingly, commercial brokers are reporting a lack of inventory. “It’s a seller’s market,” says Calkain Cos.’ Hipp.

A Generational Asset

In June, Calkain Cos. closed a record-setting lease on a newly constructed CVS drugstore in Tysons Corner, Va. The drugstore chain constructed the building, which sits on one acre of land. “It’s not uncommon for the tenant to build the building to get the depreciation in the triple-net lease world,” Hipp explains. The property was listed in the fourth quarter of 2013, but as interest rates rose, several 1031 buyers’ deals fell apart and the sellers took the property off the market. The property was relisted in early 2014 and garnered 10 offers, which were whittled down to three before the sellers opted for a buyer from the Middle East. The property garnered a staggering $24.7 million, or $1,915 per square foot, a record for CVS drugstores and a record low cap rate of 4.97 percent. “It’s a generational asset,” Hipp explains. This prized NNN will be “passed down to other family members,” adds Hipp, who along with two Calkain advisers represented the sellers.

The CVS deal follows on the heels of a March transaction in which Calkain Urban Investment Advisors completed the sale of the Dupont Circle Starbucks Building in Washington, D.C., a mixed-use net-lease investment, to an institutional private equity group, for $1,672 per square foot and 4.3 percent cap rate, another record low cap rate for this sector.

In Florida, Ralston recently represented a 1031 exchange in which a parcel of family-owned land sold for $3.5 million and the sellers were motivated to avoid a $1 million tax hit. There is an inherently narrow window for these deals, but they are "simple and easy to understand," says Ralston. "If you live in Florida, you can buy a Walgreens in Texas—you don't have to see it—and just collect the rent check. All [the buyer] cares about is the rent and how long the tenant will be there."

Still, triple-net leases are not without risks. For instance, an unfavorable environmental report may sink financing, or a tenant may go bankrupt. But as Calkain Cos.' Hipp says, "The reason triple-net leases work is you have real companies with credit ratings behind them." Against a backdrop of those what-if scenarios and a confluence of lack of opportunities and alternative fixed-income investments, the biggest challenge brokers face is finding enough product to satisfy the demand.

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