Day in the Sun

Investors Eschew Double-Net Leases, Demand Triple-Net, Longer Structures

By Keat Foong

The Takeaway

- ✔ Triple-net leases are becoming almost standard in the net lease space as a result of investor demand.
- ✔ In the low-interest environment, investors are turning to triple-net leases to offer an alternative to low-yielding fixed-income investments.
- ✔ Investors are also demanding longer lease terms and rent increases within the term of the lease.

The sun may have set on the day of the double-net lease—at least for now.

Net-leased retail stores coming onto the market today are mostly triple-net—even among brands that traditionally preferred double-net structures, according to Robert Miller, managing director of corporate sale-leasebacks at Calkain Cos.

"One of the trends we are seeing is a move away from double-net lease to all triple-net lease," observed Miller. New Rite Aid stores, for example, have become exclusively triple-net, and Dollar General, which used to sign mostly double-net leases, is now likely to go with more triple-net structures.

Investor demand is giving triple-net leases their day in the sun. Of all the net lease arrangements—single, double and triple—triple-net leases offer the greatest certainty of a fixed amount of income. Because of the low-interest-rate environment, investors are now looking to the relatively higher-yielding triple-net-lease investments to act as the fixed-income portion of the portfolio that may otherwise be supplied by mortgages or bonds, noted Michael Wippler, managing member of law firm Dykema.

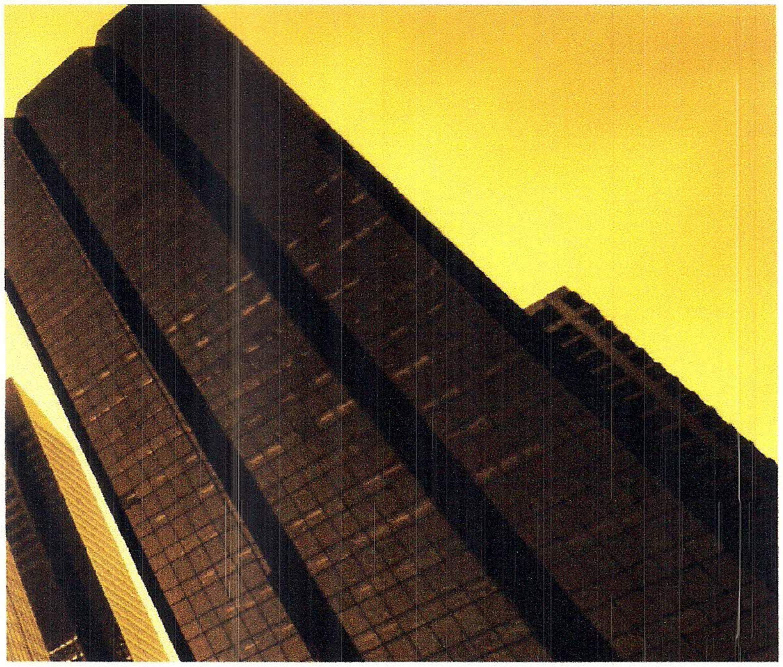
Institutional investors, 1031 exchange investors and REITs in particular are behind the demand for so-called "pure" net lease properties. Net lease REITs—such as Realty Income, National Retail Properties and W.P. Carey—especially benefit from the relative lack of operating costs with triple-net investments, as the renters pay all property taxes, insurance and maintenance. This leads to more predictable income.

In the words of Marilyn Kane, president & co-founder of Iridium Capital, a private equity investor that purchases such assets nationwide: "We are able to know the projection of distributions to investors. If we have to worry about unforeseen maintenance, that would affect our bottom line." The investment manager desires the low-maintenance nature of a true triple-net property, which offers it greater freedom to operate properties remotely. "We buy all over the country. We do not want to worry about having to replace a roof."

Of course, double-net properties are still very much a part of the marketplace. One reason is that double-net properties may be "cheaper" for buyers. And "preferred developers normally would like the buyers to accept some amount of ownership risk"—most commonly the risk of the roof and the building's structure in a double-net structure, said Miller. Nevertheless, triple nets are preferred in sale-leasebacks, as the increased investor demand translates to higher prices.

True triple-net-lease properties today are netting the lowest cap rates, assuming the tenant credit and location are also stellar. According to Patrick Nutt, managing partner at Calkain, at one end of the spectrum, McDonald's stores often trade at cap rates in the low- to mid-4 percent range. The company offers completely passive 20-year ground leases featuring periodic rental increases, as well as superior tenant credit, a corporate guaranty and primary retail locations.

On the other hand, without the desired lease structure, even with a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strong tenant credit rating and desirable property location, the cap rate for the property could be as much as 200 basis points higher, said Nutt. Starbucks leases offer a good example: The coffee house not only prefers to sign relatively shorter 10-year leases, it often requires the landlord to maintain the roof and structure, as well as "occasional other management functions, such as overseeing a full Common Area Maintenance billing" for utilities, snowplowing, et cetera.

So many buyers want to purchase only triple-net-lease properties, in fact, that those previously focused on retail are now willing to expand their search to office and industrial, according to Miller. The benefit: "Demand is not as intense on those properties, and you get a higher yield."

Regardless of property type, investors need to ensure the lease terms are what they purport to be. Many properties advertised as triple net are in fact not, said Kane. While her firm seeks true triple net and avoids double net, she said "listings often cite the property as fully net lease when in the small print the landlord is often responsible for the roof and structure. Those are not true triple-net properties."

Indeed, there are a variety of exceptions to the tenant's taking full responsibility for the property taxes, insurance and maintenance, noted Wippler. Therefore, investors need to be careful in examining the lease. For example, there may be terms that exempt the tenant from taking responsibility for paying for the real estate taxes if the taxes increased as a result of increased property valuation following the sale of the property. Or the tenant may be required to pay for maintenance items—for example, in cases where the window or door breaks—but be exempt from maintenance items that can be considered capital improvements that accrue to the value of the property—such as rebuilding a collapsed wall.

CONTRACTS:
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Stronger Terms Required

Responsibility for expenses is not the only point of concern for investors today. They continue to emphasize longer lease terms, as well. Most lease terms are 15 to 20 years, with the minimum lease term being 10 years, said Nutt. Now that the economy appears to be improving, there is a tendency among the tenants, especially fast-food joints—such as KFC, Burger King and Wendy's—to secure leases tending toward longer terms, said Nutt. For example, instead of 10 years, the terms are now 15 to 20 years.

Twenty-five-year Walgreens leases are very popular, as they provide long-term investors with peace of mind, commented Kane. Although Iridium holds its properties for about three years, the company does not purchase leases with less than 12 years remaining. Nevertheless, Nutt noted there is a slight counter-trend among the top-rated tenants holding very long-term leases: Walgreens is shortening its terms from 25 to 20 years in order to gain more flexibility. However, a total 75-year term, consisting of an initial term and renewals, has remained in place.

Investors are also starting to demand that rent increases be carried within the term. "It used to be leases would carry a flat rent rate," said Miller, and the rent would be increased only upon the lease's expiration if the tenant exercised its renewal option. Now, "there are more rent bumps, by a stated amount every year or every five years. Rent increases of 2 percent per year are not uncommon," he said. Thus, rent increases of 10 percent every five years are pretty standard, added Nutt. If the tenant declines this arrangement, insisting on increases only upon lease renewal, they may end up with a higher rental rate.

Either way, most leases today provide for options to renew for the tenant's benefit. "It is 100 percent up to the tenant whether it wants to renew," said Nutt. "The option allows the tenant to control its destiny." In the majority of cases, there is a minimum of two to three options to renew for three to five years at a time, he said. There is also a small trend of adding a few more options, taking the total to four or five renewal options. And more landlords and tenants are executing early lease renewals, extending the length of the leases as they realize that longer leases could result in a higher value for the property, said Nutt.

Securing leases containing long terms and credit tenants not only produces a more secure investment, it can also result in more favorable financing for the investor. According to Jeffrey Hudson, principal at George Elkins Mortgage Banking Co., tenant credit ratings that are greater than triple-B and long-term leases—such as a 25-year lease with a U.S. government agency, for instance—could allow the lender to underwrite the loan based on the credit of the tenant rather than on conventional real estate cash flow.

Thus, the loan would be underwritten like a bond, with a low interest rate and loan-to-value of as much as 90 to 95 percent. The condition would be that the length of the lease would have to be co-terminous with the term and amortization of the loan. CPE