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Can’t Find Enough Cash Flow In the Stock Market? Maybe a 'Triple-Net Lease' Is Your Answer

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Maybe you are getting your finances in order for retirement. Maybe you own real estate that requires a lot of oversight and you would prefer to be invested in an asset that requires less hands-on attention. Maybe you do not own any real estate, but have recently obtained funds and are seeking an investment that creates reasonable returns and cash flow.

If any of these scenarios describe you, you may want to consider investing in real property leased to a tenant in which the relationship between the investor/owner/landlord and the tenant is based on a "triple-net lease," also known in the commercial real estate world as a "NNN lease." A NNN lease, in its purest form, is an agreement whereby the tenant or lessee agrees to maintain the property and pay all the costs to do so, and also to pay all real estate taxes and insurance on the leased premises, in addition to the rent. In theory, all the landlord has to do is sit back and collect and deposit each rent check.

Assuming you have a pure NNN lease, there should be little or no management responsibility for you as the landlord. Generally the improvements on the property will be new or almost new. In addition, the quality of tenants is often high. Given all of these advantages, investing in property associated with a NNN lease may seem like the perfect investment; but like any investment, there are risks. There are many nuances to a NNN lease. You will need to analyze each of them to determine if a NNN lease is right for you.

Below is a list of a few of the key issues you should consider when investing in a NNN lease:

- Financial Strength of Tenant. The value of your investment will be primarily based on the rent payments required by your lease, thus the financial strength of your tenant is paramount. You, or your advisors, will need to investigate the tenant to ensure that it can fulfill its obligations under your lease, including the rent payments.

- Credit Enhancements. If your lessee is a new company, or otherwise does not have a proven track record of financial strength, it will be to your advantage to require the tenant's obligations to be guaranteed by a financially strong third party.

  For example, the typical tenant in a NNN lease is a franchisee of a fast food chain. Generally, the preference would be to have the fast food chain itself, such as McDonald's Corporation, guarantee the franchisee's obligations. Another option would be to have the franchisee's individual owners guarantee the lease, but you will need also to investigate the ability of those individuals to perform the tenant's obligations under the lease, including making all rent and other payments if the franchisee-tenant fails. You may also investigate whether the tenant can provide you with a letter of credit that you can call upon for rent payments if the tenant defaults. However, you should expect your tenant to negotiate a lower rate of return on a lease that includes a strong guarantor due to the perceived lower risk involved.

- Understanding Assignment/Control. Not only is it important for you to investigate your tenant's ability to make the rent payments, it is also important to ensure that the tenant you approved remains the tenant throughout the term of your NNN lease. In North Carolina, leases are freely assignable unless the lease states otherwise. You should include in your lease a provision prohibiting your tenant from assigning the lease and/or subletting any of the leased premises without your prior written consent. Furthermore, it is also important to include provisions that prohibit your tenant from having a material change of control or ownership because you are likely relying on the particular individuals operating the tenant to make it a success and be available for payment if it isn't.

- Confirming Your Lease is a NNN Lease. A pure or absolute NNN lease is one where your tenant pays all real estate taxes, insurance, and maintenance on the property. However, occasionally the marketing materials for a property may claim that a NNN lease is in place, but in reality, the lease may put obligations on the landlord.

  For example, marketing materials may claim a NNN lease is in place, however, the lease may require you, as the landlord, to maintain the structural components, roof, and foundation of the leased premises. This type of lease is sometimes called a "double net lease," or a "NN lease." There is nothing wrong with investing in a NN lease, as long as you understand the lease terms to ensure that your investment is within your level of risk tolerance and willingness to be an active landlord with responsibilities beyond just accepting rent and monitoring your tenant's performance of its obligations.

- Surrender of Premises. It is important for you to understand your tenant's obligations at the expiration of the lease. Some leases require the tenant to return the property to the same condition as existed when the tenant took possession of the property. On the other hand, some leases allow the tenant to walk away from the property at the expiration of the lease and leave remnants of its possessions behind, some of which may be valuable to you but much of which (cut computer and telephone cables and peripheral equipment, signs, etc.) is likely of little value to you or a potential new tenant and may even be expensive to remove. You must carefully provide in your lease what the tenant must do at the end of the lease term so you will know whether you will need to invest capital to get the property back into a condition to be sold or leased to another tenant.

- Dark Value vs. Capitalized Income Value. When you purchase a property associated with an already existing NNN lease, the value of the deal to you as an investor is based primarily on the value of the income stream the property can generate for you, expressed as the "capitalization rate" (also known as the "cap rate"). The cap rate is the ratio of net operating income to property asset value. For example, if a property is listed for $1,000,000 and the property generates a net operating income of $100,000 per year, then the cap rate is 10% or a "10 Cap."

  A nice cap rate is fine for the duration of the NNN lease. But what is the value you will be left with when the lease expires? You must consider, therefore, that at the expiration or termination of your NNN lease, the "dark value" of your property may become substantially less than similar properties with a NNN lease, and your property, which now has some age on it and wear and tear, may not be able to attract another NNN lease. You would then need to decide whether to attempt to sell the property "dark," without a tenant, or find a new tenant for the property. Depending on the cap rate, lease term, your age, and your goals for the investment, this issue may be of great concern.

Conclusion

The issues discussed above are just a few of the many that you should consider when deciding whether to invest in a property subject to a NNN lease. Like all investments, NNN leases involve risks, but can be strong assets in your portfolio. Most investors will need a team of advisors, including an accountant, commercial real estate lawyer, and commercial real estate broker to assess the deals available. Reaping the benefits of a well-drafted NNN lease could provide a great income stream for many years.

Are you looking for an investment that produces reasonable cash flows with relatively little active involvement? For many investors, the advantages of investing in real estate associated with a "Triple Net Lease" or "NNN lease" are appealing.

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