

Cash Flow Now or Appreciation Later?

The Financial Power of a Single Tenant Triple Net Property

Twelve years ago, a client of mine who was 69 years old, exchanged a few apartment buildings for a newly constructed property leased for 20 years by the Walgreens Corporation. About a year ago, he traded up into a larger property that was also leased by the Walgreens Corporation. Over his 12-year period of ownership, he doubled his original down payment and collected approximately \$660,000 in cash flow. He never needed to visit the property and spent an average of an hour to two hours per month handling the bookkeeping. No other management efforts were required during his 12-year period of ownership.

For some apartment building owners, exchanging into a single tenant triple net property can increase cash flow by as much as 30% and cut all property management-related tasks to less than two hours per month. It also gives investors an opportunity to own a property that is less than a year old. Values of single tenant triple net properties have dropped almost 30% over the past few years even though the income has remained the same. Values for single tenant triple net properties reflect the lowest pricing on a cap rate basis in almost 20 years.

I am not saying that single tenant triple net buildings are better than apartment buildings. Krupp and Company has specialized in Bay Area apartment building brokerage for over 20 years and continues to expand in that respect. Single tenant triple net properties offer more cash flow now, and for some investors, more cash flow now can be advantageous.

In this edition of the Krupp Report we are going to discuss

some of the advantages and risks of single tenant leased properties and some strategies to help reduce risks. In particular, we will discuss:

1. What a single tenant triple net property is
2. Which buildings, tenants, and lease types to avoid
3. Capitalizing in a buyer's market—finding a suitable property to acquire

We will also discuss strategies for obtaining the best loan, and the cash flow one can expect from a typical acquisition of a triple net leased investment.

Single Tenant Triple Net – Definition

“Single tenant” is exactly what the name implies—one building with a single tenant. One does not own or manage the business that occupies the building. You are the landlord, a corporation is the tenant. These properties can stand alone or they can be in a parking lot of a larger shopping center. In both cases, they are separate parcels and separately owned.

“Triple net” refers the type of lease that exists between the landlord and the tenant. Under a triple net lease, the tenant pays you a monthly rent. In addition to the normal monthly rent, the tenant also agrees to pay property taxes, property insurance, water, gas, electric, garbage, maintenance, repair, and any needed replacements, i.e., new roof, exterior paint, etc. The monthly rent you receive is “net” of all operating expenses of the property. This can be a hedge against inflation as rising operating expenses are all absorbed by the tenant.

Over a 20- to 25-year lease term, which is not uncommon for a single tenant triple net lease, the savings can be significant.

Total management and bookkeeping has been reported to be less than two hours per month. No professional management needed.

Selecting a Tenant

The term “selecting a tenant” in this report can be misleading. One doesn’t have the opportunity to choose which tenant goes into the building you acquire. Instead, you choose a property based on the tenant that already occupies and leases a building. For example, if you were to identify Wal-Mart as an acceptable tenant, then your search for properties would be for buildings that are already occupied and leased by Wal-Mart.

Knowing the typical lease structure you can expect with a given tenant and financials before commencing a search for properties is extremely important. It is costly to go through the exercise of locating a property, negotiating the contract, and performing due diligence only to find out that there is a provision that puts roof replacement as an expense of the owner instead of the tenant. A good broker can provide you with this data so you know what you are getting into before you make the offer.

Financial information can be obtained from the tenant and various other sources. If a tenant is traded on the stock market, you can obtain a report from your stock broker or Dunn and Bradstreet. Reports are also available from various analysts usually for less than \$50. Some buildings leased by larger tenants are buildings leased by:

- Corporate guaranteed Burger King, McDonalds, IHOP
- CVS Caremark
- FedEx
- Walgreens
- Wal-Mart

Buildings leased by riskier tenants offer higher returns but also pose difficulty obtaining a loan for acquisition. Riskier tenants have lower cash reserves, smaller financial statements, and include franchise tenants and smaller regional companies.

Finding a Property to Acquire

When the client I mentioned in the beginning of this report decided to trade up into a larger property, he wanted a brand new building leased by Walgreens with a new 25-year lease. We reviewed an array of locations ranging from downtown of major cities with premium pricing to more remote locations.

My client decided the best location/pricing combination for him came from areas just outside a major city. I was able to identify a few demographics for the type of areas my client preferred. One of the demographics included a criterion of 5,000 people within a 1 mile radius of the property. With this criterion I was able to locate approximately 240 buildings across the U.S. that was leased by Walgreens. After applying another level of screening criteria, I reduced the list of 240 down to 29. I then drafted 29 low-ball offers in the form of a letter of intent and sent them out simultaneously to the various sellers or brokers.

This put my client at a negotiating advantage he had never experienced. My client and I negotiated hard and kept pushing sellers lower and lower on price until the list of sellers we were negotiating with dwindled to four. Out of the list of four, there was one standout location which my client chose to purchase. At the conclusion, my client was thoroughly satisfied that he negotiated the best overall deal in the country.

Obtaining Financing

A good real estate agent who is representing you in the purchase of a property should know at least three or four mortgage brokers that specialize in obtaining loans for triple net leased properties. When I obtained financing for my client in the Walgreens example, I was working with loan brokers out of Florida, New York, San Francisco, and Texas. I made the loan brokers fight over the opportunity to procure the loan for my client.

Returns

Targeting some of the larger, more stable tenants, one can expect an acquisition cap rate from the high 7% to low 8%. Interest rates on acquisition loans for single tenant triple net properties at the time of print range from 6.25% to 7%. This means that you can expect an approximate return of 8% of your down payment. In simple terms, for every million dollars of down payment, you can expect about \$80,000 per year cash flow after loan payments. This can vary a bit depending on timing, loan to value, etc. For example, if you have \$3 million in equity in an apartment building you want to exchange for a single tenant triple net property, your cash flow after the exchange would be 8% of \$3 million, or \$240,000 per year.

Common Concerns

“I need a property I can drive to and see it when I want to.” If it were me, I would want to own a building in a vacation area so I can write off my trip when I go see the property. Consult your accountant for tax details, but in reality there are more efficient ways to monitor the condition of your building.

One efficient way to monitor the condition of your building is to hire a local building inspector every few years to inspect every component of the property. The report will tell you if the tenant is code compliant and identify any maintenance or replacement issues. If any issues requiring action exist, send the report to the tenant and request work to be completed.

“What if I buy a building and the tenant is not profitable at my location?” Unless there is a provision in the lease to the contrary, the corporation that guarantees the lease is legally responsible to pay for the full term of the lease. This obligation remains irrespective of the profitability at a particular location. For example, if McDonalds Corporation guarantees your lease, the security of your rental income, among other things, is dependent on the profitability of the McDonalds Corporation as a whole, not just the profitability at your location.

Summary

Diversifying your portfolio with single tenant triple net leased properties is easier to do than with other property

types because of lower management requirements. One can acquire multiple properties, in different states, each with a different tenant. Triple net leased properties may not appreciate as quickly as apartment buildings; instead, they offer higher cash flow from the first day of ownership.

For estate planning, triple net leased properties can solve a number of issues if your heirs are not real estate savvy. One client of mine has three heirs with minimal property management experience. My client decided to exchange one large property for three separate triple net leased properties—one for each heir—making the division of assets easy, and solving the issue of minimal property management experience.

Krupp & Company is dedicated to providing information without an agenda. In other words, you don't have to be ready to buy, sell, or exchange right now to benefit from my services. I've worked with countless people who did not become clients until as many as 10 years after our initial contact. I take the long-term approach, which in the end makes good business sense not only for us, but also for you.

For more information about single tenant triple net properties or for market information concerning your apartment building, visit www.kruppco.com or contact me directly at 408.356.2845.



Please see page 4 for a list of properties for sale.

KRUPP REPORT

Partial List of Properties for Sale:



WALGREENS
25 year NNN lease
S&P rating A+



BRIDGESTONE/FIRESTONE
15 year NNN lease
S&P rating BBB+



WALMART
15 year NNN lease
S&P rating AA



AUTOZONE
20 year NNN lease
S&P rating BBB



NATIONAL TIRE & BATTERY
25 year NNN lease
Subsidiary of Sumitomo
S&P rating A



ARBY'S
20 year NNN lease
S&P Rating B+



DAVITA
15 year NNN lease
S&P rating BB-



CVS CAREMARK
25 year NNN lease
S&P rating BBB+



MCDONALDS CORP
20 year NNN lease
S&P rating A



BEST BUY
10 year NNN lease
S&P rating BBB



STAPLES
15 year lease
S&P rating BBB



KOHL'S
20 year NNN lease
S&P rating BBB+

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