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Time to Trade Your MultiFamily Property into a Commercial or NNN Property?

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Many real estate investors are transitioning from Multifamily investments to commercial and NNN investments. Why are they doing this? Because they are tired of dealing with the day-to-day challenges of managing residential properties. This pace has accelerated over the last two years as residential tenants have been unable or unwilling to pay rent as a result of COVID and governments have instituted new landlord tenant laws that make it more difficult to manage property and limit rent increases by instituting rent control laws.

While residential investments offer the ability to increase rents as expenses increase, properties with NNN leases shift the payment responsibilities to the tenants, reducing risk for the owner of the real estate. As Residential CAP Rates keep dropping, they tend to be in line with NNN leased properties.

Of course, it's not as simple as it sounds. With this article we hope to create a primer that will help investors make the decision of selling residential properties and shifting into other real estate investments.

What kind of lease formats exist in the commercial building marketplace?

There are a variety of income producing properties available to trade into with different kinds of lease options available for commercial properties such as: gross, modified gross, double net, triple net, absolute NNN leases and ground leases. Read on to better understand the varieties.

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Gross Leases

Office buildings and some commercial buildings tend to have gross leases. With a gross lease, the Landlord is responsible for everything having to do with operating a commercial property. In other words, the landlord pays for:

- Taxes;
- Insurance;
- Maintenance on the interior and exterior;
- Utilities;
- Management; and
- Other operation related expenses.

Modified Gross Leases

A modified gross lease is determined during the negotiation process where the tenant takes on a proportional share of some of the costs associated with the property, such as property taxes, utilities, insurance, and maintenance. For example, a restaurant might have a gross lease, but pay for all of the utilities (water, sewer, electrical) because they use proportionately more than any of the other tenants in that building. This make it a modified gross lease.

Range of Net Leases

Triple net leases are popular among investors who want a low-risk opportunity to build equity and also make a steady and reliable income from the property at the same time. Because many of the operating expenses are passed on to the tenants, owners of NNN properties face less operational risk. Passing on the operating expenses and taxes to the renter, landlords pass on variable expenses they do not have control over.

Net leases offer property owners some key advantages, like:

- Long-term tenants who are invested in the location of the property.
- Minimal management.
- Investment stability.
- Asset flexibility.

Frequently, when an investor purchases a net leased property, there may be a lease already in place which outlines all the specifics of the deal, complete with clauses that outline exact financial responsibilities of both the tenant and the property owner.

Double Net Leases

In this lease format the tenant agrees to pay the cost of two of the three primary expenses, Property Taxes, Insurance or utilities for example. Sherwin Williams is a company that typically executes NN leases.

Triple Net Leases

With a triple net lease, a long-term lease is executed with a national tenant, which has a solid credit profile and a proven history of success. These leases range from five (5) to thirty (30) years in length, with increases of ten (10%) - fifteen (15%) at five-year benchmarks. They also often include additional five-year options to renew.

These properties tend to have a range of CAP rates that take the risk of the investment and the demand for the property into consideration.

CAP rates range from 3.5% - 9% for these properties.
The lower the CAP rate the lower the risk and the lower the yield. The higher the CAP rate the higher the risk and the higher the yield. Typically, national tenants (i.e., McDonalds, Federal Express) have lower CAP rates, if they are located in major cities.

When executing this kind of a lease with local or regional tenants that sign leases (without national bondable credit) should have their credit checked before a lease is executed to minimize risk to a property owner. Solid legal representation should be engaged. In other words, pay the money for an attorney to draft the lease, one that is focused primarily on real estate leasing and sales. Do not hire your business attorney or criminal law attorney to do it unless they have the additional real estate experience.

How Does a Triple Net Lease Work? More Specifics.

Triple net leases are typically used for retail, industrial and office properties. In a triple net lease, the tenant agrees to pay the property owner a set monthly rent payment for using the building/s. Instead of having the property owner pay operating expenses the Tenant pays those in addition to the base rent. These expenses may include:

- Property Taxes and Insurance Premiums;
- Property Maintenance and landscaping;
- Parking lot care and upkeep;
- Utilities;
- Management; and
- Any other Operating Costs.

What is a Absolute NNN Lease?

An absolute NNN lease, also known as a bondable lease, is an agreement between a commercial property owner and a tenant, in which the tenant is responsible not only for monthly rent of the building, but also all the expenses of that property as well.

The biggest distinction between a triple net lease and an absolute NNN lease is that triple net leases often don't include repairs to the structure, roof and asphalt as tenant responsibilities. These expenses are passed on to the tenant in an absolute NNN lease.

What is a NNN Ground Lease?

A NNN ground lease is an agreement between a landowner and a tenant, in which the tenant leases land for a new building (i.e., McDonalds, Chik-fil-A, Federal Express). The building may be constructed by the business owner or a developer and then owned by the business. The lessee is the owner of the building only, not the land and is responsible for all the expenses and costs associated with constructing, maintaining, and operating a business location on a leased piece of land.

This type of lease is often driven by the strength of the location, the traffic count or visibility. The Property Owner is the owner of the land only and cannot depreciate any building expenses. These are usually opportunities, where the owner wants to keep the land for the long term.

Absolute NNN ground leases are usually very long-term (lasting anywhere between 50 and 99 years). If the tenant defaults or the term of the lease expires, then the landowner can take over ownership of the building on their land as well and lease both.

Things to watch for as you make the decision to buy a net leased investment

- Make sure to carefully read lease terms to clarify the differences between Triple Net and Absolute NNN Leases.
- Make sure that a vacancy rate, reserves and property management are imputed in the financial analysis of the deal, and if not, the appraiser will. You need to adjust your purchase price to take it into consideration if the market allows it.

Things to watch for as you make the decision to buy a net leased investment (continued)

- When buying a NNN property, investors need to review the previous thirty-six months of profit and loss summaries. Double check everything. Properties may be marketed as absolute net when in fact they are double net or triple net instead.
- Listing agents may advertise a property as a triple net property, believing that all building expenses are the responsibility of the tenant, only to find out later that the costs surrounding roof repairs, parking lot or structural work to the building are their responsibility.
- This can not only cause a potential purchase to fail late into the deal, but it can also present a huge (and unanticipated) financial burden for the buyer whose 1031 fails because the deal is not structured as advertised.

How to Navigate Net Lease Commercial Real Estate Successfully (and Suprise-Free)

Here are a few tips to use to help navigate your due diligence as you are deciding on your next commercial property move.

- Do your research and narrow down what type of property you are looking for. Think about which locations will be most attractive to long-term net lease tenants.
- Pay attention to the particulars of every listing, and always ask for clarification on the details of any existing lease in place with a tenant.
- Don't nominate a property for an exchange until you are totally sure of the lease terms.
- Read the fine print so you know exactly what type of lease is in place, and what responsibilities belong to you and which are passed on to your tenants.
- CAP rates range from 3.5% - 9% for these properties. The lower the CAP rate the lower the risk and the lower the yield. The higher the CAP Rate the higher the risk and the higher the yield.
- Know your leases and understand which kind of net lease is one that is going to be most beneficial for your long-range investment plan.

Once you have purchased the property you will want to inspect it annually, just as if you owned any other real estate. If you cannot get there, hire a property manager. Some NNN tenants are not well organized and do not service their building or hire a landscaper (even if it is called out in the lease). You need to enforce the terms of the lease in case the tenant does not follow the terms of the lease.

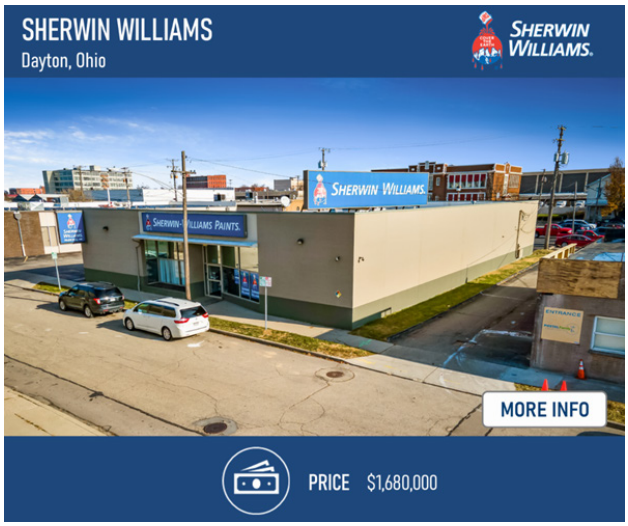
NNN properties can be relatively risk free if you do a deal with a national tenant. However, that may not be the case if you have a lease with a local or regional tenant. Never assume that the national tenant will stay to the end of their lease term. Always buy a mission critical location, one that makes money for the tenant and insures they are not motivated to move.

Sample Properties

The following are sample properties to illustrate the opportunities available for net lease commercial real estate investments.

Ground Lease Sample Property

NN Lease Sample Property



Absolute Net Lease Sample Property

NNN Lease Sample Property

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