

# KILPATRICK & COMPANY

Investment Real Estate Brokerage

## **An introduction to NNN leased investments** **By James Kilpatrick, Managing Broker of Kilpatrick & Company**

There are articles and buzz everywhere about the surging popularity of the tax-deferred 1031 exchange: Selling a property and buying another with a short amount of time to defer all capital gains taxes. Net leased investments are the single most popular exchange option for people wishing to avoid management responsibilities without giving up their cash flow. I will visit some of the basics of what people look at to evaluate these opportunities.

Generally return, location, tenant strength, building and lease are the most important factors. If any one of those aspects is truly lacking it can be enough to sour the whole investment, but there is almost always some give and take between them.

Return is generally measured as a cap rate (capitalization rate). This simply means the net income divided by the price. In other words, if you buy a \$1,000,000 building and it gives you \$60,000 in income per year, you have a 6% cap rate. Depending on which part of the country and what type of neighborhood one buys in, cap rates will generally be between 5% and 8% for most secure investments.

While net lease investment marketing material tends to emphasize the lease and return, location is still very important in any real estate purchase. Income levels and other demographics, surrounding competitive tenants, overall barriers to entry and development levels all are good indications of where the real estate market is headed long term. They also help you assess whether you could replace the tenant if necessary.

Ideally you will not have to replace the tenant. Most net leased investments have a strong tenant on a 10 to 20 year lease. This makes tenant strength extremely important, because if a tenant goes completely insolvent and declares bankruptcy they may walk away from their lease leaving you with a vacant building instead of the 20 years of rent you expected. Standard & Poor's is a company that rates the financial viability of various companies. While it's no guarantee it is some assurance that a respected professional organization has weighed in on the likelihood that a certain company will meet its immediate and long term obligations. For a non-public company if they will release their profit and loss statements you can come up with your own opinion perhaps with your accountant or financial advisor's help. You should also weigh their business sector and their business model, along with whether they operate 100 locations or 2 and have a solid record. There are other measures and companies such as Dun & Bradstreet that will help you evaluate a private company.

Evaluating the building is important. Even with new construction, any plans you can get your hands on will help, but physically looking at the building is essential. For example, if you hate the way a particular fast food restaurant looks, perhaps people won't eat there, it might be more difficult to lease it, and it might be more difficult for you to sell in the future. Many lenders will require a Phase 1 Environmental study. This gives you a pretty comprehensive report of any environmental contamination risks. With new construction, a survey and as-built plans are extremely helpful and sometimes required by the lender as well. While not common, you should still hire a professional inspector if you feel that the building may have construction defects or other problems.

One of the most important parts of a Net leased investment is the lease. This is often a 20-80 page document. It is the only roadmap you have to detail the 10-20 year tenant-landlord relationship you are about to enter! If the lease says very clearly that the tenant is responsible for everything—that's great. If it says you are responsible for gutters, drains, HVAC, roof, structure, parking lot striping, and insurance, then you are. It is common and acceptable for a "net lease" to include landlord responsibilities for certain items, but you should understand that up front. You should read your lease word for word, and if you can't understand it, you should consider hiring an attorney to read it and discuss it with you to make sure it says what you think it says.

This article is a general introduction to net leased investments only. Net leased investment loans are very different from other loans, and there are other complex issues to consider. If you are contemplating buying or selling a net leased property, do your research, consult appropriate professionals and don't skimp on the time, energy, and money you put into making an educated decision.

*Please keep in mind that my area of expertise is Real Estate Brokerage. The tax consequences, exchange validity, accounting rules and legality of various strategies are best discussed with the appropriate professional. I have several that I will be happy to recommend. If you missed last month's installment, you may contact me for a copy of the last issue.*

*James Kilpatrick: Direct: 510-844-3647 or Cell: 510-290-9647 Email: James@JamesKilpatrick.com*