Triple-Net Leases Provide Safety

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Mention you're a physician to anyone within earshot and you will be barraged with a slew of health-related questions. Mention you're a commercial real estate broker and only one question comes to mind: How is the market?

That is a question whose roots date back to the first time the Garden of Eden was sold. The question is similar to asking a chess grandmaster: "What's the best move on a chessboard?" It's a shifting transactional marketplace. Over the years, each asset class—retail, office and multifamily outperform each other, only to fall out of favor, then back in vogue on investor's radar screens.

In the early 1990s when builders were constructing strip centers on every corner, one out of eight retail stores became vacant in Suffolk County. Then came the proliferation of the big box category killers, such as BJ's, Costco and Target, which competed in central business district areas with the local neighborhood stores by offering one-stop convenience. Today, the regional mall is evolving into the new CBD---offering entertainment, banking, restaurants, etc., all under one roof. Intense competition still exists in the suburbs between outlets, strips and chain stores, but the greatest challenge facing retailers is not the billion-dollar super stores, but the growth of the Internet shopper. In 1999, there were 83 million Internet users in the US and that number is expected to rise to 165 million by 2003.

> **Triple-net leases allow the investor to COMPUTE WITH CONFIDENCE a more PREDICTABLE RATE OF RETURN.**

Even office buildings have lost some of their cachet due to sector consolidation, corporate downsizing, continuing tax hikes, skyrocketing insurance costs and rising electricity costs. One example is Cablevision, which is marketing 300,000 sf of class A office space for sublease in Jericho, NY. With operating expenses now topping $12 a foot in some parts of Nassau County significantly reducing the bottom line, an increasing number of high net-worth individuals, pension fund advisors and REITs have been searching for greater portfolio diversification.

Conditions that following September 11 and the subsequent stock market meltdown have created a new conservative breed of risk-averse investors looking to alter their multi-tenant operations, resulting in heightened interest from investors on a 'flight to quality' to the safety of an absolute triple-net leased property, guaranteed by investment-grade corporations. A definition of a 'rated' tenant might be one whose credit has been verified as excellent, in other words, rated AAA by credit-rating agencies such as Standard & Poor's. Typically, in a triple-net lease transaction, the tenant or lessee is responsible for the direct care of a property and also must pay all of the expenses related to building operations. It's also the most secure lease structure for a passive or absentee landlord, as the tenant takes over all management responsibilities. Pricing on net-leased projects is based primarily on the lessee's credit, lease term and the desirability of location, or in other words, a property's demographics.

For example, take the sales of two net-leased drug stores on Long Island—one located on the North Shore and the second located in Hicksville, with an aggregate price of $6.7 million. Both properties traded at above market yields, due to the abbreviated lease terms (under 10 years on the primary). Today's prototypical new drug stores are free-standing with drive-through windows, 20-year lease terms, offering convenience to families, seniors and other residents.

Another instance of a safe investment that earned excellent yields and proved successful for both the buyer and the seller involved a national daycare center. The firm desired to consummate sale/leaseback transactions for a number of their properties on Long Island. The asking price had been established utilizing a cap rate of 8%, with 8% increases every five years during the primary term of 15 years.

While demand continues to exceed supply in all asset classes, in a volatile market, triple-net leases are becoming more popular with lease durations of 20 years or more, bridging economic cycles and allowing the conservative investor to compute with confidence a more predictable rate of return. ◆

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