Thompson Coburn LLP
Real Estate News Alert

Understanding Triple Net Leases

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Understanding Triple Net Leases

There is a thriving niche in commercial real estate for what are commonly called "triple net leased properties." These transactions most commonly involve fast food restaurants, convenience stores or some other franchise-type business operating at the property, but can also involve significant office, manufacturing and industrial properties.

A "triple net leased" property is one where the tenant under the lease is solely responsible for paying all taxes, insurance and repairs/maintenance that may be necessary during the lease term. A property that is leased "net" of the landlord having any obligation for these obligations is called a triple net leased property. All the landlord does is collect the rent check each month during the lease term. The landlord has no obligation to perform any work or repair at the property.

A "net, net, net," or "triple net" lease where the tenant has national credit, is also known as a "bond" lease, because the monthly rental payment received by the landlord is just like getting an interest payment each month on a bond debt instrument.

With the depressed yields available to investors during the past five years from conventional bank deposits, many investors have taken to purchasing a property that is subject to a triple net lease, to invest a portion of their available cash. At closing, the purchaser then takes an assignment of the lease to capture the future rental stream during the duration of the lease and the corresponding yield on the investment.

Real estate subject to a triple net lease is sold on a “cap rate” based on the creditworthiness of the tenant. The “cap rate” is the capitalized annual rate of return that the marketplace requires for there to be a purchase of the property. The lower the risk of bankruptcy or default by the tenant, the lower the cap rate. As the cap rate goes down, the purchase price goes up.

For example, assume a fast food property is for sale for $1 million, with a triple net lease in place, and the tenant under the lease pays net rent to the owner of $50,000 per year. This is a 5% rate of return ($50,000/$1 million), otherwise called a “cap rate" of 5%. Cap rates on triple net leased properties can vary from 4% to 10% depending on the tenant’s creditworthiness, because, remember, if the tenant goes bankrupt or defaults, then all rent payments stop to the property owner.

An investor seeking yield may choose to purchase this property and get a 5% return on his $1 million in lieu of buying a $1 million certificate of deposit from a bank that only pays half of 1% annual return.

A triple net lease often has a term in excess of 10 years, with multiple renewal options in favor of the tenant. In purchasing a triple net leased property, an investor can lock in a rate of return that is significantly higher than the interest currently being paid on a certificate of deposit at a bank.

There are significant and unforeseeable risks, however, in purchasing triple net leased properties. These include;

i) **Interest rate risk.** Net leased properties are often purchased for all cash by investors because the purchase price is low, often being between $850,000 - $2 million. If, however, an investor takes out a loan to finance the purchase of the property, say at 4% interest, to get a 6% yield from the rent, the investor is at risk, upon refinancing the property, that the loan rate has risen above the rent yield. A 7% interest rate on a loan, when the rent is only yielding 6%, results in a 1% negative cash variance each year.

ii) **Bankruptcy risk.** Even a tenant with a once-solid business model can go bankrupt (think Blockbuster video locations). Since triple net leases are for a long duration, much can change over time (Walgreens leases can typically have a lease term, with options, of up to 75 years).

iii) **End of Lease Expenses.** When the existing triple net lease term ends, re-leasing or re-positioning the property for a new tenant can be expensive and time consuming. There are significant costs to finding a new tenant, including tenant improvement costs and commissions due.

Nonetheless, triple net leased properties remain an immensely popular alternate investment for many investors. Such properties are relatively easy to purchase, often sell quickly due to demand for such properties and have no landlord obligations, unlike many other types of commercial real estate investments.

The Real Estate Group at Thompson Coburn assists clients in triple net leased property transactions across the entire country and has most recently been very involved with these transactions on the West Coast. For more information on the advantages and disadvantages of triple net leased properties, please contact:

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