©iStockphoto.com/Oktay Ortakcioglu

Trends in Net Leasing

Practical Law Real Estate

Over the past year, leasing in most major and secondary markets has seen a major increase in activity. Given the cyclical nature of the real estate market, this recent upturn is not particularly surprising. What is surprising, however, is that the triple net leasing platform has emerged as one of the fastest growing, most well-capitalized acquisition structures in the US.

Net leasing, which was once a sub-category in the leasing market, has seemingly taken over. The rise of net leasing has been particularly notable in industries such as retail, stand-alone restaurant and medical. In fact, the average per square foot price being paid for single-tenant net leased retail properties in 2015 has surpassed the pre-recession highs of 2007. No longer just a niche, net leasing is now a vibrant and growing $60 billion industry.

WHAT IS A NET LEASE?

In a net lease, tenants pay their base rent plus some or all of the property expenses relating to the leased property (pass-through costs) as additional rent. Depending on the type of net lease, these pass-through costs may include operating expenses, taxes, insurance and other additional costs related to the premises. The tenant either pays:

- Directly for these costs (typically when the tenant leases an entire building).
- The landlord for its proportionate share of these costs based on the square footage leased by the tenant in relation to the entire building.

A triple net lease (also known as net-net-net), is a net lease where the tenant typically pays:

- Base rent.
- Real property taxes.
- Building insurance.
- Maintenance costs.

The tenant is also usually responsible for all costs associated with the repair and maintenance of any common areas. The allocation of costs between the landlord and tenant may vary depending on the negotiated agreement.

KEY ADVANTAGES OF NET LEASING

Triple net leases offer investors consistent and predictable cash flow from management-free real estate, especially when properties are secured under long net leases with national credit tenants. Limited owner involvement is especially

An Expert's View

RONALD D. SERNAU
PARTNER
PROSKAUER ROSE LLP

Ron is Co-chair of the firm's Real Estate Department. He has more than 25 years of experience in real estate law, representing landlords and tenants, lenders and borrowers, purchasers and sellers, equity investors and developers, managers and owners, and brokers and principals, in particularly visible transactions involving trophy properties.

Ron examines developments in leasing, including current market trends and the impact of foreign capital on the leasing market:

What factors in the market have contributed to the increasing demand for net leases?

A "net lease" is perhaps one of the vaguest terms that people use in the real estate industry, so it is important to clarify its meaning. There are basically four types of leases:

- Gross leases.
- Gross leases where the tenant pays the rent on a net basis.
- Net leases.
- Credit tenant leases or bondable leases (also referred to as "hell or high water leases").

A gross lease is a lease where the landlord, in exchange for the payment of rent, provides the tenant not only space, but also a variety of services. These services may include, for example, the landlord being responsible for making normal repairs, paying real estate taxes, providing elevator service, cleaning the space and providing electrical capacity and air-conditioning. In most cases, the tenant agrees to pay to the landlord any increase in the cost of providing these services after the first year of the lease (but the cost of providing these services in the first year of the lease is included in the rent for the first year). The tenant is usually never responsible for major capital costs that the landlord incurs in operating the property.

Search Office Leasing: Agreement of Lease (Pro-landlord Long Form NY) for an example of a modified gross lease.

A gross lease where the tenant pays the rent on a net basis is basically the same as a gross lease, except that the tenant pays as fixed rent to the landlord an amount that does not cover any real estate services. The tenant pays to the landlord, in addition to the fixed rent, an amount that covers the landlord's cost of providing real estate services (including the landlord's cost of providing real estate services in the first year). The tenant pays separately the costs associated with operating the real estate.

A net lease is a lease where the landlord does not really provide anything except the capital that is required to obtain the property. The landlord does not perform any real estate services. The tenant remains responsible for obtaining, and paying for, all of the real estate services separately.

A triple net lease basically requires the tenant to pay the rent (which services the landlord's capital) under all circumstances, although there are frequently exceptions. For example, a tenant under a triple net lease may not be responsible for major capital costs (particularly near the end of the lease term) and may have the right to terminate the lease after a major casualty or condemnation.

Search Commercial Lease Agreement (Pro-landlord Short Form) for an example of a net lease.

A credit tenant lease or bondable lease is a net lease where a creditworthy tenant basically agrees to pay the rent under the lease under all circumstances (hence the "hell or high water" analogy). This is the case even if the property is condemned, damaged by a major casualty or in need of major capital repairs. In these scenarios, from the landlord's perspective, the real estate is largely an afterthought. The landlord is looking to the creditworthiness of the tenant, and the tenant's obligation to pay the rent, as the means for servicing the landlord's capital.

appealing to passive investors who can hold large portfolios of geographically diverse real estate without the expense of hiring property managers.

Net leases are also attracting attention from both public and private real estate investment trusts (REITs) and new sources of foreign capital. Net lease REITs have become an increasingly attractive investment vehicle for foreign investors. Offshore investors looking for safe investments in the US are pumping capital into net leased properties (very often focusing on stand-alone net leased retail buildings) and

Assuming that we are talking here about triple net leases or bondable leases, these are popular with certain tenants for three reasons. First, a tenant can obtain the use of the real estate that the tenant needs without owning it. A tenant, in lieu of leasing the property, could theoretically buy the real estate itself, borrow most of the money to pay for it from a lender, and pay the lender off over a term that more or less mirrors the term of a lease for the same property. The mortgage payments would approximate the rent obligations under the lease.

The problem with this approach for many tenants, however, is that an accountant would require the tenant to reflect the real estate as an asset, and the loan as a liability, on the tenant's balance sheet. The tenant in a properly structured lease transaction can avoid this outcome, keeping both the asset and liability off of the tenant's balance sheet. For some tenants, a lease transaction offers the prospect of obtaining "off balance sheet financing" for its real estate. The accounting industry has discussed changing this arrangement and, instead, accounting for the purchase of real estate and the lease of real estate in a comparable manner that requires the tenant to show both the asset and the corresponding liability on a tenant's balance sheet. In the meantime, for some tenants, this difference in accounting treatment is compelling.

Second, under a lease structure, a tenant uses another party's money for 100% of the cost of the real estate. If the tenant were to buy the real estate itself, it could not obtain a mortgage loan for 100% of the cost of the real estate. Any lender (even the most aggressive lender) would require the tenant to devote at least some of its own capital to the purchase. In a lease transaction, a tenant effectively obtains 100% financing, thereby allowing the tenant to devote its capital to its own business (which is presumably more profitable than the alternative real estate investment).

Third, there are some tax benefits that a tenant can realize (as opposed to an owner), particularly if the term of the lease is less than the period of time that the tax rules require the depreciation of buildings and improvements. In substance, a lease transaction may provide a tenant with more accelerated deductions for tax purposes than the deductions to which the tenant would be entitled to in a purchase scenario.

Search Taxation of Commercial Real Estate Leases for more on US federal income tax rules that apply to commercial real estate leases.

How has the influx of foreign capital affected the leasing market?

In our practice, we have observed a large influx of foreign capital over the past few years which has largely explained the growth in real estate values in primary markets like New York City. Foreign investors, who are looking for the relative safety and stability of the New York City market are willing to stay invested for a long period of time, and simply do not require the same returns as other, more opportunistic capital sources. Therefore, foreign investors are willing to pay a higher purchase price for real estate than other purchasers. The effect is exaggerated in cases where a foreign investor obtains debt financing at historically low rates to finance acquisitions.

In the context of net lease transactions, a party that wants to lease rather than buy its space, for the reasons described above, can lower its financing costs (which is really the rent in a net lease transaction) by tapping foreign capital sources that require a lower current return.

How are current market conditions affecting landlords' and tenants' negotiating leverage?

The pendulum has swung toward the tenants, as capital sources (including foreign capital sources) are feeling the pressure to deploy their capital in transactions that make sense. I have no doubt that the pendulum will swing the other way as interest rates rise and capital becomes more scarce.

Have you seen any trends in lease clauses or provisions?

The net leases with which we are involved are looking less like triple net leases that we handled in prior real estate cycles. The term of these leases is typically shorter. The tenant does not usually have an option to purchase the property at some point during the term. The landlord is underwriting the real estate as a component of the transaction, rather than looking almost exclusively to the tenant's credit as the source of repayment.

are looking beyond primary markets and class A assets for interesting investment opportunities. Many investors also seem to be taking advantage of federal 1031 tax-free exchanges to enter the net leasing market.

While triple net leases are most commonly employed by landlords with retail tenants, landlords of office and industrial properties are now using net leases to achieve the same results. Since the lessee is covering all of the property costs and risks, the rents charged in triple net leases are generally lower than in standard lease agreements. These types of leases, however, are much more of a long-term equity investment play than a cash flow generator.

Property owners are also using net leases to affect sale-leaseback agreements. Sale-leaseback agreements allow property owners to liquefy their real estate holdings but still use their commercial property through a net lease arrangement as lessee.

RECENT LEASES

The What's Market Leases database contains summaries of commercial real estate lease agreements from various jurisdictions covering a range of industry sectors. The database includes commercial leases that have been publicly filed after January 1, 2014.

Each lease summary contains a short synopsis of the key negotiated clauses contained in the commercial lease. The summaries have links to the underlying leases to help target specific clauses. The following is a sampling of recent commercial leases that feature net lease structures contained in the What's Market Leases database.

For access to the leases below and more, visit What's Market at us.practicallaw.com/resources/us-whats-market.

PARTIES	LEASE DATE	USE	PASS-THROUGH STRUCTURE
Landlord: BT (Multi) LLC c/o (W.P. Carey Inc.) **Tenant: MCRIL, LLC c/o (The Bon-Ton Stores, Inc.)**	June 26, 2015	Retail use and ancillary office and storage use.	**Net Lease:** Tenant pays all costs and expenses of Tenant and all reasonable costs and expenses of Landlord associated with, among other things: (i) the ownership, use, non-use, occupancy, monitoring, possession, operation, condition, design, construction, maintenance, alteration, repair or restoration of any of the premises, (ii) the performance of any of Tenant's lease obligations, (iii) any sale or other transfer of any of the premises to Tenant, (iv) condemnation proceedings, (v) insurance claims related to the premises, (vi) Landlord's costs for external counsel related to the lease and (vii) any other items specifically required to be paid by Tenant under this Lease. Tenant must also pay all taxes related to the premises, including real and personal property, franchise, sales, use, gross receipts and rent, assessed against: (i) Tenant's possessory interest in the premises, (ii) any of the premises or (iii) Landlord, related to the acquisition, ownership, occupancy, leasing, use, possession or sale of any of the premises, any activity conducted on any of the premises, or the rent. **Audit right:** Silent. **Cap on pass-through expenses:** Silent. **Exclusions:** Yes, extensive exclusions for taxes. **Gross up:** Silent.
Landlord: DW Glendale CA Landlord, LLC **Tenant: Dreamworks Animation SKG, Inc.**	February 23, 2015	Corporate headquarters campus, general office, or any other lawful use, subject to conditions stated in the lease.	**Triple Net Lease:** Tenant is responsible for the operation, maintenance and insurance of the premises. Tenant pays all taxes related to the premises. **Audit right:** Not applicable. **Cap on pass-through expenses:** Not applicable. **Exclusions:** Yes, minimal exclusions related to the taxes Tenant must pay. **Gross up:** Not applicable.
Landlord: The Board of Trustees of The Leland Stanford Junior University **Tenant: Jazz Pharmaceuticals, Inc.**	January 7, 2015	Research and development (including pharmaceutical and biotech research and development), and ancillary general office uses, including laboratories, warehousing and full service kitchen/cafeteria, to the extent permitted by law and subject to Landlord's reasonable approval.	**Net Lease:** Tenant pays its proportionate share of operating expenses, which includes, among other things, real property taxes, maintenance and repair, Landlord's insurance, landscaping, utilities not directly paid by Tenant and property management. Tenant also pays for all utilities consumed on the premises and its proportionate share of fees related to the Transportation Demand Management programs for the research park. **Audit right:** Yes, within three months of receiving Landlord's expense statement. **Cap on pass-through expenses:** Silent, but management fees are capped at 2% of the then-current base rent. **Exclusions:** Yes, extensive. **Gross up:** Silent.

PARTIES	LEASE DATE	USE	PASS-THROUGH STRUCTURE
Landlord: Murfreesboro Branches, LLC **Tenant: Franklin Synergy Bank**	December 5, 2014	Sale-leaseback. Banking and financial services, office space, and for any other lawful use.	**Triple Net Lease:** Tenant pays for all costs related to the operation of the premises, including utilities, property taxes, maintenance and repair, and insurance. **Audit right:** Not applicable. **Cap on pass-through expenses:** Not applicable. **Exclusions:** Not applicable. **Gross up:** Not applicable.
Landlord: First Industrial, L.P. **Tenant: Clearfield, Inc.**	September 9, 2014	Light manufacturing and related industrial activities, general warehousing and distribution of non-hazardous goods, and office use.	**Net Lease:** Tenant pays its proportionate share of operating expenses and taxes. Operating expenses are all costs and expenses incurred by Landlord in connection with the ownership, repair, restoration, maintenance and operation of the property. Tenant pays all separately metered utility costs for the premises directly to the providers. If not separately metered, Landlord bills Tenant for Tenant's proportionate share of the property's utility expenses. **Audit right:** Yes. **Cap on pass-through expenses:** Silent, but management fees included in operating expenses are capped at 3% of annual rent. **Exclusions:** Yes, extensive. **Gross up:** Silent.
Landlord: Stradivarius Highlands, LLC **Tenant: Bourbon Brothers Holding Company, LLC**	July 9, 2014	Restaurant, serving southern comfort food. Beer, wine and liquor may be served on the premises to the extent allowed by a validly issued on-premises restaurant liquor license.	**Net Lease:** Tenant pays all costs and expenses necessary to own, operate and maintain the premises, including utilities, insurance, taxes, repairs and Tenant's proportionate share for operation, maintenance and repair of common areas, excluding maintenance of structural elements, which Landlord is responsible for at its own expense. **Audit right:** Silent. **Cap on pass-through expenses:** Silent. **Exclusions:** Silent. **Gross up:** Silent.
Landlord: BXP MISSION 535 LLC **Tenant: Trulia, Inc.**	March 10, 2014	General office and related uses consistent with a first-class office building.	**Net Lease:** Tenant pays its proportionate share of operating expenses, including taxes and certain capital expenses, related to the project (the building, common areas and land). Landlord may, in its reasonable discretion, equitably allocate operating expenses among different portions or occupants of the project. **Audit right:** Yes. **Cap on pass-through expenses:** Silent, but management fees included in operating expenses are capped at 3% of all gross receipts for the project grossed up to 100% occupancy. **Exclusions:** Yes, extensive. **Gross up:** Yes, 100% at Landlord's option.