

Should you Pursue a 1031 Exchange with a NNN Lease Investment?

NET LEASE REALTY PARTNERS



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Definition of NNN Investing



What is a NNN Investment?

NNN or triple net, is a type of real estate investment structure for commercial spaces. It's very common for retail properties or medical spaces because of the terms set forward in the lease. Essentially, what NNN investing boils down to is at the core of the definition: **net, net, net**. Each N stands for an expense the tenant would take on in addition to their monthly rent: annual property taxes, insurance premiums, and common area maintenance upkeep costs.

This type of lease is built off of the premise that the tenant agrees to take on more than just their monthly rent payments. In a standard net lease, the extra expense the tenant takes on is related to operating expenses (like repairs, insurance, or taxes). In a triple net lease (NNN lease) the tenant takes on all of these different expenses. This means the investor (you) wouldn't need to head out to the property or hire someone to make repairs. You also won't have to worry about property taxes or insurance premiums for the space, in most cases. (Obviously each lease is different, so there may be a unique circumstance that varies from the norm.) When a commercial real estate investor is looking for a hands-off, no hassle property, a triple net lease is the way to go.

The Difference Between Single Net, Double Net and Triple Net Leases



What is the difference?

The difference between single net, double net, and a triple net lease may sound pretty clear cut: there are more responsibilities on the tenant and less on the landlord with each increase in the number of “nets.” Each type of lease used in commercial real estate depends on the parties in the agreement, and the structure can vary greatly.

The primary difference here is that with a **single net lease**, the tenant pays for rent and property taxes. In a single net lease, the investor, property owner, or landlord is responsible for the maintenance and repair costs, as well as the property insurance. This is the least common type of lease for commercial real estate investors.

With a **double net lease** the tenant adds the insurance premium to their rent and tax responsibilities from the single net lease. The landlord still maintains responsibility for repairs or utilities. This is still time-consuming and may be costly for the owners.

The **triple net lease**, the most common type for retail properties and other commercial properties, puts that last responsibility of repairs and utilities — the day-to-day costs — on the tenant. It’s an agreement that benefits both the landlord and the tenant, which we’ll look at a little more closely later.

Net Lease: A net lease is one where the Lessee (the person borrowing the asset) pays the rent to the Lessor (the owner of the asset) after reducing the expenses to be paid for maintenances, taxes, insurance, and repair of the asset.



Understanding NNN Leases



Understanding NNN Leases

NNN lease properties are great for investors looking for an investment opportunity with consistent, equity-building returns without the day-to-day responsibilities traditionally associated with owning properties. By definition, triple net leases (aka NNN) put those responsibilities onto the tenant, freeing up investors for other projects and properties. Let's take a closer look at NNN leases and what goes into them.

Aside from the financial responsibilities for tenant versus investor, NNN leases usually anywhere from 10-25 years, meaning they are a consistent, long-term earner for investors. The business agrees to occupy the space for many years, meaning that the landlord doesn't need to constantly be seeking out a new tenant or dealing with empty properties.

Each lease is unique, so different terms may be set regarding those costs. Operational costs like maintenance and repairs, taxes, and insurance are usually fully paid by the tenant (and often absorbed as a business expense), but occasionally that cost may be shared with the property owner. However, this would be outlined in the lease so there are no surprises for either party.



Types of Net Lease Agreements



Types of Net Lease Agreements

Understanding the different types of Net Lease Agreements will help you confidently choose the best option to support your investment and create long-term profitability in your portfolio.

Single Net Lease

In a single net lease, the tenant is responsible for paying the property taxes on the building, independently of their agreed upon monthly rent sum. Single net leases tend to be the least common agreement type in net lease real estate. The owner assumes the role of a landlord in a single net lease, and must handle all the expenses and maintenance on their investment. Additionally, even though the tenant must pay annual property taxes, the owner will often collect and remit the tax payment themselves to ensure correct, prompt payment.

Triple Net or NNN Lease

A triple lease, which is also known as an NNN lease, is an agreement between a property owner and a tenant where the tenant (in addition to a monthly rental fee of the building or space) absorbs all the costs and expenses for the property, including:

- Property Taxes
- Insurance Premiums
- Maintenance, Upkeep and Repairs

Double Net Lease

A Double Net Lease is an agreement between a property owner and a tenant in which the tenant (in addition to monthly rent) is required to pay:

- Property Taxes
- Insurance Premiums and Claims on the Property

The property owner acts as a landlord and is responsible for handling all the building upkeep and maintenance costs to keep the property functional and operating.

Absolute NNN Lease

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

- Insurance Premiums
- Property Taxes
- Building Maintenance and Repairs (*Including the Structure and Roof*)

The most important distinction between a triple net lease and an absolute NNN lease comes down to structural and roof repairs. A triple net lease often outlines these types of repairs as the full or partial responsibility of the property owner. However, in an absolute NNN lease, the tenant is responsible for all the expenses on the property, including the structure and roof.

The Benefits of NNN Investing

NNN leases have benefits for both the investor and the tenant. As an investor, you can expand your portfolio with a consistent income stream without the costs and responsibilities typically associated with being a landlord of commercial properties. In most triple net lease investments, the property owner is not responsible for the daily tasks like maintenance, repairs, or upgrades. Instead of operating as a landlord, you can spend your time working on other properties or projects you are passionate about or looking for your next investment opportunity to further diversify or expand your portfolio.

As a tenant, they will gain a desirable location for their business. They can also have a greater control over their space, as they can hire a handyman they know and get repairs done on a schedule that works for them — and they don't have to wait to call the landlord to make any sort of repair.

But the benefits of a NNN property go beyond these reasons for investors. Oftentimes, you can find a triple net property at a lower entry price point, meaning investors can invest at a more affordable rate and get started with a new property sooner and enjoy the benefits of said property for longer with a good return on the investment.



What Makes a Good NNN Property

The right NNN lease investment is important for a property that can add value to your portfolio for many years to come. In order to find the right fit, you need to find the best property for an NNN lease, which may vary from other properties in your portfolio. There are a few key elements that you should keep in mind as you find the right investment opportunity to expand or diversify your portfolio:

- **Geographical Location:** The geographical location of the property makes a huge difference in its investment potential. Growing cities and areas with population growth or economic booms are often the ideal place for NNN properties.
- **Property Location:** Aside from the geographical location, the actual location of the property is one of the most compelling factors of a real estate transaction. A NNN property should have an easily accessible location, like a corner with high traffic and proximal businesses to bring more people to the area is positive when evaluating triple net investment value potential.
- **Business Type:** The long-term success of your investment relies on the success of the business, so the type of business it is can impact your investment. In order to ensure that you have a reliable tenant who will be consistently responsible for paying rent and keep up with the other expenses associated with a triple net lease, you should look for businesses that will be able to withstand economic changes, like medical facilities, retail properties, grocery or convenience stores and pharmacies. Sometimes, this business type may be a well-known brand or chain of a large company, because the brand name alone will drive traffic and provide a sense of security for the investor. Specifically, brands like Walmart, CVS, or Family Dollar can make a great NNN tenant for their brand and longevity alone.

Pros

For an investor, a triple net property has very few risks, and it can provide a steady income. The longer length of the lease ensures that your investment won't sit empty for long stretches of time every couple of years, so you know you won't be constantly searching for a new tenant. You can also better plan for the income stream of the property since the tenant is usually responsible for paying, as you will know how much it can make you over the next 10 or so years. You will also be passing off many of the expenses of the property to the tenant, making it less costly or time consuming than other properties, and in other investment scenarios, expenses can really add up.

NNN properties are very appealing from a commercial investment standpoint due to the many advantages this type of deal can offer to both property owners and tenants.

- **Guaranteed, Long-Term Occupancy:** A NNN lease is structured to offer long-term tenant occupancy (which is often upwards of 20 years), which is beneficial to an investor because it removes the risk and losses of a property sitting vacant between tenants.
- **Low-Risk Investment:** In a triple net lease, the tenant absorbs all the costs associated to the property, from taxes and insurance to regular upkeep costs.
- **Reliable Income Stream:** A NNN lease helps secure a reliable income stream from your investment property. Deals are structured to include a consistent amount of rent each month, over an extended period of time, and passing along all the property expenses to the tenant helps protect your investment from unknowns and surprise costs.
- **Equity:** Many investors add triple net lease properties to their portfolios as a conservative, low-risk strategy to create more equity. Often times, investors will hang on to a triple net property and use it as an equity builder for at least 5 years, and then sell the property when the market peaks, population spikes, or when they're ready to use that equity in their next investment.
- **Little to No Landlord Duties:** With a triple net lease in place, you're not tied to the property with your time or money as a landlord. Low-touch management frees up your time for other ventures and ensures you're not locked into landlord duties for the property.

Cons

Cons of NNN Leases for Investors

As with everything, there can be cons to entering into a NNN lease. For investors, the biggest con can be entering into this agreement with the wrong type of business. Because certain businesses are better suited to NNN leases, investors and property owners need to carefully vet potential tenants to ensure that their investment will be protected from businesses that may not be able to fulfill their end of the deal. The other thing investors need to keep in mind is that everyone needs to understand the terms of the lease and who is responsible for which expenses. Triple net leases typically pass most expenses to the tenant, but the specific terms are outlined in the lease.

While an NNN lease can offer an array of great advantages for investors and tenants both, there are some limitations inherent in these deals that keen investors will want to keep in mind when considering a NNN lease.

- **Earning Caps:** While a NNN lease provides a consistent revenue stream each year on your investment, that amount is typically fixed for the term of the lease. This means you can't increase the rent if property values in your area spike which can limit your earning potential in times of growth.
- **Vacancy Risks and Rollover Costs:** Though triple net leases are long-term, there is the risk of a tenant defaulting which can result in losses as you try to fill the vacancy. While you can limit this risk by vetting tenants and their businesses thoroughly, this is always an inherent risk.



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