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[Risks & Remedies Of The Triple Net (NNN) Investment]

What's In This Report?

* The biggest risk in NNN investing and how to avoid it.
* Metrics that can identify at-risk properties before you buy.
* Why regional & local credit tenants are sometimes a more secure investment than well known national credit tenants.
* How to compete against large investment groups with big purchasing power to secure quality NNN investment properties.

This report is designed to guide you through some of the risks and opportunities in triple net property investing. It is not designed to scare you or cause undue concern. Commercial real estate can be a great investment vehicle that generates and preserves wealth, now and for generations to come. As all investments, there are no guarantees of performance. However, through our 35-years of experience we have been able to recognize some risks that many others overlook. We want you to know what those risks are. Of course, we'd like to represent you in your next commercial investment purchase, but the aim of this report is to provide you, what we feel, are some investment fundamentals that have gotten pushed to the side over the many years of a robust economy that had substantially more value than risk. Times change, but fundamentals shouldn't. *–Ellis & Tinsley, Inc.*

The Biggest Risk and How To Avoid It

Many small and independent single-tenant triple net (NNN) investors will decide to purchase a property based upon the satisfactory answer to three main questions.

1) What is the tenant's credit worthiness, financial backing and the prognosis of the tenant being able to sustain a profitable business model into the future?

2) What is the strength and length of the Lease Agreement?

3) What is the rate of return I will receive on my money invested vs. the income being generated by the rent payments? (Capitalization Rate)

All are major considerations and should be fully analyzed as a part of any real estate investment purchase. However, there is another question, one that is just as important, that's often overlooked, under-analyzed, or underestimated during due diligence. Not asking this 4th question can destroy the profitability and viability of your investment. So what is it? Here it is…

4) Is the tenant paying an inflated rental rate compared to the REAL market rental rate within the immediate trade area?

Sounds like a dumb question. I mean, why would you care if you had a tenant that was paying more than the REAL market lease rate? Well, the answer is two-fold. 1) The purchase price of a NNN investment is based upon the amount of income the property is producing. If the income is inflated when you buy the property, so is the sales price. 2) If the lease rate being paid is above market, how can you FULLY REPLACE the income stream once the lease expires, or worse, when the tenant moves out goes bankrupt?

Most investors and real estate professionals would say it's the loss of the tenant that provides the most risk in a NNN investment. Not in our experience! The whole reason you purchase NNN properties is not to "own" the tenant. It's to "own" the income stream. How can there be any security in an income stream if you can't obtain that same lease rate from other tenants in the marketplace? Unfortunately, many investors purchase an income stream believing it will be secure and un-fluctuating for years to come. They've got what seems to be a viable tenant willing to pay "X" which provides the investor “Y” rate of return (or cap rate.) They cast a blind eye to the possibility of the income stream being inflated and what that will mean to the future income stream after the tenant leaves.

Finding a new tenant is a temporary inconvenience, especially if the property is a good asset in a desirable location. However, discovering too late that the REAL market rental rate is 30% to 50% less than what the prior tenant was paying. That is not temporary and can shatter the profitability and viability of your investment.

Some tenants may be desired over others because they provide what appears to be better financial backing and credit worthiness. However, the seemingly good, stable, well funded tenant of today can be the fallen star of tomorrow. Let’s be realistic; in the end, you don’t care who is paying the rent; All money is green. Your real concern
Is that the rent gets paid and that you’re provided the rate of return you thought you were going to receive when you purchased the property.

Just in January of 2013 alone I have spoken to three single-tenant NNN owners who have lost tenants for one reason or another. The most heart-breaking case was that of a California investor who was living off the income being generated by the investment. After analysis of the area and comparable current rents, they discovered the REAL market rental rate was 50% below that of the prior tenant. That’s a 50% reduction in his income. What a shocker! The other investors found an approximate 30% reduction in the real market rate vs. what the prior tenant was paying. Of course, this reduction doesn’t include all the expenses that come along with a vacant building, like taxes, maintenance, insurance, attorney fees, new tenant incentives and new lease commissions. If an investor has leveraged the asset then note payments will still be due even though no income is being generated.

I think we can all agree that the loss of a tenant and the costs associated with a vacant building are part of the risk of owning NNN properties. That’s why we vet the tenant and perform the due diligence, hoping to do all we can to ensure a stable and viable income stream. However, to then have a 30%-50% reduction in income on top of that is a killer.

You can mitigate and even eliminate that risk if you ascertain the REAL market rate prior to purchasing an investment. If the rate is found to be highly inflated, either negotiate a better purchase price or pass on the investment. The three keys to a good investment are 1) a stable tenant, 2) a good asset in a good location, 3) being able to replace the income should the current income go away for some reason. You already know the first two. Now, make the third one just as important as the other two.

Another Metric That Can Identify At-Risk Properties

Without obtaining nearby market lease rate data, which is sometimes hard to get and assess whether it’s comparable or not, there is another metric we use to determine if the

NNN property you're considering has an inflated lease rate. That metric is the differential, or range, between the purchase price of the property and the reconstruction price of the same asset. The easiest way to do this is to break the purchase price down on a Price Per Square Foot Of Building basis.

For example: I've seen investors buy properties that had a "great" tenant paying $35 NNN per square foot for (let's say) 3,500 SF. That income was sold to the investor on an 8 capitalization rate (pretty standard) and the investor paid a total of $1,531,250. Divide that by 3,500 SF to get your price per square foot paid; which comes to $437 per SF. The problem comes in where the replacement value (the reconstruction cost) of the same asset in the same location is only $250 per SF. That's difference of $187 per SF! Certainly there is some value in a developer securing a long-term lease with a good credit tenant, but is it worth a differential of $187 per SF? Is it worth purchasing an inflated rent you can't replace once the tenant vacates or is lost? Not in our experience.

There is a correlation between what it costs to (re)construct an asset (land, development and construction costs) and what the REAL market rental rate is. If the differential between the purchase price and the reconstruction price is too great, chances are the lease rate is inflated too. It not only inflates the purchase price you're paying, but it inflates the risk of a large, downward income stream adjustment in the future.

Regional And Local Tenants: A Better Investment?

This one boils down to, "Who Is Guaranteeing The Lease?" National credit tenants are usually backed by a corporate guarantee. Of course that means as long as the mother ship is afloat, the corporation's guarantee is good. However, if the corporation goes under, your lease is probably going down too. If the corporation files a straight bankruptcy, then you can kiss your guarantee goodbye. If the corporation files for a reconstruction bankruptcy you can expect they'll be coming to you for a renegotiation of the lease. By the way, renegotiation never means they want to pay more!

If the tenant was paying an inflated rental rate to begin with, then you'll almost be forced to accept their new terms (as long as the renegotiation rate is near the Real market rate.) The easiest way to keep the income stream from completely terminating is to accept the renegotiation. Your other option is to put the property on the market for lease. However, that has its consequences too. It will not only terminate the income being paid by the current tenant, but it's likely you find that other tenants aren't willing to pay much more than what's being offered in the renegotiation. When you do find a replacement tenant there will be new tenant improvement expenses and new lease commissions you'll be paying for.

Regional and local tenants can fall under the same risk. However, many times a regional or local tenant may have a personal guarantee attached to the lease. This gives you an additional avenue to recover lost rents should the tenant's business go bad. The key to finding more security in a regional or local tenant, vs. a national tenant, is to not only have the personal guarantee in the lease, but it's also to ensure that the personal assets that secure the personal guarantee are not directly tied to the health of the tenant's business.

For example, if a tenant is personally guaranteeing the lease of a sandwich shop, make sure the majority of the guarantor's net worth isn't tied to the health of the sandwich shop. Make sure their net worth can sustain the failure of the sandwich shop. Perhaps they have a trust fund or family money. Perhaps they were successful in another business venture prior to getting in the sandwich shop business. Just make sure they have other assets that wouldn't be completely or substantially diminished by the failure of the sandwich shop. It's the only way to ensure the personal guarantee will have value in to the future.

How To Compete For Quality NNN Properties

We know it's difficult to find a solid NNN investment. As a small or independent investor you have to compete with large and institutional investors for the supply of NNN properties. That just drives the price and the risk up for you.

Large and institutional investment groups prefer the national credit tenants with corporate guarantees because the guarantee is backed by what is currently a strong, well capitalized, usually publicly traded entity. Many large investment groups also own many NNN properties, not just one or two properties like the average small/individual investor. If one tenant fails within a large portfolio of NNN properties, then it was just one tenant of many. The severity of the loss is diluted by the size of the remaining portfolio. This isn't the same case for the small/individual investor whose portfolio may take a big hit from just one bad tenant or inflated lease.

The small/individual investor can find quality properties without paying the premium usually associated with the national credit tenant properties. They just have to look at the properties the large investors aren't paying much attention to. Many times, the properties overlooked by the large groups have very stable tenants with strong personal guarantees, like the local and regional credit tenants we've described.

Another area overlooked by many institutional investment groups is the multiple tenant NNN property. Multi-tenant properties need some additional management and oversight by the owner, but they have the added benefit of diluting the overall impact of a lost tenant. Even though one tenant has stopped paying rent, the income from the other tenants continues to flow. Think, safety in numbers.

From The Desk Of The Author

Don't allow the broker that represents the seller and their own inventory to represent you too. Don't be under-represented on your next transaction. We don't sell you our own inflated inventory. We represent investment property buyers, like you. We scour the member-only databases you don't have access to and make personal calls to the companies, institutions and brokers that have a history of quality assets in their inventory.

Our report was constructed upon 35-years of building and preserving wealth for our clients through market knowledge, adept representation and conservative analysis. If you're in the market for investment real estate, or if you are trying to identify replacement property for a 1031 Exchange, you could benefit from our representation.

We'd like to speak with you and can take your phone call anytime.

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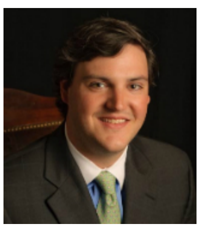

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