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Making Green: Not Only Thing on Their Minds

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Net lease properties: Calculated risk, less stress

Ask the "average" investor where he or she directs investment money, and more than likely the answer will include one or more of the vehicles such as stocks, bonds, mutual funds, certificates of deposit and interest-bearing checking accounts. Ask the same investor about risk and you'll probably hear that it's something the investor wants to avoid or at least keep to a minimum.

Like it or not, risk is an essential part of any investment decision and the owner of an asset must be willing to live with the worst case scenario. However, the past few years have made investors skeptical and many are asking themselves the question, "Am I being properly compensated given the risk level inherent in this ownership of this asset?"

There is one option that is available to investors that provides a fixed income alternative. Consider investment in income-producing, net leased real estate.

Net lease investments are a specialized type of investment real estate that usually refers to single-tenant properties (although they can be multi-tenant properties) which are leased long-term, to credit worthy tenants. A typical net leased investment property is the deeded ownership of real property and its improvements (buildings) whose tenants are under contract to lease the property for a specified period of time at specified rent terms. In a net leased property, the tenant takes responsibility for maintenance, repairs, property tax, and insurance on the property.

Because the tenant uses the improvements they are leasing, and the public perception is one of ownership, they have a vested interest in assuring the taxes are paid, the building is in good repair and the grounds and facilities are clean and maintained. Generally, the only obligation of the owner is to pay any payments resulting from any debt that is placed. These properties are considered by many to be the most liquid and secure real estate investments available because the leases have a long term (10-25 years) with most having periodic increases in the rent. By committing to these long term leases, an investor, as well as their lender, can consider the company's lease a credit obligation comparable to corporate bonds. The main difference, however, is that with a default of the tenant, the investor retains ownership of the property with all its rights, whereas with a bond, the investor gets nothing.

As an owner, you know exactly who will be a tenant in your building, how long that tenant will be there and exactly how much rent they will pay you. That means you will derive a steady income from your investment, regardless of how the economy or real estate market is performing. Furthermore, they remove the need for property management, but provide the added benefits of tax reduction and property appreciation found in conventional real estate.

Unlike traditional real estate investments, whose value is determined exclusively by the real estate itself, in this case, it is the lease and the credit of the lessee, which drives the value, so the valuation consists of a combination of factors including the tenant's credit, the length of the lease and rental escalations over the term. Factors such as location and trends within the property's market are important, but relatively minor because the key value determinant of credit tenant property is the long-term corporate guarantee.

Typically, leased property is valued in the investment market by using the net initial yield, also known as capitalization rates, or cap rates. The cap rate is used to convert (net) operating income into an indication of the overall property price including buyer's costs. The cap rate is the ratio of annual rental income of a property divided by the purchase price, and in net-lease investment deals are commonly a number between 6 percent and 10 percent.

This way, a property is efficiently analyzed on the basis of the tenant's credit and the price is efficiently adjusted to reflect the investment's risk. "Credit" tenants have investment-grade ratings from a nationally recognized rating service and are considered the most desirable. Since the tenants have typically been rated by Standard & Poor's, and the owner's investment returns correlate directly with the strength of the rating, credit tenants will provide greater security and typically lower returns than non credit tenants. Investors looking for higher returns frequently invest in properties with regional and local tenants. These tenants need to be carefully investigated to make sure that the investor fully understands the added risk and whether or not they are being compensated for taking that risk.

Like any speculative venture, investment real estate may not always perform to short-term expectations. Over the long haul, however, a well-managed and properly financed piece of commercial property unquestionably can prove to be a solid investment.

CLAY STROTHER, **CCIM** is an associate broker with Driggers Commercial Group.