

NNN-LEASED RETAIL PROPERTIES: SCRUTINIZING THE “ARMCHAIR” INVESTMENT

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Single-tenant, triple-net-leased retail properties (NNN properties) offer an attractive option for investors seeking a long-term predictable stream of income, often (and preferably) generated by a commercial tenant with an investment-grade credit rating.

Generally speaking, in a triple-net lease (NNN lease), the tenant is directly responsible for, and therefore pays rent “net of,” three main types of expenses associated with the ownership of real estate: property taxes, insurance and building and property repair and maintenance. The common example of a retail NNN property is a stand-alone commercial building leased to a national brand-name pharmacy or fast-food restaurant tenant.

One of the main benefits commonly associated with investment in NNN properties is the “hands-off” nature of the investment. These assets are routinely marketed as passive “armchair” investments, with the collection of rent payments under NNN leases often being compared to the collection of coupon payments under a bond.

Investors should view these characterizations skeptically, however. While, as a general proposition, it may be true that NNN properties are less management intensive and more predictable than certain other types of commercial real estate assets, there

are numerous risk factors to consider in underwriting the assets. Perhaps the most important of these factors are the actual terms of the underlying NNN lease.

Simply calling a lease a “NNN lease” does not make it so. There is a somewhat disconcerting lack of market standardization as to what actually constitutes a NNN lease. There is also little uniformity in the methodologies used for determining cap rates on these assets as a part of the marketing process. Without regard to the characterization of the underlying NNN lease or the advertised cap rate, the actual terms of the lease itself need to be reviewed carefully to determine the exact nature and extent of the landlord’s obligations (and potential for true cost exposure) with respect to the NNN property.

Additionally, due to the typical NNN tenant’s investment-grade credit rating and corresponding strong position of leverage, NNN leases are almost invariably documented using tenant-dictated forms. As may be expected in this context, there tends to be a relatively limited opportunity for the landlord to negotiate for terms that align with expectations for a true triple-net structure to the extent the tenant’s lease form is not already aligned with such expectations.

Though the entire lease should be carefully reviewed in connection with the due diligence process in considering an investment, the following are issues of specific importance.

Landlord Maintenance and Other Responsibilities

If an investor proceeds with the investment of a NNN property before gaining a thorough understanding of the nature and scope of the landlord maintenance obligations under the underlying NNN lease, there is a strong chance its investment goals and expectations will not comport with reality. The investor should not merely assume that the costs associated with landlord responsibilities are accurately characterized in marketing materials. In fact, it is not uncommon for NNN properties to be marketed using a cap rate derived from net operating income (NOI) that factors in base rental only. While this marketing practice may reflect reality in the context of a bondable lease (i.e., an absolute triple net lease, under which the tenant is responsible for all real estate-related risks), such practice can skew the cap rate unfavorably from the purchaser's standpoint.

Even where the marketed cap rate is derived from NOI that applies a landlord cost factor in addition to base rental, it is absolutely critical to underwrite the investment taking into account actual anticipated landlord costs, as determined following a thorough review of landlord's maintenance and operating responsibilities described in the lease. By way of illustration, a common practice in the brokerage community is to apply a capital reserve factor of \$0.15 per square foot where the landlord has "roof and

structure" maintenance obligations and a capital reserve factor of \$0.20 per square foot where the landlord has "roof, structure and parking" maintenance obligations. Assuming a building of 3,000 square feet, that would amount to an annual capital reserve of \$450 for "roof and structure" and an annual capital reserve of \$600 for "roof, structure and parking." The use of these reserve factor assumptions can also result in the cap rate not truly reflecting a particular property's physical condition and actual forecasted capital improvement requirements.

There are many critical questions relating to landlord maintenance responsibilities that should be answered as part of the lease review process. Is the lease clear as to which party has which responsibilities, or is there a lack of clarity that creates the potential for disagreement on these issues? Ideally for the investor, the NNN lease should state that the tenant is responsible for all maintenance, repair and replacement obligations except to the extent the landlord is obligated under the express terms of the lease. Are landlord's obligations limited solely to roof and structure, or do they also include building systems (such as HVAC), parking surfaces or other aspects of the property? Is the nature of the landlord's obligation limited solely to repair and replacement or does it also include maintenance obligations? To the extent the landlord has repair and maintenance responsibilities under the lease, does the lease clearly state that the landlord is not responsible for such costs to the extent same result from the tenant's negligence, willful misconduct or failure to comply with the terms of the lease?

In addition to reviewing the lease to determine the scope of landlord's main-

tenance obligations, the investor should make sure that the tenant is responsible for the payment of utilities as well as assessments payable under declarations, REAs or other instruments or contracts relating to the NNN property. With respect to utilities, a NNN lease will typically provide that the tenant is responsible for paying utility bills directly, but this should be confirmed. With respect to assessments, the investor will need to review title thoroughly to determine whether any assessments are payable with respect to the property under private or public agreements. To the extent there are assessments, but the responsibility for payment of such assessments is not covered by the NNN lease, the responsibility of these costs will fall upon the landlord.

Administrative Responsibilities

An investor should review a NNN lease with the following question in mind: “Besides maintenance obligations and collecting rent checks, what are all the things that I, as the landlord, will need to do during each month of each year of the lease term?” The lease may obligate the landlord to tackle any number of administrative responsibilities, most notably related to real estate taxes and insurance.

For example, even though the tenant is typically responsible for the direct payment of real estate taxes under a NNN lease, the landlord is likely to have other administrative responsibilities or costs associated with real estate taxes, such as the timely forwarding of tax bills to the tenant and cooperating with the tenant in contesting or appealing of any taxes or assessments. It is fairly common for leases to provide that the landlord shall be responsible for all costs (including

tax increases) resulting from the landlord’s failure to comply with such responsibilities. Additionally, even though the tenant bears responsibility for the payment of real estate taxes during the lease term, the landlord should take an active role in closely monitoring and, where necessary, contesting real estate tax increases. Failure of the landlord to do so may leave it with a higher-than-necessary tax payment once the property is vacated and also make the property more difficult to re-let to future tenants.

As with real estate taxes, an investor should not just assume that the tenant under a lease is the only party responsible for the costs and maintenance of insurance. Though this is often the case—with the tenant being responsible for obtaining and maintaining, at a minimum, commercial general liability insurance and hazard insurance for the building and tenant’s personal property—some leases require the landlord to maintain insurance, such as liability insurance, in addition to the insurance required to be maintained by the tenant. An investor should also have an understanding of the types of insurance required to be maintained by the tenant and ensure that the tenant provides, at regular intervals throughout the lease term, appropriate insurance certificates to demonstrate compliance with its insurance obligations. Investors should also consult a risk professional to determine whether other types of insurance coverage are advisable relative to the ownership of a NNN property.

Additionally, if the investor is acquiring its NNN property with financing, it should closely examine the insurance requirements set forth in the loan documents to ensure that such requirements are appropriately tailored to the insurance requirements of the NNN

lease. Ideally, the insurance requirements of the loan will be fully satisfied by the tenant's and landlord's collective compliance with the terms of the NNN lease. To the extent they are not, the landlord may be required to carry insurance with respect to the loan that neither it nor the tenant is required to carry under the lease.

Rent Abatement and Lease Termination Rights

All rent abatement rights and lease termination rights in favor of the tenant should be carefully summarized and identified in connection with the NNN lease review process. Obviously, an unexpected lease termination or rent abatement on the part of the tenant will torpedo an investor's main objective in acquiring a NNN property—namely, a stable income stream. Due to the extent to which the tenant has control over the property, the instances, if any, under which the tenant has the right to terminate the NNN lease should be limited. The most common instances under which the tenant typically has the right to terminate the lease are casualty and condemnation.

In a typical casualty provision, the tenant will have the right to cancel the lease if the building cannot be repaired within a certain period or if the casualty occurs during some final specified period. In a typical condemnation provision, the tenant will have the right to cancel the lease if the building or other improvements on the property (or access thereto from adjacent streets) are condemned in a way that results in a material adverse effect on the tenant's business operations (such as a condemnation resulting in the inability of a fast-food tenant to operate a drive-through at the property). If a

termination right relating to a condemnation exists in a lease, it is preferable for the landlord if the lease makes it clear that such termination right shall not arise unless and until the actual occurrence of a condemnation, rather than upon the receipt of notice of any pending or threatened condemnation.

Landlord Indemnification Obligations

The NNN lease should also be reviewed to determine the nature and extent of any indemnifications provided by the landlord in favor of the tenant. A typical landlord indemnification provision (usually given in connection with a reciprocal indemnity from the tenant) states in essence that the landlord indemnifies the tenant from and against any and all costs resulting from either a breach of the lease by the landlord or the landlord's negligence or willful misconduct. An investor should especially be on the lookout for any type of indemnity given above and beyond such standard indemnity. One example of such a provision would be an indemnity given by the landlord in favor of the tenant for costs relating to the cleanup of any hazardous substances that existed on the property prior to the date of the lease. While this indemnity for "pre-existing" hazardous conditions may make sense in certain contexts, it makes little sense in the context of a NNN lease where such lease was executed in connection with a sale leaseback transaction. Under such scenario, the landlord's predecessor in title was actually the tenant. The investor should be wary of any such allocations of risk.

Conclusion

A thorough review of the NNN lease with an emphasis on the foregoing issues is an

absolutely critical step in underwriting and ultimately investing in a retail NNN property. Key questions to be answered are whether the list price and associated cap rate are justifiable given the structure of the lease and whether the lease provisions adequately align with the investor's expectations regarding its level of day-to-day involvement on the NNN property (with a particular

focus on unanticipated "true costs" to the landlord). By reviewing NNN leases with these key questions in mind, investors can more effectively identify desirable NNN retail properties and accomplish their NNN investment goals.

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