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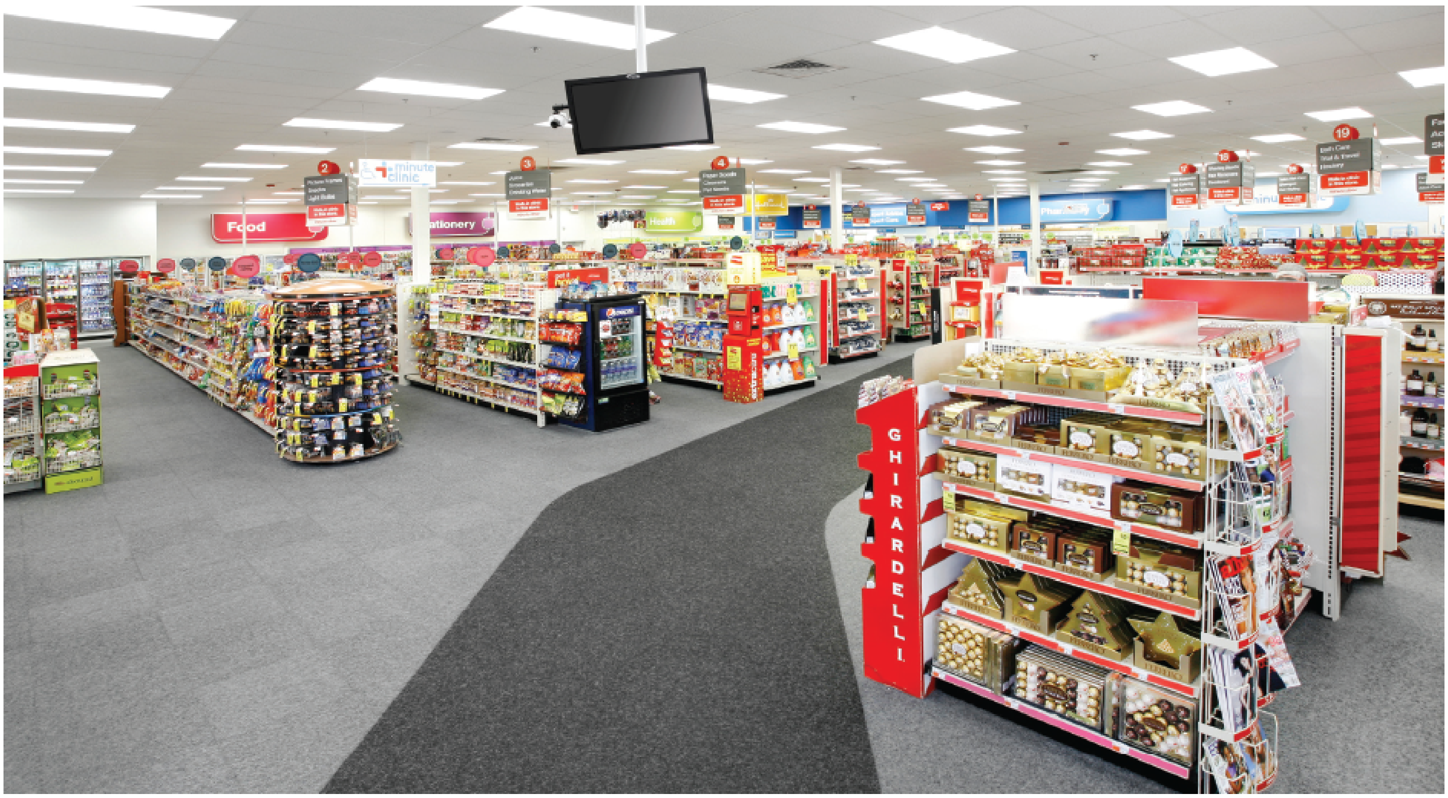

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Investing to the third power: Why people are betting on triple-net-lease assets in the COVID-19 environment

BY STEPHEN STEIN

COVID-19 has complicated commercial real estate investment in an unprecedented way. The health and economic crisis has made nearly every investor pause and re-evaluate their commercial real estate investment strategies, regardless of their risk tolerance.

While some investors will choose to sit on the sidelines longer, others are demonstrating a strong appetite for certain property types that show consistent promise and strong performance. In fact, many in the industry believe the commercial real estate investment trends that were in place before the crisis hit are likely to continue, and possibly even accelerate, as a result of COVID-19.

One of these trends is the desire to own single-tenant triple-net-leased assets (NNN). NNN assets are perennially one of the most popular real estate product types in both good and bad economic times. Industry experts, such as SRS Real Estate Partners, have reported activity in the net-lease space has remained strong during the pandemic for sectors such as necessity-based uses, publicly traded companies with strong financial positions, and quick-serve restaurants with drive-throughs.

Demand for these properties has increased, and that will enable developers of single-tenant triple-net-leased properties to expand their portfolios through new site acquisitions and development.

These deals include a $25 million facility on behalf of a Santa Monica, Calif.–based developer that plans to develop additional NNN properties for 7-Eleven, Starbucks Corp., Dutch Bros. and Chick-fil-A; a $15 million facility on behalf of a western developer that will use it for NNN developments for Circle K Corp., O'Reilly Automotive, AutoZone, Starbucks and other national-credit tenants; and a $10 million facility arranged on behalf of a private developer in Northern California to fund future development for a variety of major tenants throughout the state including Starbucks, Grocery Outlet and 7-Eleven.

There has been expanded interest in triple-net-lease assets since the start of the pandemic, and we expect this demand to continue. Here's why:

A tradition of stability. NNN assets have consistently proven themselves to be recession resistant. These properties are known for generating a reliable, steady income stream in all economic climates, with lower risk to investors. In fact, during the global financial crisis and throughout the previous real estate cycle, this property type continued to perform well, demonstrating a powerful resistance to market conditions.

One of the reasons for this notable stability is that NNN assets are usually leased to high-credit national tenants that have time-tested strategies for weathering economic ups and downs, and that typically sign long leases. In fact, the current national average lease term for net-lease properties is 11.6 years, reports Avison Young — a number that has risen during the pandemic.

Also, recent research from Green Street shows that, while overall commercial real estate pricing has decreased 10 percent during the pandemic, pricing of properties with high-credit tenants and significant lease terms that are common to net-lease deals has held up. The average cap rate for net-lease assets has also remained largely steady at 6.51 percent, despite the market slowdown, according to Avison Young, another appealing factor for investors.

Given their stability over time, NNN assets appear to be better able to withstand black swan events, such as COVID-19, and emerge relatively unscathed.

Low maintenance, low capital expense. In single-tenant triple-net leases, the tenant is responsible for most, if not all, maintenance procedures and capital expenses that would typically fall on the investor's shoulders in other types of lease arrangements, including property taxes, insurance and operating expenses.

While each lease is structured differently, the low-maintenance, low-expenditure nature of these investments makes them especially appealing to investors who may not have the time, ability or desire to manage a property hands-on. In addition, the financial upside of not having to pay for certain capital expenses makes these deals a win-win for investors. The passive investment nature of NNN assets is one of the reasons these properties are in such demand no matter what economic conditions are prevailing.

An inventory shortage. Triple-net-lease properties were in short supply for some time before the pandemic hit because owners were reluctant to sell. In the current uncertain commercial real estate pricing environment, owners can be even more hesitant to let go of these assets, making them even more attractive to buyers. The lack of inventory and strong demand for these assets have been the catalyst for the increase in NNN construction.

COVID-19 spurred obstacles related to transacting efficiently, including difficulties securing capital, inspecting properties, and negotiating in a fully remote environment — trends that have prevented many investors from placing their net-lease properties up for sale. Today this shortage of inventory translates to opportunity for buyers who can find available NNN deals.

To circumvent difficulty obtaining debt in the current environment, many investors in this space are engaging financial intermediaries that have relationships with a wide variety of lenders and can negotiate on behalf of borrowers to secure the best financing terms for NNN deals.

Diverse properties. Diversification is a hallmark of smart real estate investment. Investing in a variety of asset types can help investors hedge against downturns in any one sector or industry. NNN properties cover a broad spectrum of industries, including quick-serve restaurants, drugstores, convenience stores, automotive shops, financial institutions, and many others. Because of this breadth, even while staying within the NNN category, investors can diversify enough to keep their portfolios stable in the face of economic downturns like the one induced by the pandemic.

Tax and liquidity advantages. Single-tenant net-lease assets fall under the category of like-kind exchanges under IRS Code Section 1031. This designation allows investors to postpone paying taxes on the capital gains for these properties, provided they reinvest sales proceeds in a similar property that qualifies as a like-kind exchange within a given amount of time.

Because taxes can be deferred and 1031 exchange properties are constantly in demand, NNN assets can provide considerable tax and liquidity advantages to investors, contributing to the steadily increasing popularity of these assets in the commercial real estate investment community.

The bottom line. Although COVID-19 has shifted the investment landscape and investor appetite to a preference for lower risk, growing demand for single-tenant triple-net-leased properties will likely continue over the next 12 to 24 months. Investors who can access the deals and funds they need will benefit from these assets' consistent stability, low-maintenance and low-capital-expense nature, diversification of industry, and tax and liquidity advantages. This combination of factors makes NNN assets a winning sector for a variety of investors in the COVID-19 era and beyond.

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