Introduction to:

BUYING IN YOUR BACKYARD

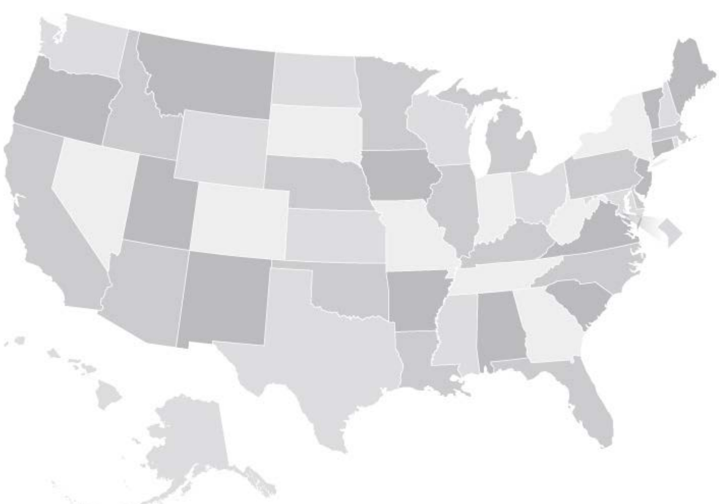
THOMASCOMPANY
NET LEASE CAPITAL MARKETS

NET LEASED ARTICLE SERIES

Location and Net Lease

Many investors have heard the maxim "location, location, location" in connection with real estate, and are familiar with the idea that in order to derive value from a real estate purchase it's necessary to buy a property only in a zip code with familiar real estate fundamentals and demographics. The logic behind this thinking is that investors should choose assets in communities they know well both so they understand how to continually reposition those properties in a shifting market, and because as landlords they should choose properties physically nearby in the event of maintenance, tenant, or other issues.

In the net leased market, however, location is less important for two reasons. First, tenants at these properties have a higher degree of responsibility for management at the site they're renting than do their landlords, meaning the owner does not have any responsibilities that require them to visit the property. Second, investors in net leased properties generally acquire them on the basis of their long lease terms (typically a decade or longer) and creditworthy tenants capable of fulfilling lease obligations, rather than on local market fundamentals or value-add opportunities, and so local market fundamentals don't play a role in the property's investment profile except at lease maturity in the distant future.



Lease Structures

Single-tenant investments typically feature triple-net leases between tenant and owner, or other lease structures that tilt the responsibility for building oversight toward the tenant. In a triple net lease, the tenant manages and more or less funds every expense on a property: The tenant handles the property's operating expenses—taxes, insurance, utilities, service contracts, and maintenance—as well as capital expenses, including larger repairs such as those to the structure of the building, exterior walls, and roof.

Even in a lease that places more responsibility on the owner—such as a double net lease, whereby the owner would have responsibilities for repairs to the roof and building structure—that responsibility is easily outsourced to a preferred vendor or contractor who can be managed remotely. In addition, the types of fixes a landlord must fund don't demand frequent attention. A roof, for instance, needs replacement only once every 15 to 20 years.

Exposure to Market

Since the credit of the tenant occupying a single tenant property is thoroughly evaluated at the time of purchase, an investor can develop clear expectations of tenant risk. This means that the landlord can expect their tenant to pay predictably throughout the remaining lease term. Indeed, leases in the net leased space obligate a tenant to pay through the end of the lease even if the tenant needs to move or close the location before the lease is up. Generally, the only way a tenant can legally stop paying the scheduled rent is by entering bankruptcy.

What this means is that the investor is guaranteed an income stream at a pre-set rent rate until the lease expires. For this reason, the investor is not exposed to varying market fundamentals (rent pricing per square foot, cap rate trends in other local-market commercial real estate, economic and

employment trends, zoning influences, tax changes) until lease renegotiation. During lease renewal, the investor will likely need to enlist or re-engage a real estate professional to position the property, factoring in the latest market fundamentals. But because market fundamentals essentially only play a role during this time, there's no particular advantage to buying single-tenant properties locally.

A National Marketplace

Once they understand that net leased property sales aren't built on market fundamentals, but, instead, on the predictable cash flow from a building leased to a tenant with strong credit, investors may find themselves looking at properties all across the country rather than in their own back yards. By looking in other markets, they may be able to locate properties that better fit their investment criteria, and they may also benefit from more favorable tax structures available in other states. Further, owning property in multiple geographies allows for diversification within an investment portfolio.

While an investor's introduction to the net leased real estate sector may emerge in their local marketplace, it's important that investors understand that the value proposition offered by these properties is consistent across markets. By working with a real estate professional familiar with the national marketplace for single-tenant properties, investors can research buildings at a variety of price points, all of which deliver reliable income streams with relatively low risk. While market fundamentals vary widely from one metro area to the next, the single-tenant sector isn't driven by those fundamentals. It's driven, instead, by a tenant's financial strength—and the fact that many national retail and services tenants must locate stores and branches throughout the country.