Trends in the Triple Net Lease Industry

Q3/Q4 – 2022

WESTWOOD
NET LEASE ADVISORS

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COVERING Q3 AND Q4 OF 2022

As the end of 2022 approaches, commercial real estate investors will shore up their investment strategy for the current tax year and review potential changes related to laws and regulations. It's important to know that despite the reports of widespread economic woes, 2022 is finishing up the third strongest year in single-tenant, net-lease history and sale-leasebacks have taken the market by storm.

As you plan for the end of the year and look to next year, this report provides you with an overview of 2022 tax opportunities, some market tips and trends, and how to get your last-minute NNN investment on the books by December 31, 2022.

TAX OPPORTUNITIES

When purchasing a triple net lease property, it is possible you may qualify for one or more tax benefits, including the following IRS tax codes.

1031 EXCHANGE

A 1031 exchange allows you to invest profits from the sale of one or more investment properties into one or more "like-kind" and often more valuable properties, and defer 100% of the federal capital gains tax from the sale of your original property. The key here is that you must own your new property within 180 days of the sale of the old property or by the due date of your tax return for the year in which the transfer of the old property takes place, whichever arrives first.

With the end of the year right around the corner, if you haven't started your 1031 exchange, it may be too late, unless you engage a 1031 specialist who can often expedite the process to help you meet the deadline.

In other 1031 news, you may have heard of the proposed changes to the 1031 exchange that were to start in 2023. There's good news — there won't be any changes in the upcoming year. Therefore, if you plan to trade one or more underperforming or high-maintenance investment properties for low- or no-maintenance NNN lease properties and defer 100% of the federal capital gains tax without the intended restrictions, you can still do so in 2023.

Here are a few facts you may not know about the 1031 exchange:

- There are no restrictions on the number of times you can use the 1031 exchange in your lifetime.
- You can defer the federal capital gains tax on any income-producing property, including trading a rental home for a NNN property.
- Since this tax code is federal, you can use it to trade properties from one state to another.
- The 1031 exchange can be combined with other tax codes, like depreciation recapture, for even more benefit.

DEPRECIATION RECAPTURE

Depreciation recapture provides an additional tax opportunity when using the 1031 exchange. When the sale price of a property exceeds the tax basis or adjusted cost basis, the difference is "recaptured" by reporting it as income.

When using a 1031 exchange, not only can the capital gains tax be deferred (possibly indefinitely), but you may also potentially defer the depreciation recapture tax, which can provide additional savings of up to twenty-five percent. This can add up to ten of thousands of dollars or even millions of dollars in savings, depending on the exchange.

COST SEGREGATION DEPRECIATION (CSD)

If the property you purchase qualifies for cost segregation depreciation, this highly beneficial tax code accelerates depreciation deductions, defers tax, and improves cash flow. Instead of the typical 39-year period for claiming depreciation on non-structural improvements, you can claim the depreciation over a five-, seven-, or fifteen-year period.

Here's a CSD tip: Although cost segregation depreciation is routine with newly acquired and constructed facilities, CSD can be used throughout the life of a real estate asset. Be sure to contact a specialist to perform a cost segregation study (CSS) to see if your existing property qualifies for the CSD tax benefit.

SECTION 179 & CSD

Another tax planning strategy is utilizing Section 179 and cost segregation depreciation. When used simultaneously, you may be able to increase your internal rate of return (IRR) considerably.[1] Regular depreciation allows you to claim a certain percentage of depreciation over time, while Section 179, or Bonus Depreciation, allows you to claim it all at once, depending on the state in which you file taxes.

These tax opportunities can have a significant effect on your tax outcome in the year you take the deductions. As of April 2018, Section 179 allows you to claim up to a $1 million deduction, with a phase-out threshold set at $2.5 million.[2]

The 2018 Tax Cuts and Jobs Act (TCJA) set a schedule for the maximum bonus depreciation that can be claimed each year. In 2022, 100% depreciation is allowed. In 2023, the rate will be 80%, and it will decrease by 20% each year until bonus depreciation is eliminated in the 2027 tax year.

When planning your NNN property purchase, be sure to keep these and other tax opportunities in mind and consult with your CPA or financial professional to maximize your savings.

"When using both bonus depreciation and CSD, a cost segregation study (CSS) is a valuable tool. We often recommend it to our triple net lease investors to support property tax depreciation with documentation, maximize the benefit, and potentially claim missed deductions back to 1987." — Jason Simon, Westwood Net Lease Advisor Vice President

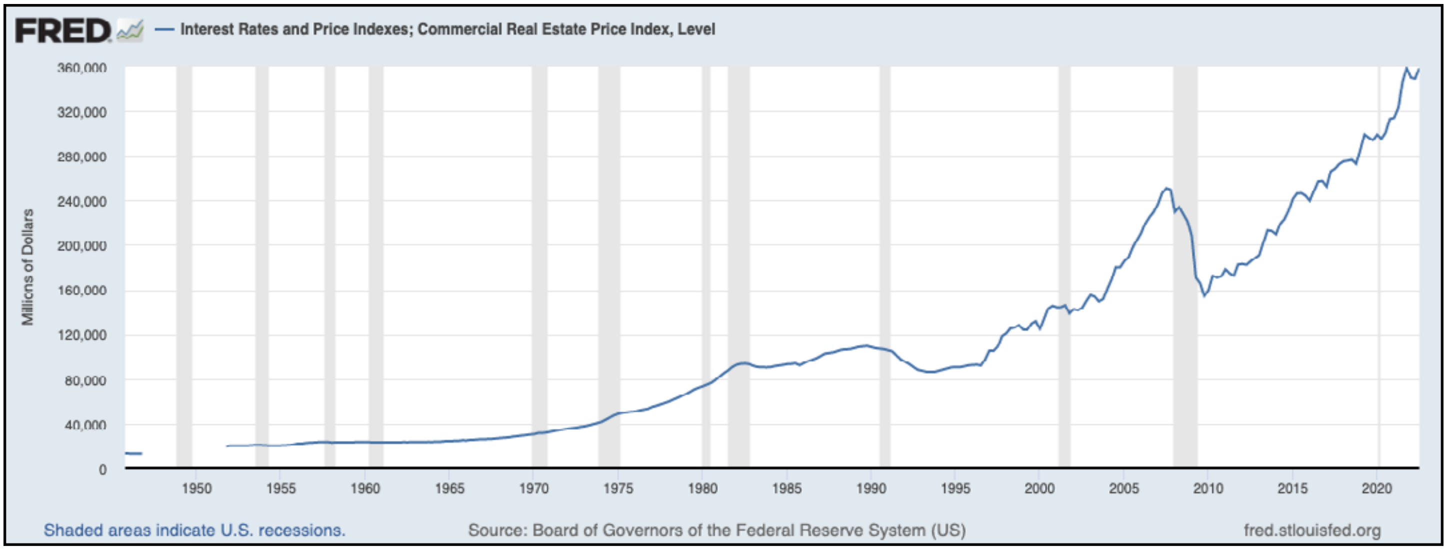
BALANCING INTEREST, MORTGAGE RATES, AND CAPITALIZATIONS RATES

INTEREST RATE MOVEMENT

In November, the U.S. central bank raised interest rates for the fourth time in 2022 to a range of 3.75–4%. This "benchmark" interest rate range influences borrowing from most lenders, such as banks and mortgage companies.

These interest rate increases, coupled with rising inflation rates, have led to an overall increase in the consumer lending rate, including those for mortgages and commercial real estate loans. If you should finance your NNN investment with a loan, higher rates can eat into the rate of return on your investment. However, triple net investments tend to receive better financing terms than traditional, non-NNN real estate.

Source: FRED Economic Data, Federal Reserve Bank of St. Louis.



A growing number of CRE investors are acquiring Adjustable Rate Mortgages (ARMs) to achieve lower interest rates short-term, as ARM rates don't usually adjust to market rates until the loan matures in 5, 7, or 10 years. Many NNN investors have a ten-year plan to own the property outright, so they reap the benefits of a lower-interest-rate ARM in an inflationary economy. After the term is up, some investors will refinance to a fixed-rate mortgage once rates decline.

Locking in the going interest rate (approximately 5.75–6.25% give-or-take depending on the property) before the next rate hike could help improve your cash-on-cash (COC) return.

Triple net lease properties tend to carry a lower interest rate than gross lease properties due to several key factors: the tenants are either a high-credit company or an investment-grade corporation, the properties are usually in prime locations or the best locations for their target audiences, and the triple net lease is typically guaranteed, so the lender carries the least amount of risk, as do you.

CAP RATES

The advertised cap rate on a NNN property is calculated on an all-cash basis and is just one measure of the equity return on investment, as many other calculations and variables can affect the outcome — one of which is the cap rate spread. Put simply, the "cap rate spread" is the difference between the aggregate nationwide cap rate and the current interest rate being offered by lenders.

Historically, capitalization rates readjust to account for the increases in interest and inflation rates and close the spread, however, that change is not immediate nor is it guaranteed. Supply and demand can also influence the average cap rate.

In Q3/Q4, for the first time in years, the NNN sellers' market began the shift to a buyers' market. Sellers, with a little encouragement, are adjusting cap rates up and pricing down; they see that demand has slowed. So, if you're in the NNN market — especially as a cash buyer or 1031 exchange buyer — you can potentially get a high-quality triple net property at a better price with a slightly higher cap rate than you could have in Q1/Q2.

Working with a triple net lease advisor is critical to successful negotiations and finding the most ideal property for your financial goals. An advisor is your advocate, helping to negotiate a fair cap rate and price.

TRIPLE NET LEASE: THE CURRENT MARKETPLACE

Economic factors resulting from the COVID-19 pandemic continue to influence certain fields in commercial real estate. For example, the rate of office rental vacancy is anticipated to increase through 2022 due to an oversupply of office space and a decline in the total number of businesses, according to an August 2022 report by IBIS World. The same report states that an increased employment rate suggests support for a boost in demand for commercial centers, retail space, and distribution centers.

From June 2021 to June 2022 net-lease sales activity rose about 25%, and if Q4 pans out as expected, the net-lease market will have earned $74 billion in 2022 annual sales volume.[3]

NNN sale-leasebacks are also ticking up. Nationwide, in Q3, there were 237 sale-leaseback transactions, with industrial properties as the main driver, pushing the period to the strongest quarterly performance in deal count since Q4 2019.[4]

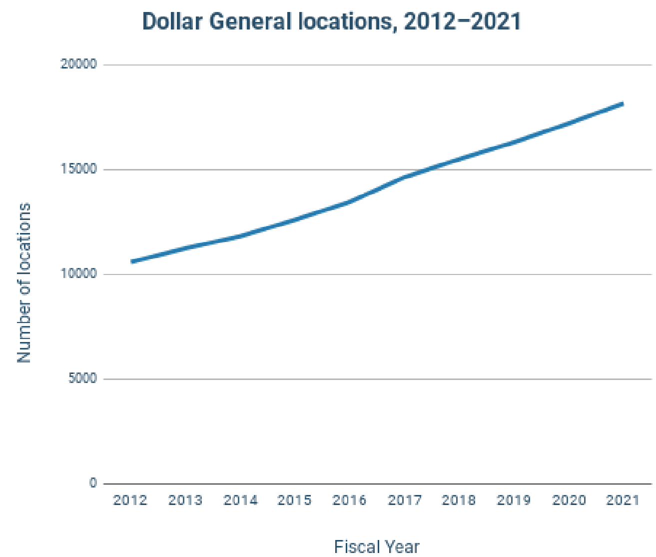
Triple net retail properties remain a sound investment because of their essential nature, recession-resistant history, and straightforward cash-on-cash return, as well as the potential for a much higher IRR when compared to other types of CRE properties.

NNN essential retailers, medical clinics, gas stations, fast food, drive-thru, and quick service restaurants (QSRs), child care and early learning, and drug stores continue to strengthen their brands and report record sales when other CRE brands and property types are struggling.

Take a look at the following NNN lease tenants that continue to grow, add locations, and offer CRE investors a viable investment vehicle. These and many other NNN tenants offer reliable monthly income backed by billion-dollar companies or high-credit franchises, tax opportunities, and inflation-resistant lease protection.

DOLLAR GENERAL

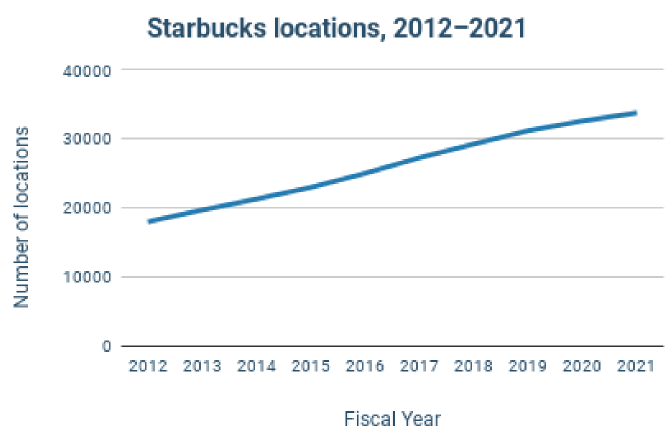
Dollar General NNN investments frequently offer higher cap rates than other triple nets, even in a slightly compressed marketplace, provide stable income with tax opportunities, and carry additional investor benefits that other commercial real estate (CRE) can't match.



Source: Dollar General — Dollargeneral — Annual Reports

STARBUCKS CORPORATION

Starbucks Corporation goes above and beyond the usual net lease investment attributes, driving home record revenues (up 15% to a Q2 record of $7.6 Billion), and providing new commercial real estate investment options.



Source: Starbucks Corp. — Financial Data — Annual Reports

SUMMARY AND SOLUTIONS

As you and your CPA plan for the end of the tax year, you may consider investing in triple net real estate using a 1031 exchange to defer all federal capital gains tax and possibly defer recapture depreciation, potentially saving thousands to millions of dollars. There is also bonus depreciation and cost segregation depreciation to factor into your tax strategy.

If you are ready to find the right NNN property for your goals, look for major brand tenants from multibillion-dollar corporations, such as Dollar General, Walgreens, and Starbucks. These investment-grade tenants are significantly less likely to default, reducing owner risk while offering tax advantages.

Triple net lease properties tenanted by essential businesses offer a predictable overall return with periodic rent escalations and little or no management responsibilities, guaranteed monthly income — potentially for decades — and the ability to diversify between asset type, location, tenant, and lease type.

With the combination of tax opportunities, rent escalations, possible leverage, the value of a tangible asset, and financing terms, your internal rate of return (IRR) can be as much as 7–10% or more, which is in line with gross lease investments and stock market returns.

If you are ready to learn more about NNN lease property investments or the 1031 exchange, our advisors have decades of experience and a vast, nationwide network of sellers, brokers, and developers with whom we work so we can help you find exactly what you're looking for and help you meet your financial goals with ease.
Our buyer representation is cost-free.

Contact us today for a no-obligation conversation at 314-997-5227

Endnotes

1 https://www.irs.gov/newsroom/new-rules-and-limitations-for-depreciation-and-expensing-under-the-tax-cuts-and-jobs-act

2 https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-a-comparison-for-businesses

3 Pigott, Matthew. August 2022. Commercial Real Estate in the US. IBIS World.

4 Globest.com https://www.globest.com/sectors/net-lease/