Trends in the Triple Net Lease Industry

Q1/Q2 – 2023

WESTWOOD
NET LEASE ADVISORS

Table of Contents

THE CURRENT TRIPLE NET LEASE MARKETPLACE

COVERING Q1 AND Q2 OF 2023

The commercial real estate (CRE) market is always changing, and shifts can be even more pronounced during times of economic recession. Though we are not currently in a confirmed recession, we have experienced recessionary turmoil in the last 18 months and will likely do so throughout 2023. Last year, investment volumes plummeted across asset classes, and triple-net lease properties were no exception. Research from CBRE shows that NNN sales volumes fell 63% year-over-year in Q4 of 2022.

Low inventory and the Fed's ongoing efforts to restore inflation to its target 2% has some commercial real estate investors hesitant but for triple net lease investors with the appetite, rising interest rates and fluctuations can be favorable allowing them to take advantage of shorter bid lists to secure higher quality properties. In the current environment, nearly all investors are seeking investment opportunities that offer some certainty.

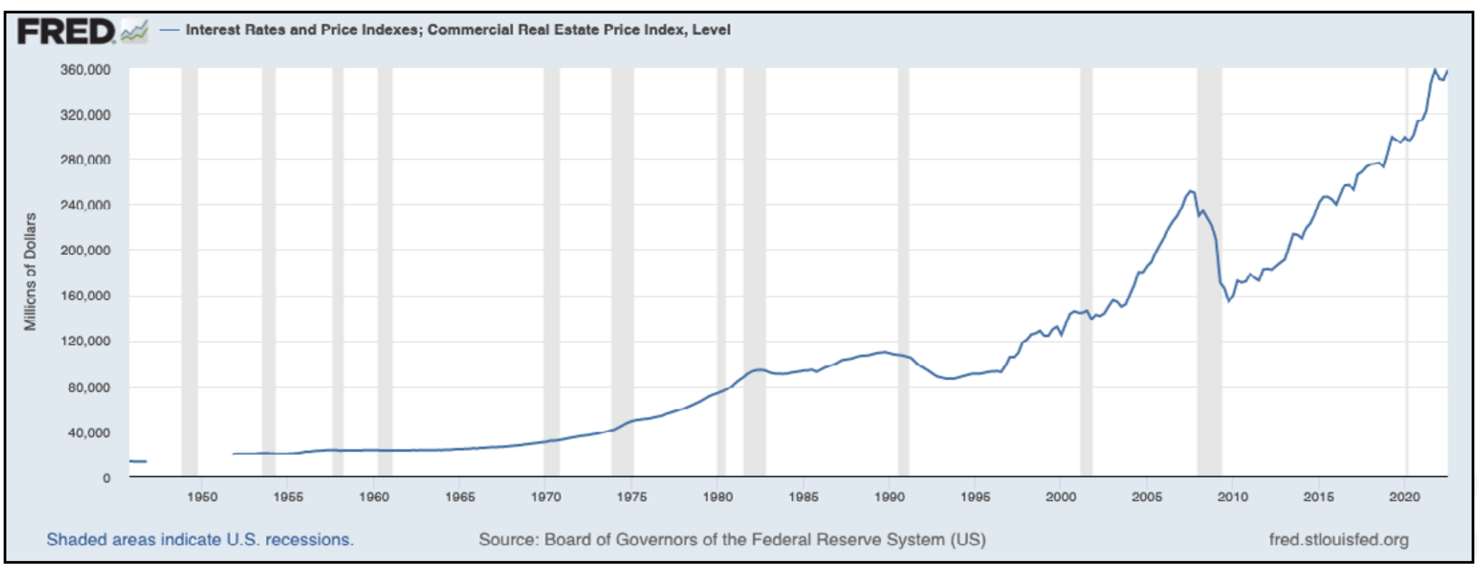
BALANCING INTEREST AND CAPITALIZATIONS RATES

INTEREST RATE MOVEMENT

Interest rate increases, as part of the Fed's continuous pursuit to reduce inflation to its 2 percent target, have some investors approaching the market with caution and taking more potential increases into account as they adapt their investment strategy for uncharted territory.

Though interest rate hikes can act as a short-term deterrent, they are less of an issue for triple net lease investors, since many NNN properties can be purchased between $1M and $10M and NNN investors often use all cash or finance just a portion of their investment.

After the most recent 25 basis-point increase in early May of 2023 landing the federal funds rate at 5.00% to 5.25%, analysts and investors alike are hoping for a pause on increases allowing time to alleviate the uncertainty accumulated since the start of the year, build confidence, and restore volume for the second half. Rather than letting your money sit idle due to uncertainty, a steady NNN lease investment could help you preserve wealth and passively add to your monthly earnings.



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

If you need financing to NNN invest, consider investing sooner than later to avoid future interest rate hikes and take advantage of negotiating power and tax opportunities. 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.

Your CoC return is the amount of cash you receive (rent minus debt service) divided by the amount of cash initially invested. When you take out a commercial loan to finance your triple net property, the interest rate on the debt can affect your CoC and the long-term value of the investment. With all things being equal, a higher interest rate can lower your CoC return, and a lower rate can increase it.

CAP RATES

First, it's important to note that an advertised cap rate on a triple net lease property is calculated on an all-cash basis, and on absolute triple net properties, the cap rate is your net operating income (NOI) as there are no expenses. It signifies the level of risk and is just one measurement of the equity return on investment. Current average NNN cap rates range between 4.50% and 6.00%. Other calculations and variables also affect a triple net investment's outcome, including the cap rate spread.

The "cap rate spread," or cap rate to interest rate spread, measures and compensates commercial real estate investors for the additional risk assumed by taking on debt. If the spread widens, as it has over the last few years, investors are more highly rewarded.

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.

When interest rates change, cap rates tend to be slow to catch up, and when they finally do, it's usually only partially. In the 13 years I've been a triple net lease advisor, even during the Great Recession, NNN cap rates have stayed reasonable and unchanged for long stretches of time, mostly between 4.50% on the low end and 7.00% on the high end, with some exceptions, of course.

In the first and second quarter, cap rates are gradually increasing as the supply and demand curve shifts. With a bit of nudging, we are seeing cap rate and purchase price negotiating power as the market moves from a seller's market to more of a buyer's market."

— Chris Schellin, President of Westwood Net Lease Advisors

Q1–Q2 TAX OPPORTUNITIES

1031 EXCHANGE

A 1031 exchange allows you to invest profits from the sale of one or more investment properties into one or more higher-performing properties while deferring 100% of the capital gains tax. You could save tens of thousands if not millions of dollars and build a high-quality portfolio that provides decades of monthly income.

- 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.

Beyond being an excellent vehicle for deferring capital gains taxes, like-kind exchanges help drive the economy. They comprise 10–20% of all commercial real estate transactions and like-kind investors invest significantly more capital (15.4%) into replacement properties than non-1031 buyers. 1031s have been independently studied and proven to contribute to local, regional, and national tax revenue, with far-reaching socioeconomic and financial impacts that drive the US economy forward.[1]

In any economy, but especially in an inflationary or recessionary economy, like-kind exchanges:

- Stimulate all types of business growth.
- Can increase federal and state tax revenue through reduced deductions and depreciation.
- Keep real property transactions moving, shortening real estate holding periods.
- Reduce the cost of capital.
- Help keep real estate values up and cash-strapped businesses open.
- Minimize large and frequent rent increases.
- Contribute to economic expansion and US GDP.

A properly structured like-kind exchange is a win-win for you, investors, the economy, and its people.

An Ernst and Young study[2] found "2021 like-kind exchanges supported 976,000 jobs and contributed $48.6 billion in labor income and $97.4 billion of value added to U.S. GDP."

DEPRECIATION RECAPTURE

Depreciation recapture is how the IRS "recaptures" any depreciation or amortization you've taken on your tax return over the years. When the sale price of a property exceeds the tax basis or adjusted cost basis, the difference is "recaptured" by reporting it as income. Depreciation recapture is taken and the profit is taxed as ordinary income when you sell the real estate and realize a profit unless you utilize a 1031 exchange.

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 can help preserve capital, provide immediate cash flow, and achieve significant tax relief on new and existing buildings. 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.

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 NNN property qualifies for the maximum CSD benefit.

To satisfy the IRS's strict CSD guidelines, your CSS must be performed by a highly accredited engineering, architecture, construction, or tax accounting specialist who will determine the cost estimates and allocations in accordance with the law. This also ensures you don't leave any money on the table.

PROPERTY TYPES AND TENANT SECTORS TO WATCH

Historically, no matter what the economy is experiencing, triple net property investments are known to carry the lowest risk in the commercial real estate market as they offer a potential IRR that rivals other types of investments (7–10%) without the daily worry of maintenance and value fluctuations. Triple net lease property types (retail, medical, child care, fast-food, QSR, auto parts, drug stores, convenience stores) have recently come through the worst modern-day economic and health-related crises, and they are stronger for it.

RELIABLE TRIPLE NET (NNN) LEASE OPPORTUNITIES

Westwood Net Lease Advisors has selected the fast food and QSR asset class as our NNN Tenant of the Quarter, Q2 2023. Fast food and quick service restaurant (QSR) brands, such as Taco Bell, Starbucks, Dunkin', McDonald's, and KFC, are to serving consumers more efficiently with technologically-enhanced services like mobile apps, self-ordering kiosks, and customer rewards programs to drive increased and repeat sales and reduce overhead in existing and new locations across the US, creating NNN lease investment opportunities that provide steady, income-producing investments in an unsteady economy.

The medical sector is highly sought-after in the net lease investment marketplace. In Q1 of 2023, Regardless of world events, whether it's a pandemic, global unrest, or economic uncertainty, medical care is essential for people who need urgent and ongoing care. For these reason, in combination with their financial strength and investor benefits, Fresenius Medical Care Centers were deemed Westwood Net Lease Advisors NNN Tenant of the Quarter, Q1, 2023.

With an aging population, increased demand for healthcare resulting from the pandemic, and potential changes in reporting for Medicare and Medicaid-funded nursing homes to improve accountability, planning, and ultimately lead to healthier nursing home deals[3], NNN medical tenants are reliable option for low-risk, long-term income opportunities.

TENANT SECTORS TO AVOID IN 2023

Many CRE tenants, such as office space, multifamily, and full-service restaurants, are still being impacted by the adverse effects of the pandemic, supply chain woes, rising interest rates, inflation, and the labor market, making them high-risk investments. It's best to avoid these tenants since they lack stability and predictability and their ability to pay rent may diminish as the economy slows down.

SALE-LEASEBACKS FOR STABILITY

Triple net lease sale-leasebacks can be especially attractive to buyers seeking certainty in this unpredictable economy because they rival or exceed the internal rate of return (IRR) of other commercial real estate investments.

Sale-leasebacks have been a popular type of real estate investment for ages, but there has been increased activity in recent months, likely due to businesses such as convenience stores and quick service restaurants (QSRs) needing post-pandemic operating capital, as well as investors redistributing their capital from other, more volatile investments.

"Business owners and corporations see the increased interest from sale-leaseback buyers and their available capital as an opportunity to cash in and expand their businesses while not losing value.

Companies that may not have considered a sale-leaseback before the pandemic are hedging against risk with their liquidity before the market changes and spreads widen. Real estate investors are buying now to avoid a potentially higher cap rate spread and turning to leasebacks for the stability,"

—Vince Vatterott, Westwood Net Lease Advisor.

SUMMARY AND SOLUTIONS

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. They offer predictable overall returns with periodic rent escalations and little or no management responsibilities, reliable monthly returns — potentially for decades — and the ability to diversify between asset type, location, tenant, and lease type.

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.

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, with significantly less risk and management responsibility.

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://1031buildsamerica.org/study-ling-petrova-2020/

2 https://1031buildsamerica.org/study-ey-lke-macroeconomic/

3 https://www.healthaffairs.org/doi/10.1377/hlthaff.2022.00278