Double Net vs. Triple Net

By Glenn Kindred, CCIM

Triple net leases ("NNN") call for the tenant to be financially responsible for the payment of property taxes, insurance, and repairs and maintenance costs. In some cases, the landlord remits some of these payments, but is reimbursed by the tenant, qualifying the lease as triple net. Double net leases ("NN") call for two of these three costs, usually property taxes and insurance, to be paid by the tenant and the third, repairs and maintenance to be paid by the landlord. Sometimes maintenance costs are bifurcated between tenant and landlord, usually by calling for the landlord to pay for capital expenses such as roof and structural repairs while the tenant pays for general maintenance and repairs.

Many investors look at this difference in the context of time, meaning roof replacement and structural repairs are years away, especially for leases on newly constructed buildings. Because of how far into the future these costs are expected to be incurred, investors often disregard this difference. But are these costs which can be 20 years or more away, really insignificant to the extent they can be ignored? This article explores the answer to that question.

The argument that NN and NNN leases are essentially the same is simple. It is usually as follows; "The expense is so far down the road and a building inspection at the time of acquisition did not reveal any condition defects, so I don't need to worry as I won't ever have to pay it." The arguments that the difference is significant are far more complex.

First, typically if the responsibility for roof and structure lies with the landlord, the cost of both scheduled maintenance and unforeseen repairs typically falls on the landlord. This can have material financial implications and be time consuming for the landlord. Typically, the cost to repair and replace damage to the tenant's property and improvements arising from a damaged roof will also fall on the landlord. As a result, landlords often are required to carry additional insurance that would not be needed with a true NNN lease. However, in some cases, the lease does not require the landlord to carry this insurance and assumes the landlord has sufficient capital on hand to fund needed repairs. This is often not the case with passive investors as a roof could cost $100,000 depending on the extent of a replacement.

Second, appraisers typically reduce a property's NOI by an amount needed to meet roof and structural repairs. This reduces the appraised value and the amount of money an owner can borrow on the property. Appraisers and brokers often value net lease assets by simply applying a cap rate to rent as if there are no landlord responsibilities, rent is effectively NOI.

Assume for a moment that the buyer of an NN property maintains insurance to cover roof and structure risks. This policy could cost as much as $10,000 a year or more for even a small net lease property. The Difference in value can be meaningful as illustrated in the table below, if a buyer is paying the same price for an NN lease as for an NNN lease, the price paid actually reflects a 6.07% cap rate as opposed to a 6.50% cap rate. This is a substantial difference.

	Ignoring the Difference Between NN and NNN		
	NN	**NNN**	
Rent	$ 150,000	$ 150,000	
Cap Rate	6.50%	6.50%	
Value	$ 2,307,692	$ 2,307,692	
	Recognizing the Difference Between NN and NNN		
	NN	**NNN**	
Rent	$ 150,000	$ 150,000	
Insurance Cost	$ (10,000)	$ -	
NOI	$ 140,000	$ 150,000	
Cap Rate	6.50%	6.50%	Difference
Value	**$ 2,153,846**	**$ 2,307,692**	**$ 153,846**
	Cap Rate for Equivalne Value		
NOI	$ 140,000		
NNN Value	$ 2,307,692		Difference
Comparable Cap Rate	**6.07%**	**6.50%**	**-0.43%**

Third, lenders may require the amount stated by the appraiser to be set aside in a restricted account to cover anticipated long-term repairs. Note that this amount is usually based on the inspector's view of the useable life of the roof so it is possible the reserve period may be much shorter.

Assume for example that the roof cost is expected to be $100,000 and that roof has a 15-year expected life. The lender may escrow $6,667 each year with the debt payment. In the following table, one can see that the even this small escrow meaningfully changes the buyer's initial cash on cash return. This example assumes the lender did not reduce the value of the asset. If the lender did make that adjustment, the buyer would have had to put more equity in the property which would have a similar effect on returns.

	Ignoring the Difference Between NN and NNN		
	NN	**NNN**	
Price	$ 2,307,692	$ 2,307,692	
Rent	$ 150,000	$ 150,000	
Less Debt Payment	$ (119,038)	$ (119,038)	
Less Escrow	$ (6,667)		
Free Cashflow	$ 24,295	$ 30,962	
Equity to Close	$ 923,077	$ 923,077	Difference
Cash on Cash Return	**2.63%**	**3.35%**	**-0.72%**

*6% Interest on a 20 year loan at 60% LTV

Fourth, when selling an NN property, smaller properties such as restaurants, single tenant retail buildings, convenience stores, drug stores, banks and dollar stores are often sold to 1031 motivated passive investors. These passive investors, due to their tax motivation and limited access to direct real estate investment, are typically willing to pay a higher price for properties than institutions or other buyers would pay. These buyers need the certainty of not having an unforeseen capital expense and are generally not equipped to manage a construction project, even a roof replacement, thus they may not be present in the market for the double net property. This results in setting the market value of the property subject to a NN lease lower than a NNN lease.

From an economic standpoint, the market should be addressing these differences by setting the rents differently. The double net tenant should pay more than the triple net tenant to address the added expense being borne by the landlord. The reality is that most lease negotiations do not address this aspect of expenses and often use it as a concession at the end of the discussion given by the landlord to close the deal. For example, restaurants who often set rents as a percentage of revenue or a yield on total cost rather than on a per square foot basis generally do not address the concept. A restaurant might agree to pay 7.5% of sales as rent but it rarely then says “but if we can go NN, I will pay 7.75% of sales.

There are arguments on both sides of the question. Tenants often argue that long term capital expenses belong on the landlord as the useable life of those components is much longer than the lease term and if the tenant is called upon to replace the roof, their tenancy will not be long enough for them to recover the cost of the roof. They effectively argue that a NNN lease should place property taxes, property insurance, and maintenance but not capital costs on the tenant.

Landlords often concede the point by rationalizing that their investment period will be over by the time the expense is actually incurred, therefore they will never actually pay the cost and because net lease assets are typically valued using a capitalized income approach, few buyers will take the diminished roof life into consideration when buying the property.

When evaluating an NN investment vs a NNN investment, the difference is material. A buyer’s ability to borrow on the property and the cashflow from the property may both be lower with an NN strucutre. The Buyer may be called upon to actively manage the repair process in the event of a property casualty or upon the end of the assets expected life, making the investment less passive. The buyer may not be able to sell the property for as much when she or he chooses to exit the investment due to the nature of an NN lease. Still, properties with NN leases may be exceptional investments. Buyer’s need to be aware of the differences and build them into their understanding the investment’s likely returns and the amount of time that will be needed to manage the investment.

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