INTRODUCTION TO TRIPLE NET (NNN) LEASE INVESTING
Guest Speakers: David Sobelman and Austin Simmons

OK, folks, tonight we have two guest lecturers, David Sobelman from Calkain Companies and Austin Simmons from Brightwork, which is his company. And tonight they're going to talk primarily about triple net leases and development. Take it away, guys.

Thanks. Thanks.

Thanks, Greg.

Yeah. So Austin and I are not partners, but we work together frequently. And, in fact, we probably talk to one another, our respective firms talk to one another, probably close to daily. And Austin and his company, Brightwork Development, is a client of ours. And our company, Calkain Companies, is a brokerage firm.

So Austin's company builds the properties. And then they hire us to sell the properties. And we focus on a property type that is very, what we call, "niche-y," and there's a specific niche. It's called a triple net lease investment.

So this is Net Lease 101. It's passive. But it's passive to a certain extent. So Steve said it's taxes, maintenance/management, insurance. The tenant, for the most part, takes care of all those.

And in exchange for that, the landlord gets a check-- today it's a wire. And they get it sent to their account every single month or however the lease is written. Typically it's with nationally recognized tenants. Why don't you talk about some of the tenants that you are currently working with?

Sure. When Dave talks about nationally recognized tenants, so we would know the Walmarts of the world. And we would know the Publixes of the world. And we'd know the Verizons of the world, all we do business with.

We also will do regional tenants. So we do a lot of Wawa gas stations, Regions Banks before they stopped. Those are regional tenants, not national tenants. They don't have a breadth from LA to New York.

But primarily, as David said, the net lease market-- which is also fed a lot by the 1031 market-- looks for-- and we'll talk about it-- looks for credit. And it's one of the things that David's going to talk about in a minute. And one of the ways you get credit, you find something that's really big. Because when they're really big, most of the times, they have a lot of money. And if they have a lot of money, many times-- not all the time-- many times that means they have good credit.

That's right. So when we try and find a value to a net leased property-- and this is great for the finance majors-- is we look at three main criteria. There are thousands of minutiae that go into each of these. But we broke it down in a very elementary fashion.

First and foremost, number one, real estate. So everyone in here is interested in real estate because they like the action. There's a lot of money in it. But you have to remember that, at the end of the day, where that property is, is the most important criteria to any real estate investment.

And a lot of residential realtors will say location, location, location. It applies the same to us, even though we work with bigger numbers, or national tenants, or fancy algorithms. Whatever it is, it always goes back to where that real estate is.

I would add that the owner of the asset-- so myself-- when I buy an asset, and I develop the property, and I receive the rent, the first thing that I ask myself is do I like this real estate? And if I like this real estate, if I can see someone else here, other than the person that I'm developing for, I like it. If I can't-- if in my experience I can't see someone else here tomorrow if the tenant were to go away, or 50 years from now after the lease is over and the tenant has moved up the street-- then I call Dave.

[LAUGHS] That's right.

Because as an owner, if it's not good real estate, I don't want it.

That's right. So we look at real estate first. Very close second to that, still second but very close second, to the real estate is what we were talking about, the credit of the tenant.

So most of you here who are finance majors, you know what Standard & Poor's is. You know what Moody's is. There's other credit rating agencies, Fitch, NAIC. There's probably another one I'm missing there.

In any case, they establish the creditworthiness of that tenant. And so, in our pathetic lives, we've memorized what their credit rating is for the majority of the major national, and international, and regional tenants. So you can say "McDonald's" to me. So McDonald's is a huge company. So they have an A+ S&P credit rating.

Starbucks, they have a BBB+ S&P credit rating. So it's actually lower than McDonald's. Yeah.

So what the credit rating means is what is the percentage of chance that they won't pay you.

That's exactly right.

That's the analysis. And many different credit agencies have different rankings. But essentially, they're all ranking the default percentage.

And the credit risk, anybody above junk-- so BBB- in the S&P scenario, BBB-, the world says that's credit. If it's below BBB-, it's not credit. So the percentage of default ratio there is very compressed.

It's not A is 1% and BBB- is a 50% chance. It's 1%, 1.5? 2%, 2.5%, 3%, 3.5%. Then you get to junk. Really after about 4% or 5%, it's all junk. In the vernacular, it's what people call non-investment grade credit.

And so primarily what I do is I seek out--

Credit.

--Credit. And the only spin that I would put on that, again as an owner as opposed to an investor, is that credit to me means like S&P, their ability to pay, and what their default ratio would be. But I can make that judgment since I'm an owner independently of S&P. So I would invest in Anthony's Coal Fired Pizza, for example. We developed an Anthony's Coal Fired Pizza.

They don't have a credit rating. There's no S&P. You couldn't look them up. No financing company has ever analyzed their shadow rating and decided what their percentage chance of defaulting is.

But I could look at their balance sheet. And I can look at their income statement. And I can analyze their operations. And I understand what restaurants need to do in the economics of sales to rent, and operation costs, and CAPEX and all. I understand that.

And I can look at that and say, you know, these folks understand this. And they've got 42 locations. In every single one of them, their balance sheet shows, and their income statement shows, they understand it. I perceive them as a good credit risk. So we were happy to develop an Anthony's Coal Fired Pizza for them, because I think they are a good credit risk.

But in the true triple net market, primarily-- we're talking what David is talking about-- it's credit. You open a book. And their name is in it. And it has a number, or actually a letter.

Right.

A couple letters.

Right. So to recap, we're looking at real estate first, credit second, and then terms of the lease, our third. So this is probably the most variable part of any triple net lease property, because there's a big long document-- sometimes 100 pages or more-- of legal wording. Being polite, right?

Good way to put it.

And it outlines exactly who is responsible for what during the entire term of that lease. So sometimes leases are five years. And you may say, well, that's a long time, five years. You're in and out of college in five years.

Well, in our world, that's meaningless. Five years is a very short amount of time. Austin and I talk about 20 years and more. And that's how we want the length of most of our leases to be.

And we also want it to be very passive. So we want to make sure that it's truly a triple net lease. And there's lots of iterations to this. But there's just pages and pages that are outlining exactly what the terms of that lease are.

And every lease of every property is different from the other property. So you can't say this is a standard x tenant lease.

And really the lease is where the heart of our business might come into play a little bit. So where David brings really the most value is taking two leases that are dissimilar-- very dissimilar, I mean two national tenants, both A rated, their leases, it's like they're totally different languages. Different terms, everything's different about them.

But the nuances in there, to a sophisticated investor, go away. And you are able to filter through to the truth of what you're trying to get at. So on 100 pages, you need somebody that knows how to look at that and say, no, no. For clarity's sake, put this aside, and let's filter. And then they can filter these leases.

And David's company, one of their most important things to do is to take a lease and really filter out the dirt. And then show an investor, what are the pieces-- what are the diamonds in here, where are the gold? And so when they filter this out-- and the person has to believe that this filter is valid.

They filter this out. They say, well here are the nuggets of gold in this deal. This is why you want this. Or filter it and say, it's all dirt. There's no nuggets of gold in here. There's nothing in here.

Right.

So the lease is really, that's the art of this business on this side of the equation. That's a weird one. You need an expert.

You do. So again, real estate, credit, lease-- those are the three things that are going to resonate throughout our talk tonight.

So why do people invest? It's fairly safe place to invest. There's less fluctuation in a triple net lease property. Because from the day you buy that property, or from the day you sign the lease, you know exactly who is responsible for what, for how long. And usually it's for a long period of time.

So we have, again, leases that are short, five years, leases that are 75 years. And that's what we're trying to look at. So as the macroeconomic fluctuations start occurring, the ebbs and flows of the economy, the lease is standard.

It's static. It doesn't change. It's always going to be, here's what the rent is, here's who's responsible for what.

It's different than apartments, where if someone rents an apartment for $1,000 a month, if the market starts becoming very soft for rentals, then all of a sudden it becomes a $600 rent the next time someone rents it. So with net leased properties, the leases are so long that people like that steady cash flow for long periods.

Little bit of overview here. So here's the advantages. And I can email this out to Greg and so on. But the point that we're trying to make here is that there's a lot of work that's done up front, literally years of work that is done, before a property actually becomes a single-tenant, stabilized, net leased property that generates income for decades.

So that's what Austin's job is, and then sometimes my job, to work back and forth with him. But he spends his money doing that. And so what he's ultimately trying to do is establish a secure-- I did that with my mind. [LAUGHS]

What he's trying to do is establish secure, consistent, long-term cash flow from credit tenants. And that's hard to do. That's a hard job. Who doesn't want that steady income for literally decades?

And that's why this seems like a simple and easy business. But the amount of work that goes into getting to that point is what Austin spends all of his time on. So there's unique tax benefits. And are there any accounting people in here, or anyone who likes talking about taxes? No?

Nobody likes talking about taxes.

So there's unique tax benefits here. There's depreciation. We use exchanges to go in and out of properties so we don't pay long-term capital gains. That's a 1031 exchange.

What's not on here is something called a 1033 exchange. And that's when a government entity-- federal, state, local-- comes and takes your property, says we're going to build a road here. Or we're going to build a government building here, or something like that. And then they pay you to do that. And then you have a period of time to find a new property and not pay any capital gains on the sale of your property that they took from you.

Depreciation and then able to leverage. And we talked about the benefits of passivity.

So the three criteria that we come up with-- real estate, credit, and lease terms-- all rolls into one number. And that number is a cap rate, or a capitalization rate. It's a measurement of risk, is a cap rate.

And so people want as high a return as possible. So if I give you $100, and you say, I'm going to give you $50 back every year for 20 years, you have a 50 cap, which doesn't exist. But that's just how the math is.

So the equation to find that cap rate is the NOI, which is Net Operating Income. That's just a fancy way to say your rent, your triple net rent. And then the value of that property, so if it's $100, or $1 million, or $1 billion. So the NOI divided by the value, you get your cap rate. And it's a percentage.

And the percentages that Austin and I work in-- he works in the higher cap rates, because he's taking a lot of risk when he's building his properties. He has to-- well, why don't you explain the process?

Yeah, so if you were to do an analysis of a cap rate on a developer transaction, I'll buy the land for $1 million. Put a million-dollar building on it, that's $2 million. And I have some costs at $500,000.

So I have a $2 and 1/2 million deal. And I'm getting $250 in rent. So that return on my $2.5 million investment is a 10 cap. So I'm going to get 10% return on my value. And my value is the cost.

Right.

Now, I have that $250,000 income. And that income has a value. So that return is valuable to someone.

So I signed a personal guarantee. And I spent $250,000 in advance doing all the due diligence, with no guarantee of return. I got the tenant to sign a lease that was contingent on me getting 57 things done. All those things that I did, that I would've lost all my money if it hadn't occurred, I got them done.

So they're starting to pay me rent. And I'm getting a 10 return on that. And the tenant says, hey, that's fair. I don't know how to do this. You know how to do this. You've got it figured out. You pay me that.

Now, that $250,000-- if I said to the market, I've got $250,000 a year coming every year to me for 20 years. And it's being paid to me by Walmart. There comes a Walmart check. And it comes from Bentonville.

It's not the big checks.

Yeah.

It's a little check.

It's a little check with a lot of zeros on it. Anybody would say, well, I think that check's going to show up every year for 20 years. In fact, I think there's no chance it won't show up. Even if Walmart closes the store, even if they build one next door, even if they decided to leave Florida-- I think that check's going to always come.

So to someone who doesn't have the skill to figure out this problem, but does have the money to buy that income, that income has value. And that's the sale. There's a cap rate on that income.

That's exactly right. So what we're doing is real estate, credit, lease terms. So we talked about-- well, we didn't talk about real estate. But let's say it's great real estate. Walmart has AA+ credit. Again, we memorize these things, because we work at them all the time.

And then lease terms, it's 20 years. It's triple net and so on. And all of those together, you can amalgamate them into one number. And that is Austin's number.

So what Austin then does is he says, OK, Dave, I just spent two years talking to Walmart, spending my money, putting all of this together. I get a 10% return-- he usually doesn't tell me the return, but sometimes he does. [LAUGHS]

Only when I'm bragging.

And then he says, what is it worth? So he's done all the work. He stabilized the property. He has the income in place.

And now a passive investor, who is not Austin Simmons and Brightwork Development, can come in and reap the benefits of all of their work, and take and pay him money to do that. So Austin asks me, what is the most someone would pay for all of this work that I did? And if we're using Walmart as an example today, and let's just keep the numbers easy, the cap rate that someone would probably pay is 5%.

So if you're working backwards in all of this, you're at $5 million. So Austin has generated a property of a value of $5 million. This remains constant.

But now we have a different value, because the lease is in place. It doesn't change. Austin's cap rate was 10% on his development work. But now someone needs to buy that, and they want that $250,000 a year for 20 years. And they're willing to pay $5 million to get a 5% return.

It's probably a little bit lower than that. But we'll just use it for rough numbers. And so this is where Austin makes his money, here, respectfully.

That's where a developer who wants to recycle his equity makes his money. And we can get into it. That $2 and 1/2 million transaction probably required me to write a check for $400,000 or $450,000 in equity. So the bank would finance the rest.

And so I have $450,000 of cash stuck in that deal. And so if that's all the money I had, was $450,000, well, then I would have all the money I own is in this transaction. Now, I could think, I'm done. I can get the $250, that's fantastic. That's all I ever wanted to do. I'm finished.

Or I could get my $400,000 back, plus the difference between $5 million and $250, and presumably go do it again. And not just once, because now I don't have $400,000. I have, putting aside tax implications-- well, that's terrible to say.

[LAUGHS]

Putting aside tax implications, I have five times that to do. So I could conceivably do five of them. And then I could-- you can see the math and how that works.

Now, it's not a logarithmic progression, because there isn't any logarithmic amount of transactions out there They're arithmetic. And actually, they tend to tip in terms of numbers.

But that is what's seductive about this type of work. You can create value with leverage.

That's right, a lot. Greg?

Just to clarify, when I'm teaching this concept in class, I refer to the 10% as a yield on cost, like a developer.

Perfect.

It's still a cap rate. It's cash on cash.

We call it the development cap rate and the sale cap rate.

Right. But just to clarify the difference, the 5% is really the market cap rate.

The value, the market value.

Yes, value that the market's, the return the market wants--

Willing to pay.

--for that type of property, that amount of risk.

Yield on cost is your development cap rate, so my return on my costs. Exactly. And then the sale cap rate is someone else's return on their buy. And as Greg probably has said, really this-- we can go deeper into cap rates.

Cap rates are an implicit discussion. So if 10 people walk in, and they all say, for this deal, I would pay 5%. Well, implicit in that is their analysis of the world and what is going on in the world.

And they say, well, 5% return on a very stable asset is extremely good. Because the government's paying 1%, zero. You're getting zero in your money market account. So this is good.

Now, if we were all getting 10% in our money market accounts today, so no one would buy this cash flow for 5%. They would pay 15%. Because 10%, we can get by just doing nothing.

So that 5% is a very important number. It's a macroeconomic number. You can imply a lot of stuff by trying to sell one asset.

And so what Dave does a lot-- we do a little-- we hear what the market tells us about these numbers. We try to pay attention to them, because those numbers are Adam Smith's invisible hand telling us what's happening. And they're not really lagging indicators. That number is what's happening today in Hong Kong, or France, or Brazil.

And you have to pay attention to those things, because if you don't, you'll do this deal for $2 and 1/2 million. You'll get the $250,000 in rent. You'll take it to the market, and somebody will say, I'll pay you 11% for that. Oops. I just lost $150,000.

In that sense, the 10% is very important to the developer, because the 10% is the developer's break-even cap.

That's right.

Developer needs to sell for a cap under 10 to make a profit.

Yeah. And forgetting transaction costs and time equity, you need at least a point or two below, just true break even. If I sold it for 10, I would have lost two and a half years of my life and the brokerage commission.

So from your perspective-- first of all, I noticed that you use the cost approach, like [INAUDIBLE], to determine the value of the property. That's 25, so $100,000, right? And so I'm just trying to ask what's your order, first of all? First of all, you determine the value of the property. And then you start to consider about what is the cap rate I want to earn first?

It depends on how I come across a piece of property. So we just bought a piece of property in Sarasota. It's an acre. We paid $2 million for it. And you might say, wow, that's a lot. That's super expensive.

Well, I know-- without asking, I know what I can do with it. And I know I can make those type of spreads. There are other pieces of property that I walk up to, and I have no clue what this is worth. I have no idea.

However, I have a tenant who asked me to go there and look at the property. And the tenant told me, I will pay you this amount of money. Austin, I will pay you $100,000 if you can build a store here. So I go, well, OK.

So I walk up to the piece of property. And I don't care what its value is then, do I? I simply need to understand that if I understand how much it costs to build it, subtract that from the number to buy the land, I'm at a cap rate.

So if I walk up and the guy says, I'll sell it to you for $5, I go, hey, it's a great deal. Or if he says, I'll sell it to you for $5. But I know I can pay $10, and I pay $10, I don't care. But if he says, I'll sell it to you for $2 million, then I walk away.

So the land value is important. But depending on where you get to the property, it's one, it's two, it's three. It could be in a different order for me. But when I buy a piece of property, I know it's a good piece of property, value is number one.

When a tenant is behind me and says, I want you to do this. And I'll pay you $100,000 to do it in lease rent, then the value is important. I think I have a fiduciary responsibility not to just give away the farm-- I'll take it for whatever you've got. But the value is second.

And what Austin and I do on numerous occasions is when he is entertaining the idea of developing a property-- so he has spent $0 at this point, and it is truly just a concept-- he calls me, and he says this is what I'm thinking about doing. What is it worth? And we ask a lot of questions of each other.

And a lot of times, he's making me guess two and three years out. And he comes up with a pro forma. So he has a list of expenses that he needs to incur over that time. He uses my end number as a gauge to see if it's worth him spending his initial money to make the money.

And so he has a much narrower window of an exit on his potential property if he chooses to sell. And he'll just know from day one if, number one, it's worth it for him to do, if there's a spread there for him; and number two, what that spread may be. And so we have these conversations frequently.

I'm showing you a graph here, because I know there's some finance people here. And we're in a educational environment, so you want to see some graphs. But we are showing the cap rates for all triple net retail, which is the red line, that goes back to 2001 to roughly today. That's the top line.

The bottom line is the 10-year treasury. Everyone knows what a treasury is, right? OK. So why we look at this is we're always trying to compare to see how these numbers, these cap rates, are compared to other types of long-term passive investments. Because it's really important to understand where net leased properties, and the returns that they yield, are compared to other types of investments.

So we have a treasury that we have just corporate bonds. That's another example of long-term passive investments. We just used one measure here of a 10-year treasury.

So you can see, what's most interesting here is the delta between the two lines, delta meaning the difference between the two lines. And back in 2001, you had roughly 400 basis points, or 4%, between cap rates and a 10-year treasury.

So to put that in context, if someone bought a net leased property in 2001 and they paid the average cap rate of that year, they would get a 9% return. So there's a big difference between getting a 5% return on a 10-year treasury. So you can really justify in your mind why it made sense to potentially buy a net leased property at that point, because your return is just so much higher than other passive investments during that time.

What becomes really interesting is, as the market starts getting more aggressive- 2005, 2006-- you can see that those yield curves are coming much closer together. So the risk that you're taking buying real estate at that point is very close to what it is buying a 10-year treasury.

So what a lot of buying clients were saying during this point of the economic cycle was, why would I buy a net leased property if I can buy a 10-year treasury at 100 basis points, or 1%, over? Why would I take that risk when I know that the federal government is behind the 10-year treasury, as opposed to a corporate entity that fluctuates a lot more?

And the answer I had was, I don't know. That's up to you. And people still bought them, still bought them. That's why the cap rates you see were going down, down, down.

And this is when we had our Great Recession. Because people were paying very low cap rates, but they were still willing to take that risk. Now, we had the recession during the time.

And you can see that 2014, we're pretty close. And I'd say in a lot of instances, we are well below this cap rate number. But you can see the yield curves are much farther apart again.

So again, it makes a lot of sense to invest in a net leased property with a higher yield, even in these types of yields, versus a 10-year treasury. 10-year treasuries are around 2 and 1/2, 3 now, something like that. So you still have 200 plus basis points difference between a very stable treasury yield and a net leased property. So it's really interesting to see how these types of investments fit in with everyone else who has these options.

Some case studies-- so what Austin I work on typically are properties that cost $10 million or less, maybe even $5 million or less. And people hire us, and Austin hires us, to try and find those buyers. So in one case, we had someone who had $3 million to invest. I say this very respectfully, but in the big scheme of our world, a lot of people have $3 million to invest.

So even though it's a very big number, and we all would like to have an extra $3 million in our bank accounts, we know, because we work with these people all day long, that there is a tremendous amount of competition for a $3 million property.

So a person comes to us. They say they want a 20-year lease. We identified five properties. They ended up buying two of them at 4.5% blended yield. So even lower than what we're talking about now, because the market's so aggressive.

$2 million, same scenario, but this time it's a McDonald's property. Austin and I were just talking about a McDonald's property before. They have great credit.

They're usually on the best corners in town, or close to it, very high visibility. And there's a long-term lease in place. This person paid $2 million and received a 4% return. So now we're going even lower, because they know how stable it is, and that they'll have that income for such long periods of time.

This next one's a little more interesting. I was hired several years ago to help a client with a $300 million exchange, 1031 exchange. So the back story is that he came back from Vietnam. And he took his money that he was supposed to use for the GI Bill, and started investing in apartments in the outer boroughs of New York.

And he started with a four-unit apartment building. And he built it up until he had-- over 40 years-- until he had 3,000 units. And it was just him. He had a small staff of people, a manager, some rent collector people-- very frugal, very bare-bones operation.

And at the time, which was 2007-- which you saw on the yield curve was the peak of the market-- someone came and offered him $300 million for his 3,000 apartment units in New York. And he said, thank you very much. But before he actually sold the properties, his bank gave him a $300 million line of credit. I don't think I've ever told you this story.

I've never heard it.

So before he had $300 million in his bank, the bank said, we know that you have a signed contract for this. We know it's going to happen. Here's $300 million that you can borrow from us. And we know that you're going to go buy net leased properties.

So he bought net leased properties for $300 million. And we helped him buy a lot of them. And then when he sold the apartment units, he paid back the bank the $300 million plus interest, whatever it was, because he didn't want to do big, huge tax-deferred exchanges, especially on a large scale like that.

And so there's very large variations to the types of investors and the types of properties that can all go into this. So he was obviously retiring. He doesn't like apartments. Like Ken, he doesn't like apartments anymore. He loves triple net leased properties.

This person was the exact same scenario. He made his money. He was tired of the management. But he still wanted to own real estate. And so he bought net leased properties. And that's it.