Doron F. Eghbali Commercial Leasing Law

Commercial Leasing May Not Be All Dead

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Your definition of commercial real estate could determine whether you view this sector to be on life support or not. If your definition encompasses luxurious shopping malls or office parks, then commercial real estate is in real trouble. However, if your definition is less ambitious and much pragmatic you might be surprised to hear fast-food restaurants, convenience stores and gas stations ("Triple-Net Lease Properties") are faring much better in this economy. Let us review some of the fundamentals and lessons to prudently and cautiously take advantage of this opportunity.

WHAT ARE TRIPLE NET LEASE PROPERTIES?

Triple net lease properties typically have the following features:

- **Less Headache:** Tenant agrees to pay for taxes, insurance and maintenance.
- **More Peace of Mind:** The lease term is for several years.
- **Less Risk:** Investors purchase individual properties.
- **Less Investment:** Investors either individually or in limited partnership with other investors make such investments. Such investments often vary between $500,000 and $5 million.
- **Examples:** Some typical examples of such properties are: drug-store chains, quick-serve restaurants, convenience and dollar stores, medical outfits and even large retailers such as Costco.

CAVEATS FOR TRIPLE-NET LEASE PROPERTIES

- **Creditworthiness of Tenant:** This is extremely important to ensure your tenant has a very good credit score to protect your investment.
- **Location:** As always, location, location and location.
- **Physical Condition and Expansion of the Property:** The building should be in a condition where not more than your investment is needed to pay for repair costs. You might want to think of expansion down the road as well.
- **Term Lease:** The longer your term lease, the better off you are. You have relatively lesser risk of losing income and incurring charges to find another tenant.
- **Tenant with Less Risky Product or Services:** Some products or services might fall out of favor and then the tenant cannot pay you. Ensure the tenant's products and services are not just some passing fad.
- **Health Ratio:** Know the health ratio defined as the percentage the tenant pays you as rent relative to store sales. The lower the ratio, the better off you will be.
- **Capitalization Rate:** Needless to say, there are two ways to make money off triple net properties: asset appreciation or higher income. The best yardstick to ascertain your

likely income is capitalization rate. Capitalization rate is the net operating income DIVIDED BY purchase price of the property. Net operating income is different from net income. Net operating income is defined as income before depreciation and interest expenses. So, INCOME=Net Operating Income/Purchase Price of the Property. The higher the capitalization rate the more income you potentially earn. However, in recent months the capitalization rate has been tumbling as more people look for better-valued properties and as a result driving prices up. Although this development is a good sign for the economy as a whole, your potential return on triple net lease properties has relatively diminished.

DORON EGHBALI *is a Partner at the Beverly Hills Offices of Law Advocate Group, LLP. He Primarily Practices Business, Real Estate and Entertainment Law. Doron Can Be Reached at: 310-651-3065. For More Information, Please, Visit: www.LawAdvocateGroup.com*