Cashing In on a Real-Estate Boom

Most Commercial Properties Are Slumping, But 'Triple Net Lease' Deals Are Hot

BY M.P. MCQUEEN

Brian Shumway for The Wall Street Journal

Michael Federman at his property in Lower Manhattan, which houses a new Chipotle Mexican Grill restaurant.

Are you overlooking a commercial real-estate boom?

If your definition of the category is limited to splashy office parks and shopping malls, both of which took a pounding during the financial crisis and haven't fully recovered, then you probably are.

But think a little smaller—like fast food-restaurants, convenience stores and gas stations—and the returns get bigger. Such ventures, known as triple-net-lease properties, are "the best-performing sector of the commercial real estate marketplace," says David Bailin, head of global managed investments for Citi Private Bank, which serves ultra-high-net-worth clients. "It is the sector that lost the least value [during the recession] and rallied the quickest."

Triple-net-lease properties are usually freestanding buildings in which a tenant agrees to take responsibility for maintenance, taxes and insurance during a long lease—leaving the investor with little to do but collect checks. Investors typically buy individual properties through commercial real-estate brokers like Marcus & Millichap, CB Richard Ellis Group or others, either alone or in limited partnerships with a few other investors, and then lease them out to occupants such as drug store chains, quick-serve restaurants, convenience and dollar stores, medical outfits, and in some cases big-box retailers like Costco.

Triple-net-lease properties are generating annual returns of as much as 12% these days, estimates Bernard J. Haddigan, managing director of Marcus & Millichap Real Estate Investment Services' National Retail Group. Individual investors and small groups of partners generally invest $300,000 to $5 million per building.

Some publicly traded real-estate investment trusts concentrate on triple-net-lease properties, too. They returned 16.9% during the first quarter—compared with 11.1% for Dow Jones Equity All REIT Index, which includes all types of commercial and residential property.

Triple-net properties suffered during the recession, but less than other types of real estate. Whereas overall commercial prices fell by about 40% during 2007-09, prices for triple-net properties fell by about 15%, according to Mr. Haddigan.

Like all kinds of investing, triple-net-lease plays are based on risk: the more you're willing to take, the greater the potential returns. There are several important factors that determine a triple net deal's riskiness: the creditworthiness of the tenant, the location, physical condition and functionality of the property, and the remaining term on a lease (shorter is riskier). Also important: the "occupancy cost" or "health ratio," defined as the percentage that the tenant pays in rent relative to store sales. (The lower the ratio, the better.)

Besides overall economic risk, there's the risk of picking a tenant whose product or service might fall out of favor. Changing consumer trends can wipe out cash cows, as happened with some video-rental stores during the last decade.

"You need a good tenant," says Jeffrey Rogers, president and chief operating officer of Integra Realty Resources, a commercial real-estate appraisal and consulting firm that doesn't own or broker real estate. "Then you need an optimal location and to know what the market rent is. That is absolutely key."

Investors who lack the time or inclination to invest in triple-net-lease properties directly can get into the category via REITs such as the publicly traded **Realty Income** Corp. and **Lexington Realty Trust** in New York, as well as **American Realty Capital Trust** in Jenkintown, Pa., which is not traded on a stock exchange. These REITs invest mainly in triple-net properties, and they're generally sold through broker-dealers. They sometimes have minimum-net-worth and other requirements.

As with most income properties, investors can come out ahead—or behind—on triple-net properties in two ways: through price appreciation and income. The best measure of income potential is the so-called capitalization rate, or the net operating income divided by the purchase price of a property.

In recent months, cap rates have been falling because property prices nationally are rebounding. More investors are going after fewer high-quality properties, driving prices up. This is considered a positive sign for the broader commercial real estate market—but it means the easy money in triple-net-lease properties might be coming to an end.

But there is still opportunity for savvy investors. Michael K. Federman, 38 years old, is an attorney in New York who began investing in triple-net properties in 2004, during the previous recession. His first acquisitions were fried-chicken restaurants in upstate New York, followed by a Circle K convenience store in Arizona. He later sold the Circle K and purchased more buildings, and currently owns a portfolio of 15 properties.

A self-professed "conservative" investor, Mr. Federman now concentrates primarily on single-tenant properties, he says. Most recently, he and a business partner in March purchased a long-term lease property for about $4 million housing a Chipotle Mexican Grill in Lower Manhattan with a cap rate of 8.5%. That return was in line with the national average for casual dining restaurants in 2009, according to Marcus & Millichap.

"For me it was a perfect deal," he says, "because it combined prime real estate, stellar credit and minimal management responsibilities."