HEALTH LAW AND COMPLIANCE

Understanding the Ins and Outs of Triple Net Leases

ALAN A. AYERS, MBA, MAcc

Urgent message: As urgent care expands into traditional retail space, it's important to understand the obligations of leases that require tenants to act as property "owners" responsible for all taxes, utilities, and maintenance of the real estate.

While the defining characteristic of urgent care facilities across the country is the offer of convenient walk-in (no appointment) care with extended hours of operation, research shows that location is the primary driver of urgent care volume. This retail delivery channel for medical services sees the best-performing urgent care centers located in high-visibility, high-traffic areas with favorable demographics.

Medical service providers are continuing to move beyond the traditional notions of hospital facilities and are moving to locate their businesses closer to their patient base. One way this is being made easier is through innovative lease agreements. This article will discuss triple net leases for urgent care owners, developers, and operators and provide an explanation of the benefits, features, and obligations of this type of agreement.

Background

A triple net lease—also be referred to as a *net-net-net* (NNN) lease—is a lease agreement that designates the lessee or tenant to be solely responsible for all the costs relating to the asset being leased. This is in addition to the rent applied pursuant to the lease. Typically, the triple net lease requires the lessee to pay the net amount for three types of costs:

1. The net real estate taxes on the leased asset
2. The net building insurance
3. The net expenses for common area maintenance

Alan A. Ayers, MBA, MAcc is Vice President of Strategic Initiatives for Practice Velocity, LLC and is Practice Management Editor of *The Journal of Urgent Care Medicine.*

Net, net, net. The triple net lease is considered a turnkey investment, given that the landlord has no responsibility for paying any operating expenses.

For instance, if a property owner leases a building to an urgent care center using a triple net lease, the urgent care is responsible for paying the building's property taxes, the building insurance, and the cost of maintenance and repairs for the building during the lease term. In light of the fact that the urgent care center is responsible for these costs—which would be covered by the property owner under most other leases—rent on the space in the triple net lease is usually less than rent charged in a standard retail property lease.

The *capitalization rate*, the calculation of the lease amount, is determined by the tenant's creditworthiness.

The advantages of triple net lease investments include a predictable revenue stream due to the long-term leases and pass-throughs, as well as relatively issue-free investment because of the few obligations of the property owner.

Urgent Care Triple Net Leases

The most valuable or lucrative real estate for urgent care is leased under a triple net lease agreement. Net lease investors are showing that they are willing to pay a premium for coveted medical office space located in those high-visibility, high-traffic areas which will provide the best return on investment.

Still in the initial stage of growth, many investors—particularly those proponents of the triple net lease—believe there's a significant need for urgent care clinics in strong, primary locations.

New construction is one aspect of urgent care facility investment that appeals to investors. Couple with this is their preference for high-traffic retail locations that have the potential to be backfilled with other tenants in the future, and investors are finding a ready pool of buyers wanting to grab newly built facilities.

Medical service providers are attracted to the net lease as a vehicle to finance growth. Urgent care properties have the highest level of buyer demand—a reason why this sector is trading for the lowest cap rates at 6.3%. Compare that rate with 6.6% for dialysis clinics and 6.68% for general medical buildings.

The Three Ns

Let's look at the three Ns in greater detail:

Building Maintenance. If the building is in solid condition, the maintenance should be minimal, allowing the urgent care owner to reap the benefits of lower rent; however, if the property is in disrepair and requires significant renovations or repairs, then then the landlord is advantaged because he isn't obligated to address that maintenance. The urgent care owner incurs those expenses.

Insurance. Tenants are required to carry insurance on the property and may have to pay deductibles on the policy along with any uninsured damage. Commercial General Liability (CGL) insurance, also known as "third-party" insurance, protects the urgent care owner and the landlord from claims by others. Property and casualty insurance protects the building—the roof, interior and exterior walls, stairwells, and parking structures. The urgent care owner's own business property, such as trade fixtures, inventory, and other personal property, are not covered by this policy. Trade fixtures can include expensive equipment like x-ray machines, examination tables, and other specialized medical tools. Another policy would be needed to cover these items.

"Even if a triple net lease is a true absolute net lease, it may not cover all expenses associated with a property."

Property Taxes. One distinct disadvantage to the urgent care owner as a tenant is his or her responsibility for property taxes. It's not uncommon for a community to raise the appraisal on commercial property every year. Another way of upping the urgent care owner tenant's tax bill is when the municipality raises the tax rate per $1,000 of value. To get any relief, the tenant must rely on the landlord to contest a higher appraisal. Since he isn't paying the taxes, the landlord may not care to invest in a private appraisal to contest the new appraisal. But this can create a backlash if the urgent care owner moves out at the end of the lease. As a result, the landlord will be stuck with paying the higher tax bill until he secures a new tenant, or he'll have a vacant property on his hands.

"Medical net leases account for a small portion of the overall real estate market today; however, it's clearly a growing sector."

In some cases, the landlord may agree to pay all real property taxes for the first year of the lease (known as the "base year"); after that, the urgent care owner would be responsible for the taxes. A savvy negotiating landlord may also try to set the base year sometime in the past—when the taxes were lower than they are currently—so that the tenant must immediately begin paying the increase.

Conclusion

Remember, even if a triple net lease is a true absolute net lease, it may not cover all expenses associated with a property. Although a true absolute NNN lease with a strong tenant can be termed a turnkey commercial property from the landlord's or investor's perspective, even an absolute net lease may have some expenses that won't be covered by the urgent care facility tenant. For example, the cost of security services, landscaping, and advertising may or may not be included.

Medical net leases account for a small portion of the overall real estate market today; however, it's clearly a growing sector. Experts say that the future is quite bright for medical triple net leases in the next 10 to 15 years. ■

Utilities

While not "officially" one of the "nets," utilities within the rented space are the tenant's responsibility under a triple net lease, typically. Utilities include water, sewage, natural gas, and electricity. Related are cleaning and maintenance expenses. A tenant's utilization may be metered individually by the utility companies, in which the tenant pays the utilities directly, or the landlord may sub-meter the tenant's space, in which case the tenant reimburses its share of the landlord's utility bills. It is rare that utilities would be included in a tenant's lease, the exception typically being older buildings in which installing separate utility "lines" or sub-metering isn't practical. An example might include renting a space in a building that has one HVAC system covering multiple tenants, in which case gas or electric could be considered a "common area expense."