FOUR SPRINGS CAPITAL TRUST

Characteristics of Single Tenant vs. Multi-Tenant Commercial Real Estate Investments

Investors often don't fully understand the differences between single tenant and multi-tenant real estate investments. Despite the obvious one – one tenant vs multiple tenants occupying a commercial property, there are a number of other distinctions that are important for investors to understand. Such distinctions have generated two very different investment strategies in connection with commercial real estate investments – one directed at acquiring "traditional real estate investment product" and the other is directed at investing in "net lease investments" or "single-tenant investments". Neither strategy is wrong. They are just different. Each strategy offers different rewards and risks.

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With multi-tenant real estate, lease terms are generally shorter – three to seven years for commercial real estate and one year for multi-family product thereby allowing an owner to capitalize on increasing rental rates in a good real estate market. While you have the opportunity to increase rents more frequently, the owner also has the risk of incurring costs of finding new tenants in the event the tenant leaves or of paying for costs to retain tenants in the form of what is known as tenant improvement costs (e.g., painting, new carpeting, re-modeling the bathrooms). As the property gets older, the landlord may also need to pay for periodic capital improvements (e.g., repaving the parking lot, new windows, new roof, new HVAC systems). In the event a tenant vacates, the landlord also has to absorb the costs (insurance, utility costs, security) associated with operating the vacant premise until a new tenant is found. This time period is referred to as downtime and may range from as little as a few months in a strong real estate cycle to as long as several years depending on the market and/or attractiveness of the property relative to competitive properties in the market. Additionally, the owner has to pay a broker a leasing commission to show the property and sign a new tenant to a lease. Thus a landlord needs to factor these increased costs when evaluating the potential return on investment.

It is also important to note the difference in the lease structures that often accompany multi-tenant properties. Sometimes referred to as space leases, the tenant typically will pay a "full service gross rent" in which the landlord deducts the operating expenses from that rent amount. The landlord has to estimate the operating expenses, insurance costs, real estate taxes that they will incur for the year so they can determine the amount of rent to be charged. Many times, landlords are able to negotiate "modified gross" leases where the tenant is responsible for paying directly certain expenses like utility costs or insurance expense.

If the landlord or owner underestimates operating costs or there are unexpected major building repairs that occur in a year, the landlord may experience what is referred to non-reimbursable expenses (sometimes called "leakage") which could negatively impact the return on the property's investment. Despite such risks and costs, experienced real estate operators manage properties to minimize leakage and maximize the net operating income.

When the real estate market is robust, owners of multi-tenant properties stand to generate excellent returns if they are good property managers and if they are able to grow rent as leases roll over. However, when the real estate market experiences a downturn, landlords may experience little or negative rent growth, more vacancies, and increased costs to operate properties thereby negatively impacting the return on investment.

Single tenant properties represent more of a fixed income alternative which is characterized by passive property management given the nature of the lease structure. Lease terms are longer – typically ranging between ten and twenty years. These leases are characterized as triple-net leases where the rent paid by the tenant is net of real estate taxes, operating expenses and insurance costs. In addition to the rent, the tenant pays all these costs directly or to the landlord. Additionally, the tenant is often responsible for paying for the repair and replacement of capital items like repaving the parking lot, or replacing the roof or HVAC equipment. Since the landlord has little or no cost obligations or management responsibilities under single tenant triple net leases, there is reduced risk with respect to leakage of the net operating income and with respect to negatively impacting the return. To provide some rental growth, landlords will typically negotiate annual or periodic fixed rent increases or increases tied to a CPI index. Such increases will provide a partial hedge against inflation risks as well as provide modest income growth over the life of the lease.

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Characteristics of Single-Tenant vs Multi-Tenant Investments

Single-Tenant

- Longer lease term (10-20 years)
- Stable increasing rental stream
- Passive management responsibilities NNN leases
- Minimal capital requirements
- Higher value retention
- Modest capital appreciation

Multi-Tenant

- Shorter lease term (3-7 years)
- Periodic lease rollover and lease-up risk
- Active management responsibilities
- Gross or modified gross leases
- Periodic capital requirements
- Increased susceptibility to value loss during down cycle
- Higher upside potential during strong market cycle

With the single-tenant product, an investor is able to lock in a long-term rental stream and enjoy a high certainty of the cash flow because the tenant is paying all or most of the costs and they are committed to the property under a long term lease as they have no termination rights.

With a long term lease, the landlord does not face 1) the risks of short-term lease rollover, 2) the costs associated with re-tenanting the property if a tenant does not renew and 3) the possibility that rental rates might decline if the real estate market is in a downturn. Consequently, an owner of a single tenant property is locked into a fixed cash flow stream for 10-20 years; however, they will not experience as much upside in rent growth during a strong real estate market cycle.

Having the ability to properly evaluate the tenant's credit, the lease structure and the real estate attributes is critical to underwriting a single-tenant investment. All three investment disciplines need to be considered, otherwise an investor may face the risk of re-tenanting an entire property and incurring substantial costs to attract a new tenant(s).

With the single-tenant product, an investor is able to lock in a long-term rental stream and enjoy a high certainty of the cash flow because the tenant is paying all or most of the costs and they are committed to the property under a long term lease as they have no termination rights.

In summary, single tenant investments are best characterized as having higher occupancy, stable income streams, minimal management responsibilities, low property costs and higher value retention. The investment profile of a single tenant investment lends itself to income oriented investors.

The investment profile of a multi-tenant investment lends itself to growth-oriented investors because of the ability to more quickly grow rental income over shorter periods of time especially when leases are rolling over during the upturn of the real estate cycle; however, investors can experience significant losses during the down cycle if rents decrease, tenants do not renew and the real estate requires significant capital expenditures.

Four Springs Capital Trust

Four Springs Capital Trust is a real estate investment trust, or REIT, that is led by an experienced team with substantial public REIT and net lease real estate experience. Since our formation in 2012, we have focused on acquiring and managing a diversified portfolio of single-tenant commercial properties that are subject to long-term triple or double net leases with investment grade or other creditworthy tenants.

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