NATIONAL REAL ESTATE
Investor®
March 2018
www.nreionline.com

EXCLUSIVE
NET LEASE RESEARCH REPORT

SITTING PRETTY

NREI's exclusive research shows net lease assets remain in demand, with few signs of caution for the sector's performance in the near term.
p. 13

Alternative lenders step in as banks get conservative on construction loans.
p. 18

Knotel CEO Amol Sarva gives his outlook for the flexible office space trend.
p. 20

SPONSORED BY
W. P. CAREY

A Safe Bet

Exclusive research shows net lease investors continue to expect stability.

By David Bodamer

Photo: Justin Sullivan/Getty Images

The single-tenant net lease sector is a bedrock of commercial real estate investment. Bulwarked with long-term leases to stable tenants, the sector is always a popular bet for a variety of commercial real estate investors. And all signs point to the sector remaining in solid shape for the foreseeable future, even in what many are viewing as the late stages of the current real estate cycle, at least according to the results of *NREI*'s most recent exclusive research into the sector.

Sentiment on the sector remained consistent with 2017. This year, 15 percent of respondents said there is too much supply on the market for investment—up slightly from 13 percent in 2017 and 7 percent in 2016. Overall, 35 percent said there is the "right amount" of supply, which is consistent with both 2017 and 2016 results. Meanwhile, 27 percent said there is "too little" supply, down from 29 percent in 2017 and 35 percent in 2016.

As of the fourth quarter, cap rates for the single-tenant net lease retail sector reached a new historic low rate of 6.07 percent, according to The Boulder Group, a net lease commercial real estate services firm. During the same time period, cap rates for the office sector increased by 2 basis points to 7.00 percent and cap rates for the industrial sector decreased by 2 basis points to 7.25 percent.

Respondents estimate current cap rates for net lease properties to be at about 6.1 percent. But there is some expectation that cap rates will increase, although sentiment that cap rates would increase was stronger in 2017. This year, 63 percent expect an increase, down from 69 percent in 2017. In 2016, only 42 percent said they expected cap rates to increase. Meanwhile, 27 percent expect no change (up from 20 percent in 2017 and down from 48 percent in 2016). In addition, 11 percent of respondents said cap rates will decrease, the same figure as the previous two surveys.

In terms of money chasing deals, 45 percent of respondents said they would characterize the availability of equity in the net lease sector as unchanged from a year ago (vs. 48 percent in 2017

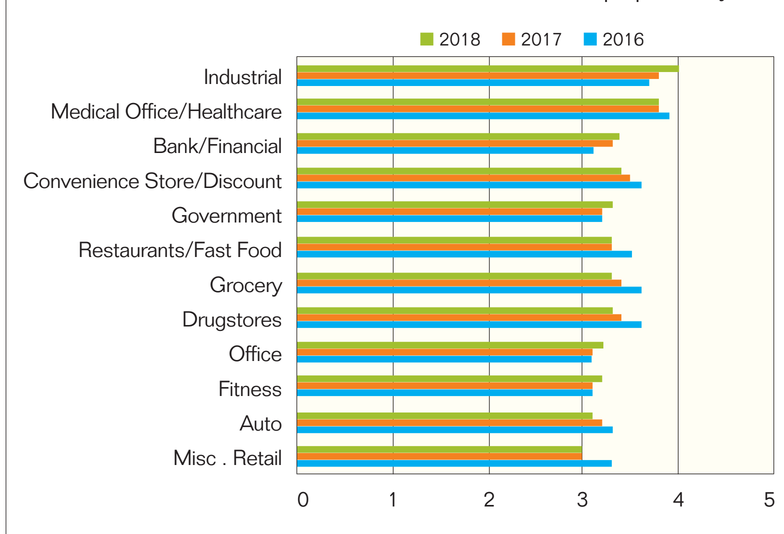


Figure 1: Respondents were asked to rank the outlook for each net lease sector in the next 12 months. Industrial took the top spot this year.

> **"Offering cap rates have decreased and it is very difficult to find properties that will offer a competitive return to investors with traditional LTV assumptions. Also, with interest rates increasing, it is going to become even more difficult to find properties that work for investors."**

and 52 percent in 2016). An additional 27 percent said equity capital is more widely available, while only 10 percent said it is less available and another 18 percent said they weren't sure.

On the debt side of the equation, responses were also consistent with recent years. There, 46 percent said the availability of debt is unchanged from a year ago. Meanwhile, 21 percent said it is more widely available (up from 19 percent) and 15 percent said it is less available (down from 21 percent). Another 18 percent said they weren't sure.

Respondents were also asked how they expected various financing aspects to change for the net lease sector in the next 12 months. For loan-to-value (LTV) ratios and debt service coverage (DSC) ratios, a majority of respondents (66 percent and 65 percent, respectively) said they would remain the same. For LTV ratios, an equal number of respondents (17 percent each) said they would increase or decrease. On DSC ratios, 26 percent said they would increase, while only 9 percent said they would decrease.

When it comes to interest rates, not surprisingly, 83 percent said they expect increases in the next 12 months. Only 2 percent said we will see decreases, while 15 percent said they would remain flat. On the risk premium (the spread between the risk-free 10-Year Treasuries and cap rates), a plurality of 47 percent said they would remain flat, while 43 percent said they would increase.

On the development front, 43 percent of respondents said there is the "right amount" of development, which is identical to a year ago. Another 24 percent said there is "too little" (essentially unchanged from 25 percent in 2017), while only 12 percent said there is "too much," up slightly from 11 percent. Another 22 percent said they were unsure.

As part of the survey, we asked respondents to write about what they saw as the biggest changes in the space from 12 months ago and what they saw as the biggest opportunities and challenges for the net lease sector.

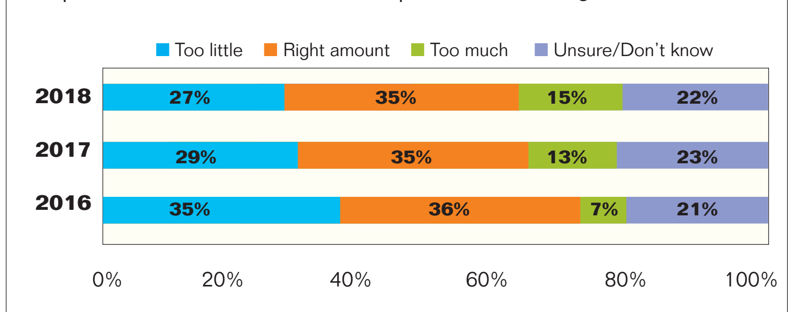
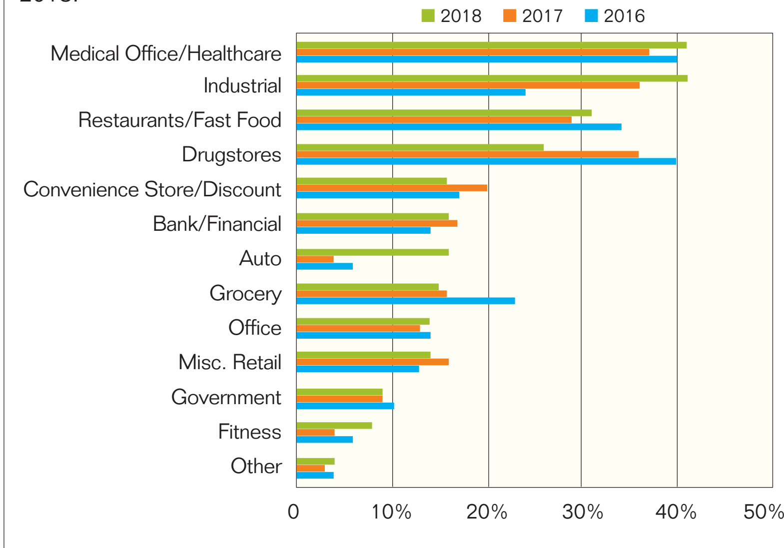


Figure 2: Sentiment on development has shifted in the survey. Fewer respondents said "too little" development is occurring in 2018.

Figure 3: Respondents were also asked what sectors they see the greatest demand for. Medical/healthcare and industrial topped the list in 2018.



“Dollar stores—buoyed by budget-conscious consumers and largely insulated from the rise of e-commerce—have become a popular bet for some net lease investors.”

Many respondents wrote in about disruptions to investment activity.

“Offering cap rates have decreased and it is very difficult to find properties that will offer a competitive return to investors with traditional LTV assumptions. Also, with interest rates increasing, it is going to become even more difficult to find properties that work for investors,” one respondent wrote.

But overall, sentiment was positive and respondents still see opportunities throughout the sector.

In terms of potential opportunities, one respondent wrote, “There are diamonds in the rough in secondary/tertiary markets—properties in submarkets relatively isolated from new competition.”

Another saw potential in the grocery sector, “particularly opportunities created by the influx of German stores Lidl and Aldi. We are experiencing a grocery store war.”

And a lot of respondents mentioned Amazon—in both positive and negative terms. They pointed to the online retail giant as creating ripple effects for both retail and industrial net lease properties—hurting one sector, while bolstering the prospects of the other.

As one respondent succinctly put it, “Amazon’s investment strategy is influencing a lot of different businesses.”

Respondents to the survey work across the spectrum of net lease property types. The most prevalent net lease property type identified was restaurants/fast food (44 percent). That was followed by miscellaneous retail (43 percent), office (41 percent), industrial (39 percent), medical office/healthcare (35 percent), drugstores (32 percent), bank/financial (29 percent), convenience stores/discount (28 percent), grocery stores (25 percent), auto (19 percent), fitness (15 percent) and government (12 percent).

Dollar stores—buoyed by budget-conscious consumers and largely insulated from the rise of e-commerce—have become a popular bet for some net lease investors.

In fact, Barry Wolfe, senior director of the national retail group and net leased properties group at brokerage firm Marcus & Millichap, says freestanding net-leased dollar stores are “among the safest and best bets in retail.”

Among publicly-traded net lease REITs, Phoenix-based Vereit Inc. has considerable exposure to the dollar store sector.

Two of the three big operators of dollar stores—Family Dollar Stores Inc. and Dollar General Corp.—are among Vereit’s 10 biggest tenants. In all, these two dollar store chains make up about 6.5 percent of the REIT’s annualized rental income.

Similarly, Dollar General and the other major dollar store operator, Dollar Tree Inc., compose nearly 4 percent of the annualized base rent for Agree Realty Corp., a publicly-traded net lease REIT based in Farmington Hills, Mich.

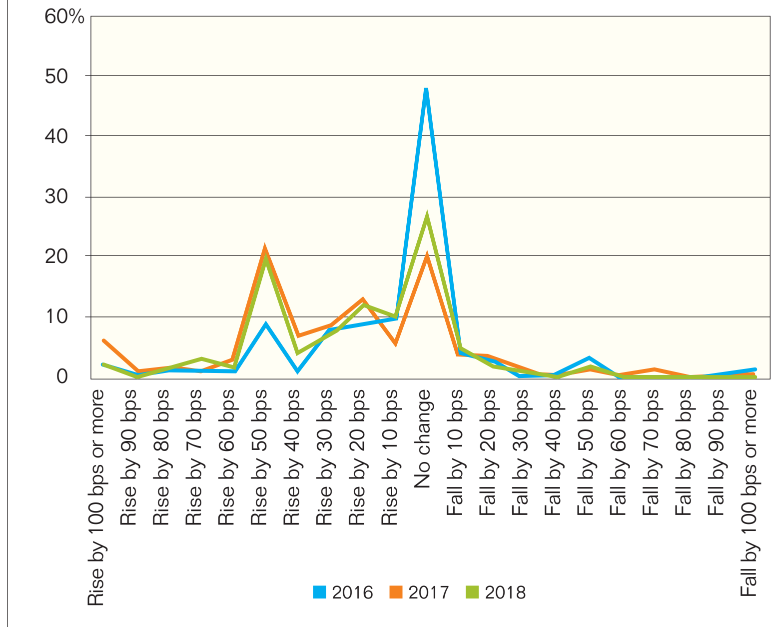
Convenience stores, however, are showing signs of struggling.

Recent estimates suggest that convenience stores will achieve total sales of about $73 billion in 2018—on the lower end of the spectrum for this sub-sector—and total sales growth of just 5.5 percent, according to the “Retail, Apparel and Restaurants—U.S., 2018 Outlook,” from Moody’s Investors Service.

Properties occupied by high-qual-

"There is a perception among investors that a corporate-backed lease is better than a franchisee-backed lease. There is more of a perceived strength associated with a corporate guarantee than a franchisee guarantee, whether that is a right perception or not."

Figure 4: Sentiments on cap rates have become slightly more bearish. Overall, 63 percent of respondents said they expect cap rates to rise in the next 12 months.



ity tenants, such as 7-Eleven, have achieved cap rates between high 4 percent and low 5 percent in the fourth quarter of 2017. According to data from The Boulder Group, retail net lease assets overall reached the average asking cap rate of 6.07 percent during the quarter.

"A lot of the market participants think this is no longer a seller's market, that it has moved to a neutral position," says John Feeney, a vice president at The Boulder Group. "Depending on the asset quality, it is not necessarily in the seller's favor anymore."

In terms of property types, respondents ranked industrial as having the best outlook (4.0 on a scale of 1 to 5). Industrial was tied atop the list last year with medical office/healthcare. That sector was second this year, with a score of 3.8, unchanged from a year ago.

Those sectors were followed by convenience stores/discount and bank/financial (both at 3.4). But, generally, the outlook for all net lease property types was fairly consistent. Every sub-sector ranked between 3.0 and 3.8.

Those results roughly match what respondents said were the property types in greatest demand. Industrial and medical office/healthcare scored 41 percent on that question, followed by restaurants/fast food (both at 31 percent) and drugstores (26 percent).

In terms of the quick service sector, there is some differentiation between franchisee-backed and corporate-backed net lease properties.

"There is a perception among investors that a corporate-backed lease is better than a franchisee-backed lease," Feeney says. "There is more of a perceived strength associated with a corporate guarantee than a franchisee guarantee, whether that is a right perception or not."

Some public companies have created business models around owning franchisee-based net lease properties, giving confidence to investors about the quality and transparency of the property owner's balance sheet.

"The differences are due to the financial strengths of the guarantors," says Matthew Berres, a senior vice president in the net lease group of JLL Capital Markets. "Many QSRs are owned by publicly-traded companies, which allows for a very large buyer pool. It gives them access to financial records and allows them to make more informed decisions and gives them more comfort level long-term." ■

Additional reporting from Donna Mitchell and John Egan.

Survey methodology:
The NREI research report on the net lease sector was completed via online surveys distributed to readers of NREI in February. The survey yielded 490 responses. Recipients were asked what regions they operated in (and were allowed to select multiple regions). Overall, 45 percent said they operated in the South, followed by the East (45 percent), the West (40 percent) and the Midwest (36 percent). About half of respondents (49 percent) hold the titles of owner, partner, president, chairman, CEO or CFO.