Net Lease Stays Steady

Fully priced properties withstanding changing capital environment.

Joe Gose

In 2017, Marcus & Millichap represented the seller of a 12,350-square-foot Walgreens in West Milford, New Jersey, for $10.6 million. A private investor fulfilling a 1031 exchange acquired the nine-year-old property.

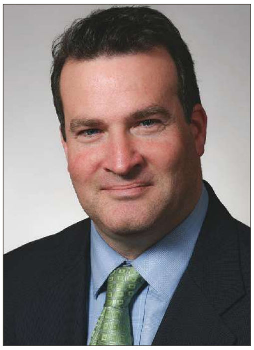
Commercial real estate investors navigating today's market are confronting a number of economic and policy variables that did not exist a mere six months ago. Tax reform and recent job gains have buoyed optimism about growth. But higher interest rates, a volatile stock market teetering near all-time highs, and possible tariff policies that could spark a trade war are generating anxiety.

The dynamics dented single-tenant net lease investment activity early this year. But brokers fully expect to stay busy, and they do not foresee capitalization rates rising significantly, if at all, especially on core properties and locations. An abundance of private and institutional buyers are still demanding the bond-like properties that house dollar stores, pharmacies, quick service restaurants and other operators, many of which are considered largely resistant to the disruption of ecommerce. Meanwhile, net lease tenants that have been hurt by online shopping — namely big box operators — are looking at creative strategies to simultaneously increase traffic and trim their footprints [see sidebar on p. 40].

"Deals, especially in top markets, are still trading at very competitive cap rates," says Doug Aronson, a managing director for Herndon, Virginia-based Calkain Companies, which has brokered $12 billion in sales since 2005. "In the past five years, we have seen more and more new investors come to the net lease sector, fueled in part by very low yields on other traditionally conservative investments."

Jeffrey Thomas
Founder
Thomas Co.

Indeed, annual dividend yields for net lease real estate investment trusts (REITs) provide a glimpse into how much cash the properties are generating for investors. Store Capital REIT (NYSE: STOR), National Retail Properties (NYSE: NNN) and Realty Income (NYSE: O) ended 2017 at around 4.5 percent or higher, according to industry trade group NAREIT. That was more than 150 basis points above the benchmark 10-Year Treasury yield.



Doug Aronson
Managing Director
Calkain Cos.

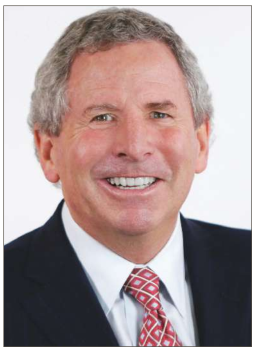
"There are not a ton of other options out there for the typical investor or that a person with capital to deploy can feel comfortable with," states Chris Sands, founder and CEO of Charleston, South Carolina-based Sands Investment Group, which has brokered $3.3 billion in sales since 2010. "There are a lot of benefits to owning a single-tenant net lease property — it creates a certainty of cash flow, you derive tax benefits from depreciation, and you own a brick-and-mortar building that provides you the chance to recoup your investment if the tenant leaves."

Faris Lee Investments completed the $16.8 million sale of a recently renovated CVS in San Francisco in February. The transaction marked the highest price paid for a single-tenant CVS, and the 4 percent capitalization rate was the lowest in a CVS deal of more than $10 million.

SLOW START

Sales of single-tenant retail properties in the U.S. totaled $14.6 billion in 2017, an increase of about $125 million over the prior year, according to New York-based Real Capital Analytics (RCA). The most active acquirers for the year were private investors, including 1031 exchange buyers, which shelled out some $8.3 billion for single-tenant assets, reports the data researcher, which tracks deals of $2.5 million and greater. REITs and institutional investors followed, paying some $4.8 billion for properties.

Investment volume of more than $1.7 billion through February this year represented a year-over-year decrease of nearly 20 percent, according to RCA. Net lease experts attribute some of the slowdown to investors taking time to review changes to tax policy and interest rates amid an extended period of peak pricing in the commercial real estate sector.



Richard Chichester
President and CEO
Faris Lee Investments

Like commercial real estate broadly, net lease properties have benefitted from the Federal Reserve Bank's accommodative monetary policy, which has sustained

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historically low interest rates and fueled asset appreciation, says Richard Chichester, president and CEO of Irvine, California-based Faris Lee Investments. As a result, to a large degree net lease real estate remains fully priced, if not overpriced, he adds.

Still, he and other net lease brokers downplay the chances for a dramatic slowdown in sales this year. In fact, in February Faris Lee Investments represented First and Mission Properties, a 1031 exchange buyer, in its purchase of a CVS in San Francisco for $16.8 million. The 4 percent cap rate marked the lowest ever paid for a CVS in a sale exceeding $10 million on a national basis, according to the brokerage. To prepare for CVS's occupancy, the property underwent a major renovation that features rooftop parking.

"We're still seeing a lot of demand for single-tenant net lease properties, and I would expect that to continue regardless of what happens in the economy because these investments are really bonds wrapped in real estate," says Chichester, whose firm has been involved in $20 billion worth of transactions since 1996. "Interest rates are still at historical lows, and there is not quite the same sensitivity to the correlation between the 10-year Treasury bill and cap rates in these assets versus other real estate sectors."

Other net lease brokers echo Chichester's sentiments, even with the benchmark 10-year Treasury yield's rapid ascent as the central bank shifted to a tighter monetary policy regimen in 2017. The yield on the 10-year bond rose to around 2.8 percent in early February — up roughly 80 bps from its 52-week low in September 2017 — and has generally hovered at that level even after the Federal Reserve announced in March that it would raise the federal funds rate another quarter of a percentage point. The central bank also affirmed its commitment to further rate increases this year.

KOHL'S CO-TENANCY PROGRAM DRAWS ATTENTION IN BIG BOX SPACE

In early March, Kohl's announced that discount grocer Aldi would share space in five to 10 of its stores in a co-tenancy pilot program. It's part of a broader Kohl's strategy to increase traffic and "right size" its first-generation 80,000-square-foot footprint as its moves to a smaller 35,000-square-foot format.

Co-tenancy is a much-discussed solution for net lease big box users, which are searching for ways to shrink space and counteract a disruptive e-commerce environment wreaking havoc on soft goods and general merchandise retailers, says Richard Chichester, president and CEO of Irvine, California-based Faris Lee Investments. "The big box is a risk in the marketplace today; you don't need the large footprint or the operating expenses associated with it," Chichester states. "So finding solutions with cooperating tenants that share a customer base is a great offering."

Kohl's is one retailer aggressively re-thinking its real estate as it enhances an omni-channel sales approach. Among other endeavors, the chain is set to expand a recently launched pilot program that not only established small Amazon shops in 10 Los Angeles and Chicago Kohl's stores, but that also allowed Amazon customers to return goods to many additional locations.

Kohl's also is looking for more co-tenancy opportunities, and supermarkets are a natural fit, said Kevin Mansell, CEO of Kohl's, during the retailer's 2017 fourth quarter earnings call in March. "But it's certainly not limited to that," he told analysts. "I think companies in the fitness category, for instance, would be a great combination with Kohl's, and there are many others. But they've got to be traffic drivers and strong brands with strong balance sheets, where we know that we can coexist together for a long time."

Chris Sands, founder and CEO of Charleston, South Carolina-based Sands Investment Group, predicts that more big box operators are going to follow the lead of Kohl's. "You're going to see an interesting and opportunistic market over the next five to seven years as leases come to term," he explains. "There are going to be different and creative ways to stabilize some of these big boxes."

— *Joe Gose*

CAP RATES HOLDING

So far, however, rising interest rates have failed to affect cap rates. At the end of 2017, for example, the average national net lease cap rate declined 10 basis points to 6.33 percent across 11 retail categories despite the Federal Reserve's tightening, according to Calkain's *Net Lease Economic Report* issued in February. What's more, in the few cases in which cap rate increases occurred, they were typically miniscule: The average convenience store cap rate, for example, rose to 5.66 percent at the end of 2017 from 5.61 percent a year earlier.

"There are net lease properties available for all types of risk tolerance," says Aronson, who is in Calkain's Fort Lauderdale, Florida, office. "But investors may need to rethink things if they believe the time has come where they can grab a brand new, 15-year 7-Eleven absolute triple net lease at a 6.35 percent cap rate. It's not happening."

The healthy spread between the 10-year bond yield and cap rates also reduces the chances for a substantial rise in cap rates, suggests Will Pike, executive vice president and managing director of the net lease property group in the Atlanta office of CBRE. During the last peak, for instance, that spread was around 200 basis points, according to NAREIT. At the end of 2017, when the 10-year Treasury yield was also around 2.8 percent, the spread was closer to 400 basis points.

"In the grand scheme of things, a 10-year Treasury rate of 2.8 percent isn't that high," declares Pike, who with his partner brokered some $2 billion in net lease transactions last year. "We have a long way to go before it gets to historically normal levels, so I'm not in the camp thinking that cap rates are going to rise much at all, if any."

Balance between the demand for net lease assets and their supply should help to keep a lid on cap rates, too, remarks Scott Holmes, senior vice president and national director of the retail division for Marcus & Millichap.

"A lot of buyers of single-tenant net lease assets are people who made their money in multifamily properties and are now transferring over to something that's less management intensive," he says. "But I would also say that we shouldn't expect the trend of cap rate compression that we've seen since 2009 to continue."

RECIPE FOR INCREASES

Other brokers, however, say that cap rate moves traditionally have lagged interest rate increases by three to six months and make the case that the market should see price adjustments this fall, if not sooner. The best price of debt for the best net lease properties with investment grade tenants already has increased some 25 basis points to around 4.25 percent from last year, says Jeffrey Thomas, founder of Seattle-based Thomas Company. And they're only going to rise from there, he predicts.

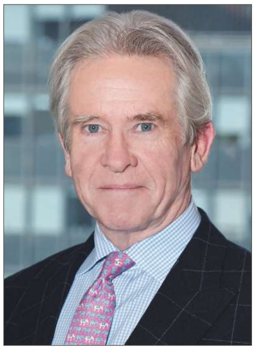
"The speed at which those changes can occur can slow things down because there's going to be a disconnect between buyer and seller expectations," he cautions. "We know people that have a real need to transact, but they're taking time to digest some of these investments, especially the larger deals."

While sellers over the past several months have largely refused to budge on price, Thomas says that some are be-

Last year Calkain Companies represented the seller of a newly constructed CVS in Elkridge, Maryland, which came with a 25-year lease and several five-year options. A 1031 exchange investor paid $5.25 million for the property, which equated to a capitalization rate of 4.95 percent.

ginning to quietly re-engage previously interested buyers with sweetened deals. That typically marks the start of a broader re-pricing process, he adds. In some cases, sellers preparing to go to market are nudging up cap rates by a quarter of a percentage point in anticipation of more central bank tightening, says Sean O'Shea, a managing director for the O'Shea Net Lease Advisory group of Los Angeles-based BRC Advisors.

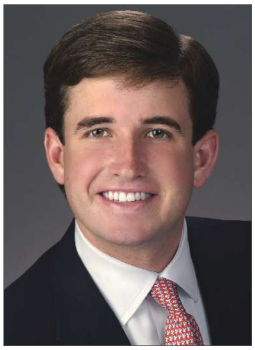
O'Shea and other experts contend that seller and buyer motivations as well as investor types are influencing the market, too. Climbing interest rates have a negligible effect on 1031 exchange buyers and other investors that use all or mostly cash, for example. In fact, 1031 exchange buyers looking to defer capital gains taxes on sale proceeds face a 45-day deadline to identify a new investment property. That pressure makes them more willing to pay a premium for net lease assets, which has also helped to keep a lid on cap rates, brokers say.



Sean O'Shea
Managing Director
O'Shea Net Lease Advisory

But higher interest rates directly impact private equity funds and institutional buyers that typically use leverage to finance deals. Even REITs, which generally try to keep their debt loads at around 50 percent or less of net asset value, are "very sensitive" to interest rate changes because of shareholder yield expectations, Chichester says.

"Therefore, those expectations are going to influence pricing, and you're seeing a gap building between different buyers as to what they'll pay for single-tenant net lease properties," he explains. "A private buyer can still be aggressive while the REITs are more disciplined and expecting cap rates to move up a bit."



Will Pike
Executive Vice President
Managing Director
CBRE

Buyers that need to use only 50 percent debt are finding it difficult to make deals work on properties with a cap rate of 6 percent or below in today's interest rate environment, O'Shea points out. In some cases, investors are taking out cheaper short-term loans, but they then run the risk that interest rates will be substantially higher when it's time to refinance.

"While short-term debt may improve yields by 30 to 40 basis points, where are you going to be in the next three to four years?" he asks. "If you have no requirement to buy anything right now, keep your powder dry and see where the market is at the end of the year." **SCB**