Net Lease Demand Continues Unabated

Despite compressed cap rates and expectations for increasing interest rates, many experts believe NNN activity in 2015 could surpass 2014.

Joe Gose

Buyers and sellers are trading net lease properties at a vigorous pace in an environment marked by an abundance of low-cost capital, lofty property values and a lack of alternative income-producing investments.

Industry professionals say that the activity simply prolongs the net lease market's banner year in 2014. Most anticipate that 2015 could even top 2014 as long as no economic, interest rate or geopolitical surprises intimidate investors. Like other bullish prognosticators, Calabasas, California-based Marcus & Millichap anticipates that lower gasoline prices will allow consumers to boost retail spending, which will further enhance the appeal of retail net lease properties.

Stan Johnson represented the individual seller and REIT buyer of a Walgreens in Kilgore, Texas, in July 2014. The drugstore chain has leased the property for 25 years, and it has 50 one-year renewal options.

Institutional and foreign investors continue to have a strong appetite for drugstores, auto parts stores, quick-service restaurants, fitness facilities, convenience stores and other retailers. More recently, private buyers such as high net-worth individuals and family offices have increased their net lease property acquisition activity, says Jonathan Hipp, president and CEO of Washington, D.C.-based Calkain Cos.

Jonathan Hipp

"The hot streak is continuing," he says. "We haven't seen any evidence of upward movement in cap rates in most property types. If anything, cap rates have compressed slightly and demand for properties is high, especially in core markets."

Philip Wickstrom

Tom Fritz, a director with Stan Johnson Co., who is focused on the Midwest from the firm's Chicago office, expresses a similar take. He points out that early 2015 was quite possibly the best time to be a property seller in the last century given the historically low 10-Year Treasury yield, which has given buyers more purchasing power. The yield in early April stood at around 1.9 percent after trending between 1.7 percent and 2.2 percent in the first quarter of 2015.

"My team is already on track to have a record year in terms of transactions and dollar volume," he says. "We expect the pace to continue going forward."

Even energy markets like Houston, which are being challenged by a drop in oil prices, continue to attract net lease investors, say observers.

"Our experience has revealed that investor interest for properties in those markets remains high," says Philip Wickstrom, a co-founder and managing principal of Atlanta-based Net Lease Group, which is marketing properties in Louisiana and Texas, including Houston.

Rate Squeeze

Cap rates generally compressed across all retail categories in 2014, according to Marcus & Millichap, which facilitated nearly 2,065 single-tenant net lease property transactions valued at $6.9 billion last year. Auto parts stores saw a drop of 60 basis points, with new AutoZone stores fetching prices that represented a 5.5 percent cap rate, on average. Cap rates for O'Reilly Auto Parts and Advance Auto Parts stores were 25 to 75 basis points higher.

Average drugstore cap rates declined 50 basis points last year, with newly leased CVS and Walgreens stores fetching prices that represented an average cap rate of around 5 percent, according to Marcus & Millichap, which in early April was listing some 880 net lease properties valued at $2.7 billion. Average cap rates for casual dining restaurants dipped 20 basis points to around 6.5 percent, the brokerage reports.

Despite flagging sales at McDonald's last year, the restaurant traded at a median cap rate of 3.75 percent in the fourth quarter for locations not more than four years old, according to Northbrook, Illinois-based Boulder Group. That was the lowest of any retailer with properties of a similar age. By comparison, newer 7-Eleven properties sold at a median cap rate of 4.75 percent and FedEx locations sold at a median cap rate of 6 percent in the fourth quarter of 2014, the brokerage says.

Investors also have displayed more interest in fitness facilities, Fritz says. Fitness properties today trade at cap rates of around 6 percent, 400 basis points lower than where they were selling five to six years ago, he explains. He recently sold a fitness property after receiving at least 10 offers on it. A few years ago, he adds, few buyers were interested in such deals because of concerns about parking and doubts that the gyms drove traffic to other retailers. But investors have warmed to the properties, which have created more daily traffic and steady income as they've proliferated around the country.

"Investors didn't like the use to begin with," Fritz says. "But more people are working out as America has become a more health-conscious market, and investors have become much more comfortable with it."

Regardless of the user, a lack of available properties is contributing to cap rate compression, professionals acknowledge. In many cases buyers are more focused on the location than the use, suggests Rick Fernandez, managing director with Calkain.

"Demand has been fairly constant, but at Calkain we continue to see a shift to quality," he says. "Triple-net investors are willing to pay a premium for quality real estate with strong fundamentals, even if the tenant is not as strong."

Debt Driven

Observers also recognize that plentiful and historically inexpensive debt is driving the activity, which harkens to the real estate lending environment before the Great Recession. While underwriting generally remains stronger than before the collapse, some professionals wonder how much an eventual interest rate hike will affect property values. In early April, the 10-Year Treasury yield stood at around 1.9 percent, a year-over-year decline of roughly 70 basis points.

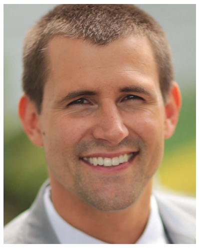
"We know there are cycles, and we know we've been in an unprecedented period of subsidized low interest rates," says Sean O'Shea, managing director of the O'Shea Net Lease Advisory of Los Angeles-based BRC Advisors. "So is this the way it's always going to be? The answer is 'no'; it can't be."

Freely flowing capital certainly has allowed private investors such as 1031 exchange buyers to become more active in the market, suggests Jim Shipman, a partner and senior vice president of net lease investments for PECO Real Estate Partners in Salt Lake City.

Indeed, private investors accounted for 60 percent of net

Rick Fernandez

Sean O'Shea



Tom Fritz

lease transactions in 2014, up substantially from 42 percent in 2013, according to the Boulder Group. Meanwhile, Marcus & Millichap predicted in its *Net-Lease Outlook* report for the first half 2015 that 1031 exchange buyers would dominate the net lease market in 2015. In particular, Marcus & Millichap predicted that apartment-owning retirees would take advantage of investment demand for multifamily properties to exit the sector and plow the proceeds into retail net lease deals.

"The landscape has been changing over the last 18 months or so as more private investors have gotten involved in the net lease market," says Shipman, who has overseen some $50 million in property investments since PECO launched its Real Estate Income Fund in 2012. "Generally that's a signal that the economy is healthier because banks are back to lending to private investors at rates that only larger institutional investors could take advantage of during the down cycle."

But affordable financing and compressed cap rates are convincing some buyers to take on renewal, location or refinancing risk, O'Shea says. That's especially true of a growing number of private investors without real estate experience. They largely see net lease properties as commodities or bonds that generate stable income in the short term but they may not be prepared for a vacancy or other setback, particularly if a tenant only has a few years remaining on the lease, he maintains.

Even tenants considered virtually bulletproof can throw net lease landlords a curve. Walgreens in early April announced that it would close 200 stores — about 2 percent of its locations in the U.S., Puerto Rico and U.S. Virgin Islands — as part of a measure to cut $1.5 billion in costs by 2017.

Dedicated real estate investors typically enter transactions with long-term goals and ideas about other users in case of difficulty, O'Shea notes.

Additionally, while many private investors are squeezing out more yield by tapping five-year debt, which typically carries a lower interest rate than loans with longer terms, smarter investors continue to take out mortgages for 10 years, O'Shea explains.

"I always ask people, 'If you're buying something at a 6 percent or 6.5 percent cap rate with an interest rate in the mid-4 percent range (and a five-year term), do you think interest rates are going to go up 200 basis points over the next five years?'" he says. "Nobody really knows, but experienced practitioners say it could easily go up 200 basis points."

Private buyers also are moving up the price curve, Fritz adds. Private investors have historically showed most interest in net lease properties priced around $10 million or less, while deals of around $20 million were largely the exclusive domain of real estate investment trusts and institutional investors, he says. But recently he marketed a $40 million property and was surprised to see an equal amount of interest from private and institutional investors.

"I would have never expected that a couple of years ago," Fritz says. "I think a lot of it is being driven by debt — more and more lenders are willing to take on risk because they have to get money out the door."

On the institutional side, investment managers also need to put a crush of capital to work, which is leading to questionable deals, warns Paul Domb, asset manager and vice president of Miami-based United Trust Fund. He sees history repeating itself only six years after the

Jim Shipman

Kyle Matthews

financial meltdown and says the Federal Reserve's money printing policy and artificially low interest rates are the "only things driving this market."

"The trend is billions of dollars of other peoples' money will be placed in substandard deals because there is way more money on the sidelines earning nothing, and fee-generated institutional 'investors' with discretion need to spend that money to make themselves money," he explains. "With the supply of 'good' economic deals virtually unavailable, prudent due diligence takes a back seat."

Rate Hike Uncertainty

Volatile economic growth and the mystery surrounding whether interest rates will begin to rise this year are among primary contributors to bearish views.

Will Consolidation Affect the Net Lease Market?

Although net lease investors continue to display strong demand for most retail categories, professionals predict that they will become more reticent about investing in office supply and dollar stores in the months ahead. The proposed $6.3 billion merger between Staples and Office Depot and the shareholder-approved $8.5 billion merger between Family Dollar Stores and Dollar Tree guarantee store closures. In fact, the Federal Trade Commission is expected to require the merged dollar stores to divest themselves of around 300 locations.

Still, investors willing to navigate the uncertainty and to accept the typically lower credit ratings associated with dollar stores compared with Walgreens or CVS should see new opportunities in the dollar store category. In light of the Family Dollar and Dollar Tree deal, Dollar General in March announced plans to bolster its position in the industry by opening 730 stores in 2015. The company opened 700 stores last year.

Investment demand for dollar stores remained strong in 2014 as investors pushed up the average property sales price 5 percent to $159 per square foot, according to Marcus & Millichap. Plus, buyers already were beginning to move their attention toward dollar stores in reaction to the slowing expansion of Walgreens and CVS, says Jim Shipman, a partner and senior vice president of net lease investments for PECO Real Estate Partners.

"I think investors will look to see how this all plays out," he says. "But I still think the dollar stores will be popular. The bigger shift is that buyers are willing to take a little more risk on the credit side of a tenant."

— *Joe Gose*

U.S. GDP growth of 4.7 percent in the third quarter of 2014 and more consistent job growth over several months served a strong indication that the economy was on the verge of booming. But fourth quarter GDP growth of 2.2 percent coupled with estimates that first quarter 2015 GDP will fall below 1 percent have tempered optimism.

Economists and other market analysts largely anticipate that the Federal Reserve will tighten monetary policy to push up interest rates later in the year as the economy approaches "full employment." However, similar expectations over the last few years have gone unfulfilled.

Even if interest rates do rise, professionals maintain that they will have minimal influence on net least property buying and selling so long as the rates move up in a measured manner. They also expect an eventual increase in cap rates to lag any interest rate hike by three to six months.

"While interest rates have been somewhat uncertain, cap rates have continued to compress on a year-over-year basis," Fritz says. "That speaks to demand."

Some observers also downplay worries about an overheating net lease property market. Shipman notes that net lease tenants tend to renew at a high rate at proven locations. Kyle Matthews, an executive vice president for Colliers International in El Segundo, California, argues that most investors in the sector remain risk averse and are often proactive in approaching tenants to renew leases.

"There is some frothiness, but nothing like in 2007," Matthews says. "In 2007, all of the market fundamentals were screwed up — you had tenants signing leases at rents that were unsustainable based on their sales or projected sales." **SCB**