Net Lease: Stronger, With Changes In Store

The single-tenant net lease retail sector has seen strong demand from investors, while supply issues ease.

Randall Shearin

CBRE's Net Lease Properties Group recently sold this Rite-Aid in suburban Philadelphia for $4.9 million.

While one of the most stable asset classes of investment properties over the past 10 years, single-tenant net lease retail (STNL) has seen a number of changes over the past 12 months. Supply is less constrained, likely because many buyers have realized what fits their investment criteria and narrowed their definition of acceptable assets. Demand, say experts, remains strong from 1031 buyers, all-cash investors, foreign investors, and opportunity-driven investors, but has been tempered by fewer transactions from larger investors. As a change in the interest rate was announced from the Fed, the market also sees some changes on the horizon.

For our annual look at the single-tenant net lease market, *Shopping Center Business* interviewed more than 25 executives active in the field, from investors to brokers to those who specialize in arranging financing for this niche property type.

CURRENT ENVIRONMENT

As 2015 drew to a close, the Federal Reserve Bank announced the first interest rate hike in a number of years, an announcement that had many investors pressing to close deals before any such action would affect lending terms. Many lenders have already priced in a rise in rates, assuming the market could not stay low forever, say some sources. That action hasn't slowed activity in the net lease transactions market at all. In a sector where many properties trade under $5 million, a number of buyers choose to pay cash and place debt on the properties after closing. While the initial bump of 25 basis points in the rate will likely not have much of an impact, further increases down the road may cause wider changes in the investment market.

"There is enough positive leverage out there already and plenty of capital seeking good quality real estate that one-quarter of a point won't make much difference in the market," says Bob Peterson, vice president of investments with Passco Companies.

While small increases are often bearable, over time they will reflect a higher cost to borrow funds.

"Increases in interest rates are always interesting, because they disrupt the market," says Joe Cosenza, vice chairman of Inland Real Estate Acquisitions. "Those who are the top bidders on properties do their due diligence and find out that no lender will give them the loan they thought they were going to get, so they will not acquire the property."

As the rate changes, activity in the market has been strong, with many firms reporting their transaction volume was up in 2015 over 2014 levels. In the third quarter of 2015, transaction volume in the industry was up approximately 8.3 percent over third quarter of 2014, according to CBRE.

"This is the longest recovery period the country has sustained since World War II," says Bernie Haddigan, senior managing director of investment properties with

Strong credit retailers, like Walmart, are always attractive to net lease investors. This Walmart was recently sold by Marcus & Millichap.

CBRE Capital Markets. "Most recoveries are typically three to four years; we are going on six years in this recovery. We are seeing a slowdown in buyer activity and fewer NDAs signed in other asset classes, but in the net lease world – specifically with assets under $5 million – the market is very active."

Many brokers *SCB* spoke with reported that they felt cap rates have stabilized and are no longer seeing sustained downward pressure.

"The cap rate compression has slowed a bit, but from time to time, we are still seeing some records broken," says Jeffrey Thomas of The Thomas Company, a net lease brokerage based in Seattle. Like others, The Thomas Company has seen its volume rise over the last 12 months.

"We have clearly tested the bottom of the cap rates; a lot of people brought properties to market that pushed the envelope," says Peter Block, executive vice president with Colliers International in Chicago. "I've seen a mix of incredible deals and a number of sellers come back with the asset re-priced. It would seem that we've hit bottom on where cap rates can go. Unique assets are still pushing that limit."

"The market is fairly stable," adds Jereme Snyder, executive vice president of the retail services group for Colliers International in Orange County, California. "Demand is very strong in the industry right now. Many are in the market looking for clean net lease deals. Credit is king; anything that you can find that has good credit and a long-term triple net lease is trading at an aggressive cap rate."

Sands Investment Group

Chris Sands
Founder

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: There is an ongoing demand from the private capital sector for certainty of return, backed by corporate credit that is sustainable. This was a trend from 2014 that followed into 2015 due to the continued lack of predictable alternative investment vehicles. As a result, private capital is still diversifying their capital into real estate, especially net lease assets.

Activity in 2015 from the REIT and institutional investment sector remained aggressive. Due to supply and demand they are getting more creative in an effort to obtain more desirable yields for their investors, while still benefiting from the core real estate fundamentals of good location, investment grade credit, and predictable yield.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: Investors are seeking acquisition diversification into new product types outside of the traditional net leased assets. Some of these investments include movie theaters, gyms, and new entertainment concepts. While they are not core corporate credit tenants such as grocery or drug stores, the strength of the operator is still there and creates an opportunity for investment diversification. For example, we completed the $12.2 million sale of a single-tenant Carmike Cinema to a publicly traded REIT in September of this year. While a cinema isn't your typical single tenant net lease acquisition it was a calculated and advantageous investment for the REIT which helped them to diversify their investment portfolio by spreading risk across a variety of asset types.

Q: Has the increase in demand for net leased properties changed your business, operations, etc.? How?

A: The demand for net lease is inevitably driving more growth for our firm. At SIG, teams focus on product categories to provide the highest level of market knowledge and advice possible to our clients. Our brokers are experts in their product type whether it is banks, grocery or everything in between. This gives us the opportunity to best position the property creating the largest marketing platform and ultimately locating the right buyer pool. This has been a proven method in remaining competitive and providing a broader and deeper counsel to our clients in helping them deal with the inevitable economic changes in the market. The increased demand for net leased properties has allowed us to continue to grow these vertical teams while keeping our collaborative culture in place. It has also ensured a quality of knowledge for both the firm as well as the individual agent, and helped us provide a stronger leadership advisory role to our clients.

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STREAM Capital Partners

Jordan Shtulman
Managing Principal

Jonathan Wolfe
Managing Principal

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: Demand in the first half of 2015 seemed to be on par with 2014. We think that with the recent increase in the ten year treasury and widening in bond spreads, it is causing somewhat of a pause or a more conservative approach from investors. In the past 90 days we have started to see investors focus in on residual value of the land and building more so than we did in 2014 and early 2015 when investors seemed to be solely focused on yield and credit.

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?

A: Demand has been strong for quite some time now. We wouldn't say that there has been an increase in demand with the threat of an interest rate spike. The low rate environment has been something we've grown accustomed to for a number of years now. Eventually - we don't know exactly when - rates will go up and the market will adjust. But we don't see investors necessarily factoring this strongly into their calculations to sell now.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: Not really. You have investors of all shapes and sizes. Some want strong credit and long term leases, some are willing to take risk on higher yield deals with small cap or mid cap credits, or shorter term leases in an effort to maybe "blend and extend." But this is nothing particularly new.

Advertorial

Stream Capital Partners recently sold this Walgreens in Readington Township, New Jersey, for $9.7 million.

Snyder's team at Colliers International expected to close 100 net lease deals by the end of 2015, about double the volume the group did in 2014.

Jonathan Wolfe and Jordan Shtulman, managing principals with Chicago-based Stream Capital Partners, feel the market is shifting. With the recent movement in interest rates, buyers are becoming more focused on the real estate.

"Location has become more important than it was six or nine months ago," says Shtulman. "Today, they are concerned with the location just as much as they are credit."

"A year ago, the market was so strong that investors weren't as concerned about location," adds Wolfe. "Now, we are hearing from buyers that they are focused on location and demographics."

"Spreads between non-credit deals and credit deals are pretty thin," adds Shawn Bakke, senior vice president with Colliers International in Los Angeles. "We are seeing non-credit deals trade at 6 percent cap rates and credit deals, outside California, probably 75 to 100 basis points lower than that."

Deals in California tend to trade 75 to 100 basis points lower than comparable properties in other states, says Bakke.

Paula Danker, senior vice president with San Diego-based Commercial Facilities, Inc., agrees. "Quality net leased investments in California are being offered at 4 percent cap rates — sometimes lower — and sites outside the state are being offered at 5 percent cap rates in markets that have historically sold at 6 percent cap rates and above," she says.

Along with Stream Capital Partners, which noticed the market for single-tenant net lease retail properties shifting this summer, other companies have seen velocity in the market shift a bit as well.

United Trust Fund

Paul M. Domb
Asset Management

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?

A: It is very possible given the global interest rate environment that when the Fed finally raises that yields may go down i.e. the rate hike is priced in and then some. But even a modest increase will not stop the 1031 machine.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: There has never been in the history of sale-leasebacks or net leased investments a less "traditional" selection of quality investments. Because the majority of creditworthy companies have already executed on their strategies to monetize their real estate what remains is in the eye of the beholder. With the demand side so strong for so long some investors have no choice but to go to a lower level of companies, a less desirable location, etc. We are seeing an emperor with no clothes…but the clothes are selling thanks to Fed policy and the 1031 tax code.

Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?

A: 2015 was strong for sellers primarily of existing net leased transactions. Sale leasebacks are United Trust Fund's only business and we are the oldest firm doing sale leasebacks. We have closed $382,000,000 YTD in 2015 and we expect to exceed that number next year.

ADVERTORIAL

The O'Shea Net Lease Advisory

A BRC Advisors Company

Sean O'Shea
Managing Director

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: Dramatically stronger, with a range of cross-border investors, Pacific Rim and Western Europe (France); tax-compelled 1031 Trade Buyers; Family Offices looking for bond diversification, crowding out normal private investors.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: Actually, the demand for better investment grade credit, that allow better debt underwriting, has never been more compelling with compressed cap rates for all sectors of NNN assets. Investors reason, that I might as well 'buy the good stuff'.

Q: Has the increase in demand for net leased properties changed your business, operations, etc.? How?

A: Yes, with the benefit of professional coaching from Massimo Group , we have dramatically "Upped-our-Game" with additional investments in human capital and team building; as well as, the technology to provide the same analytics as the big global service providers. We are laser-focused on Net Leased assets. High level Clients demand no less. Our 72,000 proprietary NNN database affords comprehensive exposure for Buyers and Sellers, alike, to assist their best investment decisions with a high certainty of full execution.

Advertorial

CBRE, Inc. | Capital Markets

Bernard J. Haddigan
Senior Managing Director
Investment Properties

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: While demand and activity remain strong, executed NDA's are slowing with slightly fewer buyers in the market.

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?

A: Not that we see. Demand has been strong for a number of years and it looks to be a solid transition into 2016.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: There are always 'yield oriented' buyers willing to take more risk through shorter leases, secondary locations, etc. At the same time, we are not necessarily seeing an increase in this profile of buyer.

Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?

A: 2016 should be another good year for the net lease sector. There is still an abundance of capital seeking stable yields.

Q: Has the increase in demand for net leased properties changed your business, operations, etc.? How?

A: We have expanded our team both on the transaction and finance side and we continue to expand our use of technology to communicate more effectively internally as well as with our clients.

Advertorial

"The average number of offers per property is slowing down," says CBRE's Haddigan. "But you only need one buyer to close a deal. Whereas you may have had 100 NDAs and 20 offers one year ago, today you might have 40 NDAs and three offers. In good times and bad, net lease is less volatile than other property types."

"The net lease space is much more liquid than other leased investments, like shopping centers or office buildings," says Bill Rose, vice president and national director of Marcus & Millichap's Net Leased Properties Group. "Because they are in single tenant buildings, you can acquire a portfolio of 50 of them and you may spin off one or two. That makes the investor feel that it is more liquid than other assets."

"Investors are a little more cautious right now," says Shtulman. "There was just so much activity at the end of last year. With the upcoming election and with interest rates going up, there is an attitude of caution."

Still, despite the rise of interest rates and caution, many brokers say it is important to maintain realistic expectations on well-located properties with strong credit.

"If you expect to buy a new 20-year McDonald's ground lease at a 5 percent cap rate, you're dreaming," says Doug Aronson, a director in Calkain Companies' South Florida office. "It's more like a 4 percent cap, and in some parts of the country, even lower."

ACTIVE BUYERS AND SELLERS

The net lease market is very active. At a relatively low price point, it is arguably the most active sector of commercial real estate by number of transactions. Marcus & Millichap's Rose says there are roughly 10,000 net lease trades that occur every year. Within that, our sources identified several tranches of investor groups actively acquiring in the market:

- 1031 exchange buyers;
- REIT, institutional and fund investors;
- All-cash investors; and
- Opportunistic investors, who buy short-term leases at higher cap rates, renegotiate lease terms and quickly sell the properties to more mainstream investors.

The most active buyer group, and the one that will pay the lowest cap rate, remains the private investor who is seeking a replacement property in a 1031 like-kind exchange.

"REITs and fund buyers have proven themselves to be a very consistent source of acquisitions," says Rose. "Even so, the private client who is exchanging out of one property and into another remains the most active investor in the single-tenant net lease retail space."

"We see second- and third-generation ownership of apartments exit those assets in favor of net lease," says Ian Schroeder, senior vice president of CBRE's Net Lease Properties Group in Newport Beach, California. Schroeder has one client who has been selling apartments in the Bronx at a 3 percent cap rate and trading into net lease assets. "They are exiting the apartment market and going into $10 million to $15 million net lease assets. The apartment money is helping to drive the net lease market, and those buyers are willing to pay. If a deal would normally be at a 6 cap, they are happy to pay a 5.5 percent cap rate to lock it up. Their return is already up. We don't see the apartment market slowing down; as long as it remains robust we expect the A quality net lease assets to maintain low cap rates."

Apartment sellers and other exchangers are fueling the market – they know real estate from their years in multifamily, yet are eager to get into less management intensive properties that still produce comparable incomes. In buying net lease, private buyers may also be willing to pay more because of their local market knowledge, says Rose. While funds buy on proven metrics like credit and lease term, a private investor may know a market so well that he or she knows if the tenant goes out, the location within the market is so desirable that another tenant – which he or she may also know – would step up immediately.

"They may love a property because it is in their hometown, and they may know that real estate really well," says Rose. "They are happy to pay a 5 percent cap rate for an asset like that."

For many exchange buyers, finding that replacement can be elusive, and they are often willing to up the offer if the replacement window timeframe is closing.

"We are seeing a lot of 1031 exchange buyers that want to find the right product but can't find it," says Andrew Bogardus, senior managing director, Net Lease Investment Services with Cushman & Wakefield in San Francisco. "When the product comes available, sellers are getting multiple offers for brand new 15- and 20-year leases that they like."

While private investors have made the market tougher for institutional buyers, Chris Sands, founder and managing director of Sands Investment Group, says those entities have navigated the market well by maintaining a blended average rate of return for their investors.

"They have made sure they check all the boxes from an institutional buying pool criteria and that their investors would be happy with the properties," says Sands. "At the end of the day, many have created a blended average cap rate that gives them a yield that works."

"There's a fragile balance that people are trying to strike right now to get an acceptable return," says Sean O'Shea, managing director with the O'Shea Net Lease Advisory of BRC Advisors. "You are going to pay a premium for the best of the best."

All-cash buyers continue to fuel the market to add to their portfolios. Many are seeking stable returns to "park" cash that other investments cannot offer at this point in time. Many of these investors hold out for properties with good locations, stronger credit and longer lease terms. Others will sacrifice one of those elements if the other two are in place.

"Some of these buyers are willing to buy a franchise concept, or something that is not corporate credit but has a strong background, like 50-plus units. They will take that in lieu or a corporate credit lease," says Sands.

"The lower yield being offered by corporate-backed sites is causing buyers to consider and purchase large franchisee sites in good locations, which offer higher yields," says Danker of Commercial Facilites Inc.

JLL

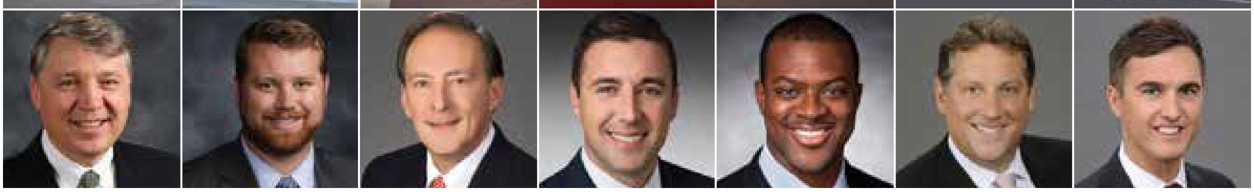
Thomas Beneville
National Team Leader,
Net Lease Property Group

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?
A: Demand for net lease product is extremely strong. Amidst strong U.S. economic performance, 2015 net lease is on track to have the highest transaction volumes on record with cap rates across sectors now below prior peak levels. Year-to-date volumes are at $34.7 billion, a 13.5% increase year-over-year. Yields have simultaneously compressed, down 33 basis points overall to 6.3%.

Q: What will be the effect on the net lease sector as the threat of an interest rate hike looms?
A: Recent global volatility has facilitated a widening of spreads, now pegged at 420 basis points between the U.S. net lease sector at-large relative to the 10-year treasury — nearly 200 basis points wider than the prior 2007 peak. With this said, the sector is well-positioned to absorb modest, controlled increases in rates, however, a pending increase will impact certain segments of the net lease market, notably assets with less lease team.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)
A: Clearly, investors have the highest demand for quality assets as there is a 90-basis point yield premium for AAA to A credit, at cap rates averaging 5.9%, relative to unrated tenancies. This increased competition for quality, credit tenanted assets has caused investors to turn to secondary and tertiary markets much more frequently as well as assets occupied by non-investment grade tenants.

Q: With 2015 as a strong year for the net lease sector, what do you predict in 2016 for the sector?
A: With continued U.S. economic growth, strong market fundamentals and healthy pricing spreads, the net lease sector is well-positioned for continued growth heading into 2016. We also expect continued competition from private investors, especially those driven by 1031 exchanges. As supply-demand balances and external forces play out, cap rate compression has the potential to slow down towards the second half of the year.



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Calkain Companies

Patrick Nutt
Managing Partner

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: Demand has remained consistent over the past several years, however there was a sharp increase in large 1031 exchanges over the course of 2015. Typically, the total dollar amount involved in a private investor going through a 1031 exchange topped out between $7-10 Million. Nonetheless, 2015 saw a record number of private families with $20-50 Million exchanges, with the vast majority of them originating from the NYC metro area, and largely focused on investing in net lease outside of NYC. We have begun seeing this trend slow, shifting the demand source from these time sensitive pools of capital to non-1031 investors, a higher percentage of which are utilizing leverage.

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?

A: The Fed's decision on monetary policy continues to be a hot topic for all investment classes, however the true impact has and shall continue to be fairly muted within the net lease space. While borrowing costs should increase, the underwriting and actual cost of debt has gone down via higher leverage points and longer amortization periods. Additionally, the spread between the risk free rate of the 10 year US Treasury notes and average cap rates for net lease continues to hover around all-time highs, in the 450bps range, whereas the peak of the 2007 cycle saw spreads at just 175bps. Lastly, equity markets are notoriously volatile during a changing monetary policy, thus we anticipate another wave of fresh capital to move from the stock market and into real estate, specifically the stable net lease sector, over the course of 2016 and 2017.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: The search for yield has certainly expanded the box within which most investors look, however it does appear that rather than chase non-credit tenants into tertiary markets, buyers have remained somewhat disciplined in their criteria and have been more willing to accept lower yields for assets in primary and secondary markets occupied by national brands. Additional yield has been sought after by taking on risk in the form of shorter duration leases, additional landlord obligations, and accepting lesser credits when the underlying real estate supports the investment.

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Bull Realty recently sold this Hooters location in Columbia, South Carolina. The listing quickly brought 12 strong offers for the property.

Investors that were not doing so previously are now acquiring assets with less than 10 years remaining on the lease, as long as the other fundamentals of the real estate make sense.

"Investors are becoming more comfortable with less term left on the leases," says Parker Carroll, managing director with Coldwell Banker Commercial in Austin, Texas. "We've done a number of transactions over the past 12 months that have not been your typical absolute, 15-year net lease properties. We have seen some ground leases transact and some older properties that are in their option periods that have been very attractive because rents can be lower compared to the market rate."

International buyers also mostly fall into the all-cash buyer category, and many of *SCB*'s sources reported that they have remained a steady force in the net lease market. Haddigan, for one, has seen buyers from Asia, Israel and Europe.

"The same mentality buying super luxury residences in Los Angeles and New York — parking money — is coming into the net lease market as well," Haddigan says. "Even in the $2 million to $10 million range, we are seeing foreign money invest in the United States that is principal direct. In past cycles, we had seen that come in through advisors. Now, we are seeing this from wealthy individuals or wealthy families buying one-off deals, or multiple properties. It is a factor that is fueling the market."

Ralph Cram, president of Northbrook, Illinois-based Envoy Net Lease Partners, also sees foreign capital active in the net lease market, with many outbidding the 1031 exchange buyers. He noted a recent transaction where a foreign buyer's offer

ANGELO, GORDON & CO.

Sale-Leaseback Financing

$108,240,535 Headquarters **$45,895,000** Structured Parking — Goodyear — NYSE: GT	**$76,000,000** — Hensley Beverage Co.	**$158,600,000** — Molina Healthcare — NYSE: MOH	**CAD 54,000,000** — Cascade Aerospace — A subsidiary of IMP Group Limited
$39,600,000 — Fresh Express — a wholly-owned subsidiary of Chiquita	**$48,210,000** — DS Services™ — A wholly-owned subsidiary of Cott Corporation	**$45,000,000** — Mattel — NASDAQ: MAT	**$160,000,000** — csm Bakery Products — A portfolio company of Rhone Group
$83,000,000 — Nordic — A portfolio company of AIM	**€22,000,000** — upc — A portfolio company of Liberty Global Europe	**$84,400,000** — Academy Sports + Outdoors — A portfolio company of KKR	**$19,000,000** — Pregis — A portfolio company of AEA Investors

Sale-Leaseback Financing From AG Net Lease

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Contact Gordon J. Whiting, Portfolio Manager • 212-883-4157 • gwhiting@angelogordon.com
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Landmark Investment Sales

Kevin Baker
Partner and Co-Founder

Daniel Kukes
Partner and Co-Founder

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?
A: We are witnessing exceptionally strong demand from private and 1031 investors for retail net lease assets. Net lease demand is significantly higher than 2014.

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?
A: There has been an increase in demand but that has been attributed to the lack of supply, limited development pipeline, and the resulting rise in asset valuations which is triggering sales and supplying the market with fresh 1031 buyers.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)
A: Absolutely. We are seeing franchisee and other unknown credits trade in ranges that are 100-200 basis south of where they were just a few years ago.

Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?
A: We anticipate continued strong investor appetite in terms of volume. However, a rise in interest rates will undoubtedly reverberate to asset prices at some level. In terms of valuation, we are already starting to see the effects of low cap rates and rising interest rates creating negative leverage. For instance, when leverage is no longer your friend, your buyer pool shrinks considerably, which is fine if you are selling a $1,000,000 STNL asset with ample cash buyers. However, assets valued over $10,000,000 have already experienced increased investor scrutiny.

Q: Has the increase in demand for net leased properties changed your business, operations, etc.? How?
A: Yes, our firm has been very fortunate. Our office has experienced steady growth which has spurred multiple new hires in brokerage, marketing, operations, and management.

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STORE Capital

Christopher H. Volk
Chief Executive Officer

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: As a public net-lease investment company (and a REIT), our demand for net-lease investments has been driven by the capital needs of our tenants. Since we have to fund new investments, primarily by issuing new shares and new borrowings, we have to pair the needs of our customers with the ability to raise capital. During 2015, domestic and global long-term interest rates remained at near historic lows, which has contributed to investor demand for net-lease returns, coupled with the growth that a platform such as STORE has been able to deliver.

Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?

A: We have announced expectations to invest a net $750 million for 2016. However, we are a flow business, making investments as needed by our tenant/customers, which makes this estimate difficult. Market conditions permitting, we would hope to exceed this amount, as we have in 2014 and 2015.

Q: Has the increase in demand for net leased properties changed your business, operations, etc.? How?

A: We have positioned this investment platform to be the finest of the three net-lease companies we have formed over the past 35 years. Since our founding in 2011, we have funded almost $4 billion of investments leased to nearly 300 customer/tenants across more than 80 industries. Our platform is highly scalable and systematized, which we intend to use to our advantage in the coming years.

Advertorial

General merchandise tenants like Tractor Supply Co. are in demand from investors. This unit in the Southeast was recently sold at a 6 percent cap rate by Andrew Bogardus at Cushman & Wakefield.

was 25 to 35 basis points lower than that of a 1031 buyer.

There are many opportunistic funds and acquirers in the single-tenant net lease retail market now. This group of buyers is looking for shorter term lease deals; properties that might have five to eight years left on a lease that do not have a slew of renewal option periods thereafter. With these assets, there is often a negotiable point on the lease structure that allows for an extended term. If the retailer extends, value is instantly added to the asset. Once that is done, this type of owner generally turns around and sells the property. Some hold the properties as investment, accreting the value to the yield.

Patriot Equity Partners is an opportunistic investor based in Newport Beach, California, that acquires institutional-quality assets with upside. The company sells when the opportunity is right, and buys when the opportunity is right. The company bought and sold about $150 million worth of real estate in 2015.

"We are buying assets that have some opportunity for improvement, whether that be a shorter term lease or a credit that is not as strong today as it will be in the future, or some feature that will add value to our portfolio," says Principal Brian Garrigan.

Institutional and fund buyers are actively seeking properties. Generally, because of commitments to investors, they are seeking properties with higher cap rates than those acceptable to a private or 1031 investor, who is in search of a safe property that generates steady yields.

One of the largest institutional investors, Inland Real Estate Acquisitions, likes to acquire properties with known

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Cushman & Wakefield

Garrick Brown
Vice President,
Retail Research
of the Americas

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: Demand for all commercial real estate product types has risen considerable over the course of 2015. It's been going up consistently since 2013. In 2014 we saw the beginning of the surge of foreign investors but they largely weren't aware of net lease opportunities so much. At first we saw much of that activity limited to multifamily, core office and hospitality. Demand for net lease investment surged in 2015 but one of the things that I noticed was that we were starting to see more interest from foreign investors. It was largely Asian investors in the Western United States and investors from Europe and the Middle East in the Eastern United States. Across the board it was mostly private investors or investment groups. For the most part, these buyers are motivated by the relative security of the U.S. economy and they are mostly cash buyers. Additionally, because they are primarily motivated by security, they are looking for safe bets and willing to pay more and get lower returns to get them. But they coincided with increased interest from 1031 investors, REITs and virtually every other investor type. The big challenge has been finding product. This surge of investor demand and the overall dynamic of too many buyers chasing too few assets has meant pricing climbing for every net lease investment type.

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?

A: Though we have seen the typical end-of-year spike in demand as investors look to close deals before the end of the tax year, we have not seen fear of interest rate hikes playing a major role. Certainly this is a motivator for some, but I think that the marketplace — for the most part — doesn't expect the impact of interest rate hikes, at least initially, to be significant. I would agree with that assessment; the impact will mostly be on the residential markets and we may feel more indirectly from Wall Street jitters over the topic than from the direct impact of the actual rate hikes.

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Thomas Company

Jeff Thomas
Managing Director

Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

A: We are seeing an increased demand from investors, which is being driven by several different trends. One major trend is the broader acceptance of net leased investments by institutional investors who continue to raise capital to be deployed in net lease. We also see private investors rotating out of actively managed investment properties such as multifamily and strip centers, and into more passively managed assets as they approach retirement years. Finally, the overall interest rate environment is still quite favorable, which allows investors to make accretive investments up and down the risk curve. All of these demand forces are playing out against a supply side that can't seem to keep up.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (Definition of "traditional" = top-credit, well-known brand properties)

A: Investor demand has been primarily focused on "core" assets, those leased to investment grade tenants with more than 10 years of remaining lease term. Currently there's a disproportionate focus on core assets, so the scarcity in that subsector is pushing cap rates lower. Core assets may be harder to find, but they are by no means impossible to source. We have not seen investors that traditionally acquire core assets move up the risk curve to a different asset class. As the scarcity of available core properties has driven cap rates for core assets lower, we have primarily seen investors either accept lower yields or move to the sidelines.

Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?

A: We often look at the spread between cap rates and the treasuries as one indicator of where the market may be headed. The market generally becomes more susceptible to a correction when the spread narrows, which often results in a build-up of supply, the first indicator of a slowdown. At this point, however, the spread is still wider than levels seen over the past 10 years and inventory remains historically low, indicating that the market may have room to absorb a slight increase in interest rates. The market may pause temporarily as it adjusts to an interest rate increase, but we feel that the market can absorb a modest increase without affecting cap rates or market volume over the long-term. We expect to see the current level of demand carry into 2016, with the continued scarcity of core assets helping to overcome the narrowed spread between asking cap rates and treasuries. Our outlook is for another active year.

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tenants, leases that have around 20 years or more remaining; rental rates that are at or below market, and a cap rate between 6 percent and 7 percent. Inland Real Estate Acquisitions has acquired $1.5 billion in assets since January 2015, approximately $400 million of that are net lease properties, according to Cosenza.

Passco Companies is in the process of acquiring single-tenant net lease assets. The Irvine, California-based company has a number of criteria that it seeks in net lease acquisitions. Chief among those are location, submarket, traffic counts, functionality of the property, tenant credit and remaining in lease term. The company also researches a path for exiting each property. Passco plans to hold properties for seven to 10 years. Passco has several funds it offers investors, including a fund it offers to 1031 exchange investors. Among the types of investors Passco is seeing in its funds are individual investors, family offices and foreign investors.

"Most of our investors want the opportunity to own institutional quality real estate and not have to deal with the headaches of asset management," says Peterson. He says that Passco is planning to acquire $500 million worth of commercial real estate in 2016.

Miami-based United Trust Fund has also been an active buyer in the market. The company buys all property types, primarily acquiring sale-leasebacks from corporations, including retailers.

With the difficulty to identify assets on a regular basis, some investors are changing the types of properties they invest in — completely. Coldwell Banker Commercial's Carroll has seen some investors that traditionally have acquired net lease properties switch over to acquiring multi-tenant projects.

"They can get the yields they had previously been able to accomplish with single-tenant assets," he says.

Calkain Companies has also been working with developers of small multi-tenanted strip centers of 7,000 to 10,000 square feet with three or four national tenants.

"Investors like these because they can usually achieve higher cap rates and hedge their bets," says Aronson. "If one of the tenants doesn't survive, they still have income from the other tenants."

Regardless of who is buying, investment sales professionals who represent sellers say that they still see some concerns with the ability to deliver inventory to buyers.

"Everything we bring to market, we end up transacting," says Rose.

"The product that will trade most quickly will offer the investor a combination of the longest possible lease term, combined with rent increases and an absolute net lease and investment grade credit," says Patrick Luther, managing director with Faris Lee Investments.

BUYING, SELLING AND FINANCING

While many say that the market for investing in single-tenant net lease properties is getting slightly less intense, the market is still tilted towards sellers. Today, there are a few big players active in the sales markets now. Some funds are selling because they are taking advantage of cap rate arbitrage with properties they

acquired during or shortly after the downturn. Apartment sellers are exchanging into net lease because they want less management intensive properties that still provide income.

"It is good to be a seller today," says Garrigan, whose Patriot Equity Partners is both a buyer and a seller. "It is a sellers' market. There is so much demand that if you have something you are unsure about for the long haul it is really tough not to sell it."

To find its acquisitions, Patriot utilizes the brokerage community and works directly with retailers, as well as finding off-market properties.

"You can't just focus on one method if you are trying to source deals," says Garrigan. "You really have to expand your horizons and find a multi-pronged approach to finding opportunities."

Sell-side brokers have plenty of success stories from 2015. For them, the thrill of the deal is being able to connect buyer to seller, and meet the expectations of both parties. Still, some are astounded at the cap rates that buyers are willing to pay. Jereme Snyder's team at Colliers International recently sold a Chick-fil-A for a 3.9 percent cap rate that had 11 years remaining on the lease.

"I don't remember any asset like that trading that aggressively with 11 years on the lease," says Snyder.

Atlanta-based Bull Realty listed a Hooters Restaurant in summer 2015 in Columbia, South Carolina. The property quickly generated 12 offers because it had an aggressive cap rate. Every offer was vetted and the best buyer was presented to the seller.

"That event has happened time and again on a number of properties we've listed this fall," says Nancy Miller, senior vice president, National Net Lease Investment Group for Bull Realty. Miller says she is seeing many all cash offers where the buyer may have a lender lined up to provide financing after closing.

"Credit, lease term and location are the deal factors," says Mark West, senior managing director of HFF in Dallas. "If you have all of those, it is going trade. If you have compelling arguments for two of the three, the deal is still going to be good. If a property is an outlier — it doesn't have much credit, there is not much term — it is going to be difficult to trade. When you have shorter leases, lesser credit and weaker locations, it is not a question of it being mispriced, it is a question of that property being less liquid."

"The majority of net lease buyers are going to think about credit and lease term first," says Jeffrey Thomas. "Then, they will look at other aspects particularly important to them, including location, net operating income growth, or other attributes."

Among the three criteria, the biggest issue that many buyers have a problem with changing is geography. Buyers like to know the market, or at least know of it.

"Some buyers want a major metro area or they want to stay out of small towns," says Bull Realty's Miller. "Often, those major metro markets are going to be a lot more expensive, notching cap rates down 25 to 50 basis points."

Bull Realty represents one buyer that has a property under contract in a smaller market with a brand new, 15-year net lease with a known retailer. The buyer is comfortable with the location because of the long length of the lease and credit of the tenant.

"Buyers have to move quickly when they see an opportunity that fits their criteria," says Michael Bull, CEO of Bull Realty. "They need to provide as quick and clean a contract as they can."

International buyers, meanwhile, prefer to stick to major metro markets and like to have credit and lease term present as well.

"We generally see foreign capital show up when there is a Class A asset in a gateway market," says Thomas.

For many investment sales brokers, educating buyers is a part of the acquisition process. While many investors may be familiar with real estate, they are used to the fundamentals of operating real estate, which can be different than thinking of a property as an asset in an investment portfolio.

"Some 1031 buyers are buying these properties like they are buying a car," says Christian Marabella, president of Marabella Commercial Finance in Carlsbad, California. "It is not a car; it is real estate. You need to look at all facets of the deal, from the environmental aspects to the lease to the common area maintenance agreements, before pulling the trigger on a deal. It may not haunt you now, but after you close, something could come back to you."

Education has lessened over the years, as investors have become more familiar with the asset class.

"Twenty-eight years ago, when I started The Silver Group, institutional experts didn't have single-tenant properties on their radar and had little interest in hearing the pitch," says Barry Silver, principal of The Silver Group, based in the San

Mid-America Real Estate Corporation

Wes Koontz
Net Lease Investment Sales Director

Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?

A: Rather than an increase in demand, it has seemed that we've come close to a bottoming of cap rates in the ultra-low yielding category. While you still see many Chick-Fil-A and McDonald's investments being marketed in the sub 4% cap rate range, only the best of those assets will actually trade sub 4%. Premium metropolitan areas, premium trade areas, tax free states and urban locations are typically the drivers of lower cap rates across categories and credit quality, and those are the additional factors that help some of these assets trade in the 3% cap rate range. However, as the 10 year treasury begins to climb, it is likely that some of these properties will be the first to see some rise in cap rate due to alternative investment yield for those same dollars. The one buffer to this phenomenon is still the 1031 exchange buyer pool. These investors must buy real estate or real estate related product, and thus are not able to defer the capital gains by buying bonds. Therefore, there will still be a large pool of 1031 investors seeking the security and long term investments provided by strong 20 year corporate leases.

Q: With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

A: As supply has remained tight for the very best market priced or near market priced assets, there have been some groups that have loosened some of their criteria. It varies by group and individual, but there are some investors that are recently back in the market after a year or two out who are taken aback as to how low cap rates have gone. When the initial surprise wears off those investors either accept the lower yields and stay true to their core investment parameters or they decide to move to a lesser credit, shorter term or secondary/tertiary location to get a bit more return on the invested dollars.

Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?

A: 2016 looks to be another good year in the industry. There is quite a bit of continued new development and redevelopment activity that should bring many new properties to the market. Additionally, the sale-leaseback rationale for many retailers remains strong, so it is also likely that we will continue to see new, long term franchisee and corporate sales. These investments are particularly attractive to the investment community when there is full disclosure of company financials, store sales, rent to sales ratios, etc.

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Quick-service restaurants are among the hottest net lease investments, with McDonald's leading the pack. This McDonald's in Canton, Ohio, was recently sold by CBRE.

Francisco Bay Area. "Individual investors required education on the features and benefits of single-tenant ownership. Today, some of the largest landlords of single-tenant properties are institutions. The attraction of little or no management associated with these properties is so appealing that the learning curve is much shorter."

While supply has been a concern for single-tenant net lease properties, many in the industry say that has been alleviated by new inventory coming to market. Supply, say many brokers, is all a matter of what you consider it to be. Buyers have narrowed the scope of the properties they consider acceptable, meaning that the supply within their bandwidth may be limited, but not the overall supply of STNL properties.

"When I talk to buyers and they say, 'there's a lack of supply,' I try to clarify that by asking, 'Do you mean there's a lack of inventory in the market or there is a lack of inventory of what you are interested in buying?'" says Sands. "Most of the time, they agree with me. Most of the time sellers are placing properties on the market and pricing them as aggressively as they can. There's a difference in buyers feeling like there is inventory, or inventory matching their criteria. They are generally speaking about what matches their strike zone."

In addition to new development [see page 68] supply is also being created by owners of portfolios of net lease properties that are culling their assets and placing non-conforming properties on the market.

"We are seeing a lot more inventory coming to market," says Haddigan. "If owners are in a position where they do not want to hold a property five years from now, they are likely to sell it now."

"Owners of multiple assets are always managing their portfolios," says HFF's West. "They may have too much concentration of one credit tenant in a portfolio or too much concentration in one geography, or maybe they have too many drugstores. They are always looking to work through assets that aren't core to their business investment philosophy as that changes over time."

As well, those who bought properties during the downturn are now reaping the rewards by selling them at higher prices.

"Buyers of REO product from 2009 to 2012 are now unloading that inventory," says Luther. "Interestingly, some have done zero on the asset level in terms of lease-up, improvement of operations, NOI growth, etc., and are simply taking appreciation on a price per square foot level."

With the attraction of low cap rates comes the danger of sellers rushing to the market. That could create a glut of properties on the market in 2016.

"A few years ago, everyone had cash to put out and there wasn't enough product," says Shtulman. "Now, there is still a lot of cash, but that cash is a little more cautious and there is a lot of product. When that happens, there is a bit of a supply-demand imbalance."

Many buyers are acquiring deals in all-cash transactions, then pulling out cash by placing financing on the properties after closing. Of those, many have loans pre-arranged so they can jump on opportunities as long as the property fits certain criteria the lender has agreed to.

"That goes back to supply and demand," says Marabella. "People roll into net lease deals to defer taxes and get into a landlord-friendly property. There isn't the amount of supply that there once was. Now, we have more buyers and fewer stores. It has created a sellers' market. They dictate the terms, like short due diligence. Buyers have to understand there is risk with short due diligence periods. If we run into issues, we are putting money at risk with the seller. A lot are closing all cash to get the deal done, then pulling cash out after the deal with financing."

"There are many cash buyers out there, most of whom are coming off 1031 exchanges," says Calkain's Aronson. "But those that are using debt are often getting 60 percent to 75 percent loan-to-value, depending on the asset, the strength of its lease, the strength of the borrower and, of course, its location. The biggest challenge for those using debt is that they cannot compete against the cash buyer who promises to close quickly. And by quickly, I mean as fast as two to three weeks from escrow."

Banks' appetites for net lease retail assets today is much like that of investors: certain attributes must tick the boxes in order to pique their interests.

"Life insurance companies, CMBS lenders and banks all love the [net lease] product, but they underwrite it according to the perceived risks," says Gary Mozer, principal and managing director with Los Angeles-based George Smith Partners. "Real estate, market and sponsor are really the three legs of the stool for the lender."

Banks have always been concerned with credit, but that hasn't been the only factor they've looked at. Many of *SCB*'s sources reported they are happy to see lenders taking a strong look at the underwriting of STNL properties because they feel it will prevent a situation where there is over-borrowing and under-cautious lending.

"Credit is important, but it is only a partial determination of a cap rate," says Envoy's Cram. "There is maybe a 10 percent differential in cap rate now [between a credit or non-credit tenant] whereas it used to be a 20 to 25 percent differential in cap rate. A franchised QSR restaurant versus a corporate QSR restaurant with the same brand will maybe have a 50- to 75-basis point difference in cap rate."

On lesser credit properties, or those with an inferior location, Marabella says many lenders look at what is known as the "hangout." That refers to when the value of a shortened term of the lease equates to the value of the loan at a given point. For example, if a property has a 15-year lease and a loan on a 10-year term with rent of $100,000, the lender wants to see the loan balance in the 10th year equate to the value of last five years of the lease ($500,000). If a lease term is shorter, a lender will look at the value of the vacated property. For properties that are franchised, they will consider the sales-to-rent ratio. Sponsorship is also important on franchise deals, he says, with many lenders wanting only multi-unit operators with a 10- or 20-unit minimum.

Regardless of the three legs of the stool – credit, location and lease term – deals are getting done by the various buyer pools, many of which are more concerned than ever about what they are buying.

"If you know your real estate, if you have a feel for the marketplace in general and you have a good feel for the area that the property is in, underwriting it for acquisition is relatively easy," says Inland's Cosenza.

NEW DEVELOPMENT

In the mid-2000s, new development provided a majority of the supply of net lease properties. Newly constructed properties continue to fuel the market, but not to the degree they once did. Merchant developers like Embree Group, GBT and others, are actively developing properties that are sold into the market or held until the market is right for the property to sell.

"We are finally seeing more development in retail, but it is really more dollar stores and quick service restaurants," says Haddigan.

Andrew Bogardus of Cushman & Wakefield works with a lot of merchant developers that are preferred developers for tenants.

"They seem to have a strong pipeline for 2016," he says. "If my group has a good pipeline, then that means that the other developers likely have a good pipeline also. Hopefully, that means we will see some new product. The great news about new product is that the leases are fresh."

Developers seek new operators or tenants that are expanding, such as healthcare and restaurant tenants. They want to be their preferred development partner so they can add scale versus just doing one-off projects. Other popular expanding tenants include auto parts retailers, dollar stores and hardware/supply stores like Tractor Supply Co.

"As a merchant builder, we continue to see significant retailer and healthcare provider expansion," says Josiah Byrnes, vice president of Embree Capital Markets Group. "We bring those properties to market immediately."

Many merchant developers follow retailers to new markets. Embree Group recently developed a Buffalo Wild Wings ground lease in the Phoenix MSA on a power center outparcel, which the company then sold.

"Given the strong location, in-favor asset class, tenant creditworthiness and perceived lower risk profile of a ground lease, we were able to pre-sell the asset many months in advance of commencement and still lock in a very favorable spread," says Byrnes.

Investment brokers, as well, have seen new developments come to market as retailers expand into new areas.

"New net leased properties come across our desks every day," says Danker at Commercial Facilities Inc., in San Diego. "Dollar General is continuing to expand on a nationwide basis, Mattress Firm is also expanding; drug stores and fast food sites are popping up. We are also learning more about food concepts that are either new to California or do not exist in California, like Raising Cane's and Zoe's Kitchen. In addition, many fast food companies are expanding their franchisee-run locations, so instead of seeing a prevalence of new corporate sites opening up, we are seeing a lot of new franchised locations."

Marabella believes the industry runs in trends. As with players like Blockbuster Video in the 1990s, the industry is seeing different tenants now that follow the changing lifestyle and technological habits of society.

"QSRs are hot right now because you can't sell hamburgers on the Internet," he says. "Those industries where the Internet can't take away from brick-and-mortar sales will be the industries that stay."

"We see more services, food and retail that can't be sold over the Internet as the categories that are developing new locations," agrees Ralph Cram of Envoy.

Quick-service restaurants (QSRs) are among the hottest net lease tenants. Pictured is a recent Chick-fil-A sold by Colliers International in Lake Park, Florida, at 3.9 percent cap rate.

Bogardus is seeing a lot of auto parts stores, like Advanced Auto and retailers like Tractor Supply Co. and bank branch locations. Bogardus has two deals that were sold pre-construction, approximately 12 months from delivery.

"These deals are good for the developer because they have passed on the interest rate risk to the buyer," he says.

Similarly, Calkain Companies has been working with PDQ, a national chicken restaurant concept from the founders of Outback Steakhouse. The company has been growing primarily in Florida, Texas and North Carolina.

Northbrook, Illinois-based The Boulder Group is also seeing strong demand for lower cap rate assets. "The product types we are selling the most of are restaurants and drug stores," says Randy Blankstein, president of The Boulder Group. "There is some hesitation in the drug store space; a lot of investors are waiting to see how the Rite-Aid acquisition by Walgreens plays out."

One of the largest single-tenant net lease retail transactions in the country during 2015 was done by Faris Lee. Luther says his team sold a Lifetime Fitness facility in Las Vegas for $51 million, representing a high 5 percent cap rate. The property was sold by Gramercy Property Trust, which purchased it a few months before for $45.5 million as part of a 10-property corporate sale-leaseback transaction from Lifetime Fitness.

Even with an interest rate hike causing some concern for the industry, net lease is on target to remain on investors' radar screens. The steady income and stability of assets keep the properties top of mind.

"The beauty of net lease is that it acts and feels like a bond, but in the eyes of the IRS, it is real estate," says Marabella.

As well, the net lease industry continues to grow; it is now widely considered its own sector within commercial real estate. The sector has spawned a number of new conferences over the past 10 years, including two sponsored by *Shopping Center Business*, and brokers and investors who are focused on the asset class continue to be amazed by the amount of data available.

"The space has gotten a lot more efficient over the last 10 years with the increased use of technology, as well as the popularity of net lease," says Garrigan of Patriot Equity Partners.

"In the past five years, this asset class has reached a whole new level of awareness and participation," says Colliers International's Block. **SCB**