Net Lease Activity Forges Ahead

Despite some concerns in the sector, net lease activity remains at robust levels.

Randall Shearin

Calkain sold six Wawa locations in 2018. Among them was this location on Belvedere Road in West Palm Beach, Florida, that sold for $7.53 million. Convenience stores are one of the many newer retail-type locations that have entered the realm of net lease retail sales.

Heading into 2019, the climate for the single tenant net leased (STNL) retail sector is red hot again. The net lease market – including all asset classes – is now a $50 billion per year industry with a variety of investors active in the market. For single tenant net leased retail assets, whose prices tend to be on the lower spectrum, activity has remained steady for the past few years.

"The number of net lease deals done in the $1 million to $10 million range is greater than the peak of the last cycle," says Scott Holmes, senior vice president and national director of retail for Marcus & Millichap.

Pushing dollars to the sector is the reliability, predictability and historical stability of STNL retail properties, which, say many in the business, have a bond-like appeal to investors.

"The driving force in STNL being a favorable investment today is the stability," says Andrew Ackerman, managing director of Sands Investment Group in Atlanta. "The stock market has been very unpredictable this year. Non-STNL real estate assets require management, which investors would rather not do currently. It's all about stability. People want to know their investment is safe and they don't have to think about it. Thus, STNL is very attractive."

In addition to large institutional investors who are active in the space, smaller investors remain the key to the success of the sector. The properties have a special appeal to those smaller investors who have prior real estate experience, like business owners and those real estate investors who have operated other, more labor intensive assets.

"Landlords can directly control their real estate investments by negotiating different lease terms with their tenants, refinance, form joint ventures, and add value in different ways," says Jason Greenspan with Landmark Commercial Real Estate Services, based in suburban Detroit. "Stocks and bonds are more passive assets where investors have little control over their capital."

The right mix of a net leased retail asset – where the retailer pays most expenses and handles property management – is perfect for those looking to use the 1031 tax deferred exchange vehicle to trade out

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of labor-heavy assets into more passive investments, while still holding real estate.

The appeal of the sector — and its relatively low entry price point — has created a large market of buyers. And while the market is still tipped to sellers, interest from buyers remains high, despite a changing interest rate environment and retail closures.

"The single-tenant net lease market is still competitive, which brings pricing pressure," says Tom Roberts, chief investment officer of institutional investor VEREIT. "The number of firms [buyers], both private and public, continues to increase which is causing demand to grow. Countering that is the current volatility in interest rates which creates a wider bid-ask spread as buyers and sellers seek price discovery on where cap rates will end up."

Shopping Center Business interviewed more than 20 investment sales professionals and net lease retail owners for this annual round-up on the sector.

Hanley Investment Group completed the sale of a 2,060-square-foot, single-tenant Del Taco with a drive-thru in Perris, California.

SUPPLY

Historically, supply has been added to the sector through new development and re-trading of existing properties. However, new development has slowed as retailers reel in expansion plans, construction costs and land costs rise and interest rates change, making the development of new assets more expensive and complex.

"New development has slowed overall due to tenants pulling back as they reconfigure their business model to account for changes in e-commerce," says Don McMinn, senior vice president, investments, for Marcus & Millichap. "Exceptions to

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this include dollar stores, restaurants and healthcare. Most private investors prefer newer properties with longer term leases."

"Over the past year, construction costs have increased dramatically," adds Greenspan. "This has led to a decrease in new developments as developers are not able to build to their desired yield."

While new development overall was slower, it is still occurring in the single tenant net lease sector. Hanley Investment Group sold an ALDI location in San Jacinto, California, the day the seller turned over the site to the tenant to start construction in 2018 at a 4.26 percent cap rate, three months before construction was complete. The company has sold 21 properties with coffee tenants – Starbucks, Dunkin and Coffee Bean & Tea Leaf – over the past two years. Of those, half were listed for sale before the tenant was open.

"2018 saw a lot of new STNL development, but most of the properties that we are selling today were started 18 to 24 months ago," says Jeff Lefko, vice president of Hanley Investment Group. "We sold more net-leased new development properties in 2018 than in the past two years. The majority of new construction projects are marketed before the property is even finished as a presale. Sellers prefer to market the property on a presale basis to remove as much cap rate risk as possible."

And while new development has slowed, a number of net lease executives see an increase ahead as retailers get plans back on track.

"New development was slightly slower than previous years but appears to be picking up going into 2019," says Ackerman. "Investors are looking for assets with strong fundamentals that can be newly developed properties or older assets. Optimum time to sell an asset is when you've just completed construction or renegotiated an extension as lease term is maximized."

After that, a retailer's historic performance plays into buyers' criteria.

"Depending on the tenant's creditworthiness and remaining lease term, the underlying unit-level performance will be more or less important," says Josiah Byrnes, vice president of Embree Capital Markets Group. "Obviously, a 15-year (or longer) lease with an investment grade-rated tenant gives most individual buyers a comfort level to somewhat ignore unit-level performance, which may not even be available per the lease. Institutional buyers often demand unit-level performance reporting."

On the horizon, many in the sector are seeing new development ahead as retailers finalize expansion plans. This may include new supply, as well as backfilling of existing properties that could then be sold into the STNL market.

"I wouldn't call it an increase in new development; however, we see an increase in landlords repositioning existing tenant spaces to uses that are more service oriented," says Brandon Hanna, managing partner at Encore Real Estate Investment Services. "I believe older assets are more desirable to buyers because they have a proven performance record. The optimum time to sell is with a lease term no shorter than 10 years. Buyers prefer a history of, at least, five years to determine the tenant's viability at the location. Sellers believe that triple net leases with S&P rated BBB+ credit located on prime hard corners, in major infill markets, are the easiest to sell as we are seeing a true flight to quality assets in the market today."

Lease term and location tend to be the biggest factors buyers look for when acquiring new assets.

"New properties are desirable because of their longer lease terms and less required capex," says Scott DeYoung, managing director at Faris Lee Investments. "Older properties are also attractive due to their established tenants and long remaining new lease. With rates projected to increase combined with the decrease of total volume for retail since the peak in Q4 2015, the optimum time to sell is now."

The supply of STNL retail properties has also been boosted by the changing retail market.

"Since the buyer pool for larger retail shopping centers – outside California – in the 5 percent to 6 percent cap rate range has all but disappeared, owners have started to execute breakup strategies to dispose of large shopping centers and create more value," says Lefko. "When a large shopping center is separately parceled and has a majority of the net-operating income (NOI) allocated to the net-leased pads in front of the center, the shopping center is a prime candidate for a breakup strategy where each parcel is sold off as an individual net-leased investment. Typically, each piece is sold to a different buyer."

CBRE's NRP-West team has been especially active in the "parcelization" or break-apart-sale strategies of larger, multi-parcel shopping centers to maximize value for sellers. As pricing and liquidity for some "box" oriented shopping centers purchased as a whole have pulled back, pricing and liquidity for the separate smaller

Landmark Investment Services recently sold this Henry Ford OptimEyes location in Clinton Township, Michigan.

components of these shopping centers, such as pads and inline portions, have not. Particularly, if they are net-leased to nationally or regionally recognized brand name or credit tenants. By marketing the larger shopping center for sale in multiple, smaller pieces, you're positioning the property to appeal to a wider, premium paying buyer pool. In 2018, the team executed the 14-property break-apart sale of Stoneridge Towne Centre in Moreno Valley, California, with multi-tenant and single-tenant portions leased to Chase, Chili's, Chevron, U.S. Bank, Jack in the Box, Taco Bell, and others. Other recent break-apart sales completed by our NRP-West team include Town Center Marketplace in Menifee, California, and Rio Rancho Towne Center in Pomona, California.

Other investment sales brokers have seen break-apart plays in the sector, including department store boxes like Sears and grocery store locations like Albertsons.

Fast food locations remain in demand for net lease owners. Pictured is a Taco Bell owned by VEREIT.

"Their lack of repositioning presents opportunity for STNL developers to acquire assets at an attractive basis compared to ground-up construction, backfill them with new tenants at market rents to then make a profit at exit," says DeYoung.

WHAT'S HOT

Perennially hot in the net lease retail sector are properties with excellent credit tenants on long-term leases in good locations. However, there are new twists in that program as retail changes and STNL buyers adapt their criteria.

"Most net-lease investors prefer at least 10 years of remaining lease term bare minimum with 15-plus years preferred," says John Read, first vice president, CBRE National Retail Partners. "They may be willing to settle for less if there is a below-market rent or upside opportunity with the property but for the passive net-lease investor, longer is better and they are willing to pay for it with lower cap rates."

Single-tenant retail properties leased to national tenants with strong real estate fundamentals in major metropolitan areas are still trading at historically low cap rates, says Lefko. As an example, Hanley Investment Group sold a STNL Starbucks in Los Angeles near the University of Southern California's campus at a 3.82 percent cap rate. The property is located in one of the densest markets in Southern California and benefited from its strategic location on a hard corner signalized intersection. Since the property had strong real estate fundamentals in a dense market, the property commanded a low cap rate and the buyer pool was willing to pay it.

Multi-tenant net lease retail properties are popular with some investors. This Sprint and Mattress One center in Oviedo, Florida, was sold by Calkain Cos. for $3.6 million.

STNL investors are now focused on retailers who provide customer service, and products and services that can't be found online.

"Investors are focused on internet-resistant uses such as food, beverage, and health/medical uses, smaller format properties with a deep replacement tenant pool, the financial strength of the tenant, and the tenant's sales performance at the specific property they are pursuing," says Read. "It's far from bad news for all of retail, and many retailers are continuing to expand with new locations. Where you find new locations, you'll find new leas-

HANLEY INVESTMENT GROUP
REAL ESTATE ADVISORS

Bill Asher
Executive Vice President

Q: Is the rising interest rate environment having any effect on property yields in the single-tenant net-lease sector?

A: The rising interest rate environment has caused buyers to be more cautious in their purchasing decisions, and, in many cases, sale cycles are taking longer than in previous years. However, overall, historical values still remain at an all-time high for well-located, single-tenant, net-lease corporate-guaranteed properties with long-term leases even compared to the top of the market pricing in 2006 to 2007. But, it continues to be vital that assets are priced in accordance with the transitioning market if we're to see transaction velocity increase moving forward.

Single-tenant, net-lease pricing $5 million and under remains the most consistent with the smallest separation between asking and final sale price due to this category having the largest buyer pool and being less reliant on financing. However, the depth of formal offers submitted from this buyer pool has started to shrink. Single-tenant, net-lease assets priced $5 million and higher have seen similar results but are experiencing longer marketing periods to procure a buyer due to sellers' "rearview mirror" pricing expectations, rising interest rates, and the fact that most buyers need financing to transact. Institutional buyers are approximately 30 to 50-plus basis points higher on pricing compared to private investors. The separation between asking and final sales price has widened in this category.

Q: What is your prediction for the single-tenant net-lease retail sector for 2019?

A: We expect that net-leased assets with strong real estate fundamentals, located in primary market locations occupied by internet-resistant tenants with newly minted long-term leases, will continue to see the best pricing and highest demand in 2019. Quick-serve, fast-food and coffee tenants such as Panera Bread, McDonald's, Chick-fil-A, Starbucks, and Dunkin Donuts, will continue to be some of the most active. Those with a drive-thru will be even more desirable due to 60 percent to 70 percent of all business now being generated via the drive-thru window. Also, expect to see significant activity within the grocery, convenience and discount categories with tenants such as ALDI, Grocery Outlet, Smart & Final, 7-Eleven, Ross and TJ Maxx.

Emerging categories like single-tenant learning and daycare leased properties and car washes will also find favor with private investors searching for higher yields. Net-leased daycare and learning centers located in affluent markets, surpass many other single-tenant investments due to the benefits of being service-based, internet resistant with long-term, triple-net leases, and fixed increases. Additionally, given the jump in overall total car wash sales nationwide in 2018, we also expect that the supply of car washes will increase over the next 12 months, especially as car wash operators begin to consider more sale-leasebacks strategies.

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CBRE National Retail Partners - West arranged the sale of a single-tenant Starbucks located in Los Angeles for $5.9 million.

es and, where you find new leases, you'll find net-lease investors interested in purchasing the properties. There is a direct correlation between actively expanding tenants and net-lease properties being sold to investors."

"There are certain tenants – 7-Eleven, Wawa, O'Reilly's, Dunkin' Donuts, Chick-fil-A, and the like – that we are highly comfortable with the exit strategies for and can be very flexible and aggressive," says Karl Francetic, co-founder and partner with Equity Capital Investors, which finances net lease properties. "Other tenants – including lesser known brands and/or tenants in spaces we consider to be oversaturated or less favorable, like certain dollar stores and weaker franchisees, cause us to be more conservative in our approach. Understandably, we strongly prefer necessity-based internet-resistant tenants, landlord-friendly lease terms, strong lease guarantors and properties in strong locations."

Roberts, chief investment officer of institutional owner VEREIT, overviews where he sees growth in the market: "The current economic landscape has facilitated the growth of specific types of retailers. The six F's of retailer growth we see include: fun & entertainment – Topgolf, movie theatres; fitness – LA Fitness, 24 Hour Fitness; frugality – Dollar General, Family Dollar; furniture & home furnishings – At Home, Floor & Décor; fashion Discounters – T.J. Maxx, Burlington; and food – Taco Bell, Bob Evans. As always, premium pricing is attributed to assets with leases that are longer than 10 years and are guaranteed by an investment grade/creditworthy tenant."

One of those areas that is seeing a lot of attention is healthcare. As the healthcare industry changes to have a more retail-centric model, and the retail industry becomes more comfortable with healthcare as a tenant, there has been a trend to bring the properties to market because of the tenants' credit. The category is broadened to include a number of national fitness chains who have strong credit and performance history. CBRE recently sold a newly built LA Fitness in Menifee, California, for $14.6 million at a 6.08 percent cap rate and a DaVita Dialysis in Hesperia, California, with a recent 10-year lease extension for $4.16 million at a 5.43 percent cap rate.

"Sellers always believe they can sell everything at a premium," says Byrnes. "In actuality, what commands a premium with investors are QSRs, convenience stores/gas stations, dialysis clinics, and STNL properties in core MSAs (primary vs. secondary or tertiary)."

The changing climate for retail has put added pressure on the STNL sector to locate properties that fit investor criteria. Many categories that were once industry staples have now disappeared from investors' radar screens. Drugstores, once the mainstay of the industry, have given many investors pause over the past few years. Restaurants, as well, have gone through major shifts in recent times.

"There are almost 30,000 drugstores and there was a lot of uncertainty with the CVS/Aetna merger and the Rite Aid/Walgreens merger," says Maurice Nieman, managing director of Savills Studley. "There was also the move/change in pace from casual dining to QSRs. Big boxes continued to have a lot of bankruptcies in the marketplace. With Sears, Toys "R" Us, and the shifting of taste/distribution, it impacted the sales of a lot of STNL assets."

Aside from some categories, other mainstays in the industry have remained relatively strong sellers.

"Restaurants, discount stores, convenience stores, healthcare and grocery continue to command strong investor interest," says McMinn. "Best of class net-lease assets with strong investment grade tenants on long-term NNN leases in primary markets and locations continue to trade at a premium."

"The single-tenant net-leased properties that are in the highest demand are the well-located properties with 15 to 20 years of lease term remaining with fixed increases either annually or every five years," adds Lefko. "Buyers understand that if they buy an asset with 15 or 20 years of lease term, there is still just as much value in the property in five years if they were to sell it, especially if they have substantial rent increases. STNL properties with 10 years or fewer of term tend to lose their value quicker unless the rents are low."

There are also several up-and-coming property types that are attracting investors as these retail-like entities become more professional and organized in their real estate practices.

"Single-tenant retail leased to service-based tenants saw a huge increase in supply and transaction volume," says Lefko. "The most relevant example right now is the STNL express car wash space. Investors demand for net-leased car washes is unprecedented. Car washes are internet resistant, highly profitable, and can be purchased at a better return than STNL restaurants, drug stores, and other auto-related tenants. Most express car wash leases come with a 20-year absolute triple-net lease and annual increases. The cap rates for car washes have not compressed to the point where they compete with other single-purpose building uses like tire stores such as National Tire and Battery, auto-supply stores like AutoZone, or gas stations and, because of this, car washes have become attractive to the private and institutional investor searching for yield."

Calkain Companies has done a number of deals with auto collision shops over the past year. Other retail-like locations becoming more popular in the net lease sector include day care and learning centers. These newer property types are creating additional supply in the industry as net lease buyers become comfortable with the concepts and the consistency of their business practices.

"The auto collision industry is one that people believe is not going away, and it functions in a good and bad market cycle," says Jon Hipp, CEO of Calkain Cos. "When we explain the story to buyers, everyone likes the model."

Also adding fuel to net lease supply are retail mergers and acquisitions, notes Mike Fitzgerald, senior vice president, retail sale-leasback, at VEREIT. "Some recent transactions include Art Van Furniture and Mr. Car Wash taking existing properties that have been rolled-up in acquisitions and then brought back to the market through sale-leasebacks," he says. "Additionally, the Cabela's merger with Bass Pro Shops created an opportunity to buy their real estate."

With increased construction costs, new build properties in some areas are becoming more difficult to sell, because the projected returns may not match what the investor has traditionally accepted.

"Newer properties with above market rents are a bit more challenging to sell in today's market," says Robert Horvath, executive vice president of Horvath & Tremblay. "Smaller price point deals have more buyers bidding on the asset than larger price point deals with higher rents. We are seeing developers and brokers prematurely taking deals to market prior to completion and rent commencement, creating due diligence and financing issues for buyers.

Aside from single tenant retail, small multi-tenant properties are also still popular with some investors, as long as they are comfortable with the tenants who habit the property.

"Multi-tenant retail offers more opportunities to grow rents," says Matthew Mousavi, managing principal of SRS's National Net Lease Group. "In the right market, where rent growth is occurring, the shorter leases available in strip and multi-tenant retail allows for rent growth during re-tenanting. In the case of net lease retail, rents are often fixed for a very long time with base term, and then multiple options, and rents are often also at the top of the market as a function of the specialized nature of the building and high construction costs."

CAP RATES AND PRICING

As one might expect in a changing interest rate environment, cap rates rose slightly overall in 2018, report most executives.

"Cap rates have increased around 25 basis points, since the beginning of the year and continue to experience upward pressure from interest rate increases and the surplus of competing net lease inventory on the market, primarily from institutional sellers," says Holmes of Marcus & Millichap.

"Pricing is stable, but interest rates are

RECENT RETAIL NET LEASE SALES

Select deals covered on shoppingcenterbusiness.com, October 2018-December 2018.

Date Covered	Property Details	Location	Broker(s)	Buyer	Seller	Sales Price
12/19/18	Walgreens	Houma, LA	Hanley Investment Group Real Estate Advisors	Long Island, New York-based investor	Los Angeles-based private investor	$5.8 Million
12/13/18	LA Fitness	Temecula, CA	Hanley Investment Group Real Estate Advisors, R&L Properties-Cerritos Inc.	Family trust from Los Angeles	Private developer based in Irvine, California	$13 Million
12/10/18	Walmart	Palm Desert, CA	Newmark Knight Frank, Millennium Properties	Undisclosed	Paragon Commercial Group	$13.5 Million
11/27/18	Carrabba's Italian Grill	Woodbridge, IL	The Kase Group, Hanley Investment Group Real Estate Advisors	Private investor based in Dallas	Private developer based in Schaumburg, IL	$2 Million
11/27/18	Chili's Grill & Bar	Arlington Heights, IL	NNN Property, Hanley Investment Group Real Estate Advisors	Private 1031 exchange investor from Southern California	Private developer based in Schaumburg, IL	$1.7 Million
11/27/18	MedExpress Urgent Care	O'Fallon, IL	L3 Corp., Helvetica Group, Hanley Investment Group Real Estate Advisors	Private investor from Southern California	Missouri-based private investor	$1.4 Million
11/9/18	Tutor Time Learning Center	Fontana, CA	Progressive Real Estate Partners, Walton Realty	Los Angeles-based private investor	San Diego County-based private investor	$4.6 Million
10/20/18	Walmart	Teterboro, NJ	Hanley Investment Group Real Estate Advisors	1031 exchange private investor from Dallas	Catellus Development Corp.	$37.5 Million
10/15/18	Giant Eagle	Medina, OH	Institutional Property Advisors	Miami-based private fund	Chicago-based private REIT	$15.1 Million

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pushing cap rates up because the cost of borrowing money is so expensive. There is a big disconnect between buyers and sellers," adds Nieman.

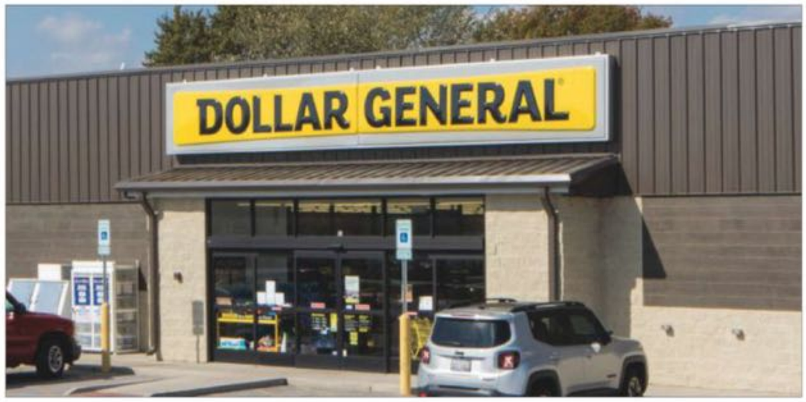
Cap rates are also very dependent on location. Many markets are seeing strong cap rates.

"Certain markets, like Florida and California, are seeing strong cap rates," says Hipp. "Florida is still seeing cap rate compression. It is amazing how certain markets can still trade extremely agressively."

The change in cap rates is changing the moods of some sellers.

"There is some perceived sticker shock after 10 years of compressed cap rates," says Sean O'Shea, principal of The O'Shea Net Lease Advisory at BRC Advisors. "1031 investors have a time-sensitive decision-making timeline; others are 'waiting-in-the-tall-grass' for some cap rate relief. Spreads have been thin for leveraged buyers; that will continue until cap rates adjust over 7 percent to 7.5 percent caps."

A number of executives told us that some property types saw more fluctuation than others with regard to cap rates.



VEREIT sees frugality as one of the trend drivers of the net lease sector. Retailers like Dollar General are included in that category.

"Cap rates are holding steady with strong credit 15-year-plus lease term deals that offer rental increases during the initial term," says Hanna. "The recent drop in the 10-year Treasury rate, which is now below 3 percent, will continue to keep the cap rates for long-term quality assets at record lows. The retail product type such as apparel, furniture, and sporting goods have felt a cap rate increase as a result of amazon and most importantly the fear that the retail segment of our economy is hurting."

"Pricing has moved from its peak levels, particularly for non-primary market assets and larger, more financing sensitive transactions, but not significantly," adds Read. "Very low cap rate transactions are still getting done across the spectrum of asset types and locations. A rising interest rate environment has put the biggest pressure on pricing. Over the past few years, interest rate fluctuations haven't significantly impacted net-lease values but with the 10-year Treasury marching upward above 3 percent this year, most expected that higher interest rates were going to be a fact of life in the near-term future."

For many buyers, the rising cap rates are a good thing, but it causes many to keep an eye on deals as they work their way through to the closing table.

"Cap rates are finally rising as buyers stick to the sidelines for retail real estate investments, financing becomes constrained and interest rates rise," says Ian Harrison of AEI Funds. "It helps to be an all-cash buyer."

Lenders, as well, are in a constant state of adjustment.

"Like everyone else in this space, we keep a close watch on cap and interest rates because we need to keep our finger on the pulse of our developers' ability to sell the developments profitably," says Francetic. "We also closely monitor the spread between the developer's yield-on-cost and projected sale cap rates along with labor and material costs."

A DIVERSE SET OF BUYERS

The buyer pool for single tenant net leased retail properties runs the gamut from private investors to large scale institutional and fund-based investors. In recent years, foreign private investors have also become an active player in the market, often just to park cash in U.S. real estate because returns have been historically more dependable than other investment vehicles.

"The recent volatility in the stock market will result in more capital being deployed into the sector as net lease properties have always served as a flight to safety opportunity for investors," says Will Pike, vice chairman and managing director of CBRE Capital Markets.

Among the buyer types, private buyers accounted for approximately 68 percent of the market, according to DeYoung of Faris Lee Investments.

"Most of the transactions through private buyers and sellers are event driven and typically through a tax deferred 1031 exchange," he adds. "Eighty-six percent of the private buyers are 1031 exchange driven, which essentially comprises 58

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percent of the overall market. For properties sold over $20 million, the percentage of institutional transactions increases from 20 percent to 27 percent."

"Private investors still make up the lion's share of today's buyer market," adds McMinn of Marcus & Millichap. "The primary reasons for this are that private buyers are more competitive with their pricing and are not constrained by geography or returns."

While the buyer mix varies from brokerage to brokerage — many brokers have specialized which buyers and which sellers they work with — the overall consensus among investment sales professionals specializing in single tenant net leased retail properties is that the types of buyers, and the rate at which they invested, did not change much over the past year.

Hanley Investment Group sold this Starbucks near the University of Southern California at a 3.82 percent cap rate.

"Many of the smaller deals on the table are purchased by tax motivated 1031 exchanges and individual buyers who will often pay a premium and focus primarily on the tenant and not the underlying real estate fundamentals. The downside of these buyers is their reliability to close," says Dan Lovitz, senior vice president, single tenant retail, VEREIT.

"The most predominant buyers for net-lease properties are 1031 exchange buyers based in California," says Lefko of Hanley Investment Group. "Across the board in every sector of net-leased retail, whether it was the sale of an auto parts store, bank, dollar store, drug store, or a restaurant, more buyers came from California than any other state. Using the restaurant sector as an example, in 2018, 40 percent of all net-leased restaurant sales — both QSRs and sit-down restaurants — were sold to California buyers, according to CoStar Group data."

Some brokers reported a large influx of private investors, who often transact at higher prices because of the need for a replacement property in a 1031 exchange.

"In 2018, we did not sell even one property to an institutional investor," says Barry Silver, principal of The Silver Group, based in San Rafael, California. "In the past we have been more active with institutional buyers, but the yields being offered for single tenant investments have made institutional owners more active sellers. Institutional investors offer some important features to sellers including surety of closing and flexibility with timing."

"The vast majority — probably in the 70 percent range — of the private capital investors we've sold our net-lease listings to are in 1031 tax-deferred exchanges," says Read at CBRE National Retail Partners. "Many 1031 exchange investors are cross-property-type buyers, selling one type of investment property and purchasing a net-lease property as their replacement or 'upleg' property. Residential property investors who have sold apartments and even single-family home investments have been active buyers on our net-lease listings."

Institutional buyers, like REITs and fund buyers, have remained active in the space. Many REITs have been pruning assets and selectively acquiring properties that fit their investment criteria. Institutional buyers tend to acquire portfolios versus one-off transactions in order to deploy larger tranches of capital in a single transaction. As an example, Agree Realty Corporation recently acquired more than 100 Sherwin-Williams locations in a sale-leaseback transaction, for more than $150 million.

"Institutional level buyers have remained active on a national basis, primarily with larger dollar size one-off purchases and portfolio transactions," says Read. "Their national look gives them the ability to pursue higher-yielding net-lease opportunities throughout the country versus focusing on specific markets where yields might be lower and competition from non-institutional level individual buyers might be greater."

In addition to large acquisitions, a property's criteria – making sure it fits a set checklist of figures – is very important to many institutional buyers.

"Today, more than in the past, having a 'story' to accompany the investment is highly critical," says Harrison at AEI Funds. "We are very interested in 'seasoned' assets, but we will often require the maintenance/repair obligations be addressed as part of the closing, unless we fortunate enough to acquire an absolute net lease."

Foreign capital is also still at play in the sector, and again, as brokers and finance firms have specialized who they work with, many have more foreign clients than others.

CBRE National Retail Partners - West arranged the sale of a newly built single-tenant LA Fitness in Menifee, California.

"Knowing that we fund STNL development across the U.S., a surprising number of foreign investors regularly call us seeking to purchase STNL properties that we provided the capital for," says Karl Francetic, co-founder and partner with Equity Capital Investors. "These buyers are typically high-net-worth investors looking to move money out of their countries, like Brazil, Turkey and China – and into the safe haven of U.S. real estate, which has a strong focus on the safety, security and long-term income stream of net-leased assets."

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The longevity of the STNL retail asset class has served it well at this point, and many brokers say whenever the interest of one buyer pool wanes, the interest of another picks up.

"During the past 30 years focused in the single tenant space, whether we are in a rising or falling interest rate market, there have always been investors seeking predictable cash flow from single tenant investment property," says Silver.

SELLERS

Sellers have the upper hand in the market right now, according to many investment sales executives, but that tide may soon be turning. The rising interest rate environment puts additional pressure on private 1031 buyers seeking replacement properties, in a time when new development is relatively limited. That has given sellers strength. The most active sellers are private entities, who accounted for 58 percent of sales in 2018, according to DeYoung of Faris Lee.

However, additional retail bankruptcies and weaknesses have led a number of owners to doubt their faith in many leases and list properties for sale, which is changing ownership criteria to more internet-resistant properties.

"Respectfully, sellers have had it so good for so long in our post-Great Recession cycle of almost 10 years," says O'Shea. "We think the ninth inning has finally arrived. The spreads, even for unleveraged investors, have provided very modest returns – bond-equivalent returns – so it is imperative to buy quality assets. Separating the NNN wheat from the NNN chaff is mission critical."

Today, sellers fall into three categories, says Silver: "companies doing sale leasebacks; preferred developers; or professional, institutional sellers."

The tide has changed into a buyer's market in 2018, says Hipp of Calkain Cos.

"The beginning of 2018 started out with a lot of momentum," he says. "But once interest rates started to tic up a little bit – and this happens when there becomes a disconnect between the expectations of buyers and sellers – cap rates had to adjust. In the seller's market we had, sellers were used to getting multiple letters of intent to acquire a property. As the market starts to change, you start to get fewer LOIs. When interest rates move, that affects financing costs and the return on financed properties. Even if a buyer is not financing, there are other opportunities out there to buy other properties. Comps that are six months old are no longer valid. There's a disconnect between buyers and sellers, whereas before the buyer felt if they didn't make an offer they were going to lose the property. Now, buyers have the mentality that they may give an offer, but they are going to wait to buy something else if the offer is not accepted."

Because of specific capital motivations, some private capital investors have been the most active sellers of net-leased properties, says Read of CBRE.

"Private capital sellers within the net-lease space consist of developers selling newly built properties with fresh leases, investors who have repositioned existing properties with new leases or lease extensions or held properties longer-term taking advantage of appreciating values, as well as investors who have purchased larger, multi-parcel retail centers and are selling the net-lease portions off to create liquidity at a cap rate premium compared to the cap rate on the larger center," he says.

Other top sellers include owners of properties with flat leases, like drug and dollar stores, says Patrick Luther, managing principal of SRS's National Net Lease Group. "Owners of assets that fit these descriptions are looking at the potential exposure to re-tenanting big boxes, and with flat leases, the erosion of value as interest rates rise," he says. "In some cases, these owners are choosing to sell for losses now, versus the potential to lose more value in the future if their tenant potentially approaches them to downsize, or as rates rise and lease term burns off on flat leases with no rental increases."

While private players are predominant on the buy side as well, many sellers target institutions for top assets that they know fit the specific criteria of this buyer pool. Institutional buyers also have a positive characteristic that many sellers like: they are usually at the closing table when they say they will be. For some sellers, this sense of security trumps a slightly higher sale price.

"Sellers who prefer surety of close and ease of execution will favor an institutional buyer over a private investor," says Lefko. "Sellers who need to squeeze every last dollar out of a property sale will generally favor the private investor."

Capital events, upcoming lease expirations and fear of changing market conditions often cause properties to be sold. Those conditions and events can change from time to time. Presently, STNL property buyers are seeking assets they can hold long term because the stock market has been volatile. That means properties with long lease terms are in favor.

"We have seen numerous professional buyers and owners decide to trade out of some shorter lease term assets into new longer term investments," says Wesley Koontz, vice president and net lease director at Mid-America Real Estate. "Many groups have been buying larger centers and segmenting off outlots for resale at lower cap rates than their purchases, and holding the balance at very attractive yields. Some of the institutions have had changes in their objectives and are selling assets that they bought in previous years, creating good buying opportunities for individuals or other institutions in some cases."

FUTURE CHALLENGES

The changing retail climate is forcing change in the single tenant net lease retail sector, and supply constrains will also force change in the future. Those in the industry say they keep a very close eye on retailers' performance, and how they are generally adapting to changes in the market.

"Certain retailers are struggling to keep up with e-commerce and will undoubtedly close underperforming stores in the future," says Greenspan of Landmark. "Several retailers rolled out too many stores at once, creating internal pressures that will lead to the closure of underperforming stores, and undoubtedly create vacancies within the STNL marketplace."

RECENT RETAIL NET LEASE SALES

Select deals covered on shoppingcenterbusiness.com, July 2018 - October 2018.

Date Covered	Property Details	Location	Broker(s)	Buyer	Seller	Sales Price
10/11/18	Walgreens	Malden, MA	Encore Real Estate Investment Services	Undisclosed	Undisclosed	$5.3 Million
10/3/18	Walmart Neighborhood Market	Chattanooga, TN	Marcus & Millichap, Tobin Properties Inc.	Undisclosed	Fletcher Bright Co.	$3.7 Million
9/20/18	The Home Depot	Jupiter, FL	SRS Real Estate Partners	Home Depot USA	Indiantown Road LLC	$8.1 Million
9/7/18	Publix	Fredericksburg, VA	Calkain Cos.	Publix Super Markets	Silver Cos.	$15.6 Million
8/28/18	Crunch Fitness	Lawrenceville, GA	SRS Real Estate Partners	Public REIT	Local developer	$5.3 Million
8/24/18	Mariano's Fresh Market	Arlington Heights, IL	CBRE	Undisclosed	An affiliate of Inland Private Capital	$25.5 Million
8/24/18	Vacant restaurant	Ontario, CA	Undisclosed	CalBay Development	MGR Real Estate Inc.	$2 Million
8/24/18	Chevy's Fresh Mex	Ontario, CA	CAPRE Brokerage	CalBay Development	Undisclosed	$3.9 Million
8/20/18	Best Buy	Woodland Park, NJ	Encore Real Estate Investment Services	Midwest-based investment fund	California-based investment fund	$12 Million
8/7/18	Advance Auto Parts	Kalamazoo, MI	Encore Real Estate Investment Services	Michigan-based buyer	California-based seller	Undisclosed
7/10/18	Safeway	Phoenix, AZ	Faris Lee Investments	Family trust	CF Albert Propco	$9.8 Million
7/6/18	Smart & Final	Highland, CA	CBRE	Los Angeles-based private buyer	Smart & Final	$9.5 Million

Break-apart, or parcelizing shopping centers into net lease deals has become more popular in the sector. CBRE's NRP-West team executed the 14-property break-apart sale of Stoneridge Town Centre in Moreno Valley, California, with single-tenant and multi-tenant transactions.

"Though the supply of new product is strong right now, there could be a slow-down of future new development," says Lefko. "Construction costs and land costs are at an all-time high, rents seem to be hitting their maximum, and interest rates are starting to tic up, which make it very difficult for developers to pencil new development."

Many in the sector are looking ahead and taking a close look at the business practices of retailers, especially how they are future-proofing themselves against online competitors and adapting to generational shifts in shopping habits.

"There will be a separation between companies who embrace omni-channel and the ones are who are not adapting," says Nieman. "For example, grocery stores are changing. There is going to be a much smaller footprint with brick-and-mortar stores and that's because of online shopping. You have a strong group of an aging population of baby boomers that are retiring. Soon, we will have as many people retiring that are currently in the workforce."

NET LEASE

Properties tenanted by medical retail users have also become popular net lease investments. Pictured is a DaVita Dialysis location in Hesperia, California, recently sold by CBRE for $4.16 million, representing a 5.43 percent cap rate.

"One of the key disruptors in today's retail environment is the rise of e-commerce," says Paul McDowell, chief operating officer of VEREIT. "Single-tenant retail is often concentrated in off-price, necessity- or service-oriented categories, which can be more internet-resistant compared with other types of retail. Additionally, the long-term nature of the leases in traditional sale leasebacks dictate the functionality of the building and location for the retail tenant, which is also applicable to single-tenant office and industrial property types."

Fallout among retailers is another worry. After the bankruptcies of Toys "R" Us and the office boxes, there is additional worry that future bankruptcies could cause another glut of stores to hit the market, which can't readily be absorbed.

"Aside from rising interest rates, changes at the tenant level could present challenges to the net-lease sector," says Read. "The changes would include continued turmoil within certain segments of retail, particularly more box oriented retailers. There is more risk perceived with these types of properties given the store closures and bankruptcies over the past few years. For taking on more risk, investors want more return and with more return comes lower pricing. Investors will also factor in the downside risk and associated costs and timing to re-tenant the property should the existing tenant vacate."

The rising interest rate environment is already presenting a challenge to some brokers.

"The biggest challenge is how to execute on existing deal flow with a rising rate environment," says DeYoung. "Our focus is on 1031 exchange event driven buyers more than ever as they have a timing constraint on when they have to purchase real estate. Rising construction costs and a substantial amount of vacancy has reduced the amount of new construction."

While many of the issues present in retail real estate today seem ominous, there is a lot to be positive about. New development appears to be on the rise for 2019, report many brokers, and the present economic and political climate is perceived as development friendly.

"In 2019, we expect to see an increase in the supply of properties and the number of transactions as a result of both sellers and buyers attempting to consummate deals before additional interest rate increases and changes in the political environment," says Ed Hanley, president of Hanley Investment Group.

The much talked-about Federal Opportunity Zone Program is another bright spot for many developers of net lease properties, but some caution against rushing into questionable locations.

"Opportunity Zones seem to have become the real estate topic du jour," says Byrnes. "While incremental tax benefits are always welcome, we are starting to see investors letting the tax 'tail' wag the investment 'dog' – chasing fundamentally questionable deals solely because of the tax benefit."

THE SECTOR AHEAD

Despite the challenges ahead, many see positives in the sector because of its renowned stability.

"STNL remains a consistently attractive investment option in an ever-changing economic environment," says McMinn. "Whether it's the volatility in the stock market or the bond market, net lease is viewed as a flight to safety. This is due to the ease of management, long-term leases, steady cash flow, low risk and tax benefits."

With an unpredictable stock market, many investment executives predict that investors will continue to turn to net lease properties to balance their overall portfolios in 2019 and beyond.

"Build-to-suits are becoming increasingly popular and are expected to be a large portion of transactions in the coming year," says Lovitz with VEREIT. "Successful retailers will continue to expand and the focus on omnichannel retail will grow. Additionally, retailers will shift focus to new avenues for the last-mile of delivery and use space that was previously filled by traditional retailers for warehouse and shipping needs." **SCB**