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Exclusive research shows that investors expect cap rates on net lease assets to remain stable even amid rising interest rates.

By Beth Mattson-Teig

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The net lease investment sector is continuing to ride a wave of strong liquidity that is fueling robust transaction volume and steady cap rates and that momentum is likely to stay the course in the coming year, according to *NREI*'s latest exclusive research into the sector.

Despite an uptick in interest rates over the past year and a strong view that the commercial real estate market cycle is at its peak, a majority of respondents still see healthy flows of capital targeting net lease assets. Nearly two-thirds of respondents rated the availability of both equity and debt as the same or better than it was 12 months ago. That liquidity is supporting an active buying market. According to Real Capital Analytics, single tenant property sales (including office, industrial and retail properties) rose 11.4 percent in 2018 to $65.4 billion.

Traditionally, buyers have gravitated to net lease properties for the steady income, credit quality and low management responsibilities. That stability

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is even more attractive to investors who are shifting to more late cycle "defensive" investing strategies. "Most people think we are in the late stage of the cycle, but the cycle also could last for a while," says Randy Blankstein, president of the Boulder Group. "It wouldn't surprise us to see things similar to 2018 play out in 2019."

Demand for net lease appears strong across the board from public and private institutions, REITs and funds to individual investors, including an active pool of 1031 buyers looking for assets to satisfy requirements on a tax deferred exchange. "There remains a voracious appetite among investors for net lease, specifically retail net lease, which is where we play," says Josh Lewis, senior vice president of acquisitions at National Retail Properties Inc. Since 2011, the REIT has been acquiring between $625 million and $850 million in net lease assets annually, as well as funding between $100 million and $150 million in new development through its developer financing program.

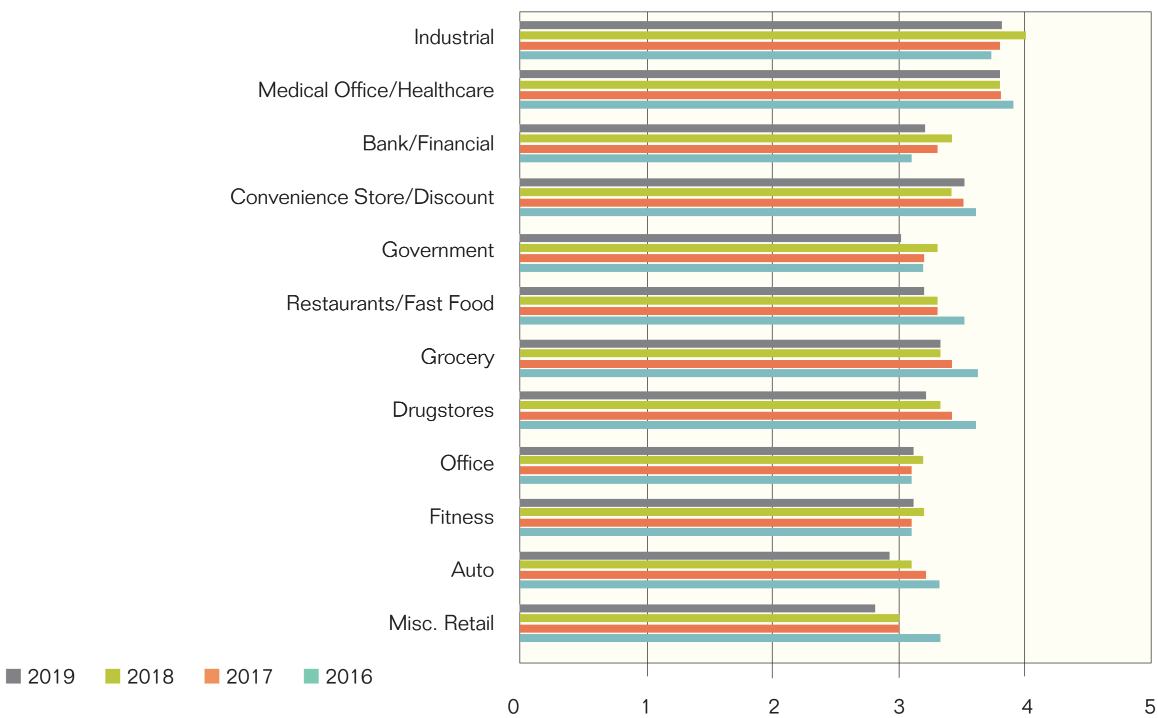
Competition has kept pressure on cap rates and pricing. In fact, respondent views on current cap rates for net lease properties remain unchanged, with estimates averaging 6.1 percent that are the same level as in both the 2018 and 2017 surveys, and only 10 basis points higher than the 6.0 estimate in 2016. There hasn't been a material shift in cap rates, agrees Mark West, senior managing direct and head of the net lease practice at HFF in Dallas. "If there is movement in cap rates in the net lease space, it probably has more to do with the credit of the tenant than it has to do with the real estate," he says.

Third-party industry research supports *NREI*'s survey findings. According to Real Capital Analytics, cap rates for single tenant properties edged slightly lower by 10 basis points in 2018 to average 6.2 percent. Although a majority of respondents (59 percent) do expect cap rates to increase over the next 12 months, that percentage has edged lower over the past two years compared to a high of 69 percent in 2017 and 63 percent in 2018 who predicted that cap rates would move higher.

Weathering rising interest rates

The 10-year Treasury hit a cyclical high of 3.24 percent in November, then dropped back more than 50 basis points to hover at about 2.7 percent in February. The Fed has also indicated that it might slow the pace of its rate hikes in 2019. "I think there is going to be volatility over the next year and it's difficult to say exactly where rates will go," says Christopher Marks, senior

Figure 1: Respondents rated industrial and medical office at the top of the list in terms of assessing the outlook for each net lease propert type.



vice president, originations, Marcus & Millichap Capital Corp. That said, it's probably safe to expect that interest rates will remain in a fairly narrow range, moving 20 to 25 basis points up or down, for the next year, he adds.

Generally, cap rates tend to move in concert with rising interest rates due to the higher cost of capital. However, that hasn't materialized yet in the net lease sector. Cap rates have held steady even as both the two-year and 10-year Treasuries have increased by about 50 basis points over the past two years. Respondents are split on their views on how the risk premium (such as the spread between the 10-year and cap rates) will move in the coming year. Overall, 45 percent believe it will remain the same, while a nearly equal amount (43 percent) expect the spread to increase and 13 percent predict a decrease.

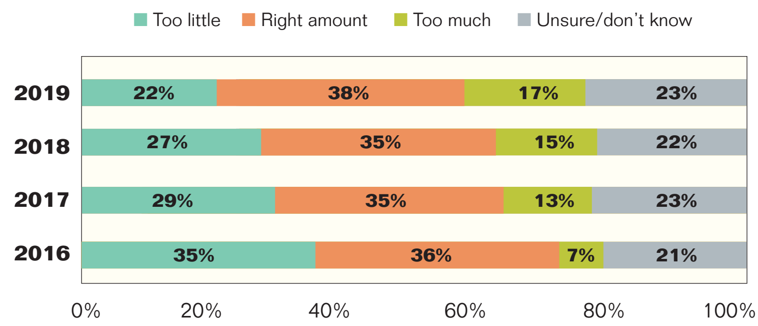
"If interest rates were to move meaningfully, I think cap rates would move, perhaps not lock step, but they will follow," says Lewis. However, even if cap rates do move higher, it might not have a negative impact on buyer demand for net lease assets, he adds.

Buyers find ample supply

Anecdotally, some investors continue to voice frustrations about stiff competition to acquire assets. However, respondent views on the available supply of net lease properties on the for-sale market remain consistent with prior years. In all, 35 percent said current inventory reflects the right amount, while 22 percent believe it is too little and 17 percent think too much. An additional 26 percent were unsure of the answer. Putting that sentiment in context with the increase in transaction volume certainly suggests that investors are still finding good buying opportunities.

"The environment for sale-leasebacks is very good. We are seeing lots of deal flow, both in the U.S. and in Europe, and we think that should continue," says Gino Sabatini, head of investments and managing director at W. P. Carey Inc. Part of that steady pipeline of inventory stems from CFOs and CEOs who understand the value of unlocking capital tied up in real estate and putting it to higher and better use within their business, he adds.

Figure 2: Respondents continue to indicate that the supply of net lease properties for investment is in balance with demand.



Another source fueling supply for institutional investors is an active M&A market. "Many of the private equity firms that we work with have record amounts of dry powder and they are very aggressively pursuing middle market companies," says Sabatini. W.P. Carey provides capital for sale-leasebacks both on the front end of M&A deals with acquisition financing, as well as on the back end once a purchase is complete and companies want to pull money out of the real estate and reinvest in business operations.

According to the Boulder Group, the supply of net lease properties available for sale rose 7 percent in the fourth quarter. However, inventory was heavily skewed to retail properties, which also make up a bigger percentage of the overall net lease market. (The Boulder Group noted 4,766 retail properties on the for-sale market in the fourth quarter.) The inventory of office and industrial properties declined by 6.5 percent and 6.0 percent respectively. One of the challenges with that supply is that owners are taking advantage of low cap rates and selling off lower quality assets, notes Blankstein. Generally, there has not been an increase in new development. So, the new supply is generally coming from older, legacy properties with shorter term leases, he says.

Survey respondents reported mixed views on the current level of development of net lease properties in their respective regions. In all, 38 percent believe that the current level is the right amount, while 22 percent said too little and 17 percent think it is too much. An additional 23 percent were unsure of the answer.

Investors favor healthcare, industrial

Industrial and medical office/healthcare are the two sectors that respondents believe are in greatest demand at 44 percent and 42 percent respectively, while restaurants/fast food rated a distant third at 31 percent. That correlates with opinions on which sectors have the most positive outlook in the coming 12 months. On a scale of 1 to 5 with 5 being the highest, respondents rated industrial and medical office/healthcare as the highest, each with a mean score of 3.8, followed by convenience/discount stores at 3.5.

Industrial properties are in broad demand among commercial real estate investors due to growth in e-commerce and the same is true in the net lease sector. However, respondents also rated sectors in a fairly tight range from a high of 3.8 to a low of 2.8, which suggests only a slightly negative view for some sectors. The only sectors that rated below 3 were miscellaneous retail at 2.8 and auto at 2.9. Sentiment in both of those sectors has eroded from a higher score of 3.3 in the 2016 survey.

"Obviously, there are some big-box retailers that are struggling and those with weaker credit are more difficult to sell and finance," says Marks. "But overall, the market is fairly fluid. I would say that there is more demand than there is inventory for really good deals in the net lease space." Especially for 1031 exchange buyers who need to identify replacement assets within a certain window, it is a challenge to find good assets to buy, he adds. Despite news of store closures and bankruptcies, buyers still have an appetite for retail. However, many investors are gravitating towards Internet-resistant and needs-based retail such as grocery-anchored retail, auto service and food.

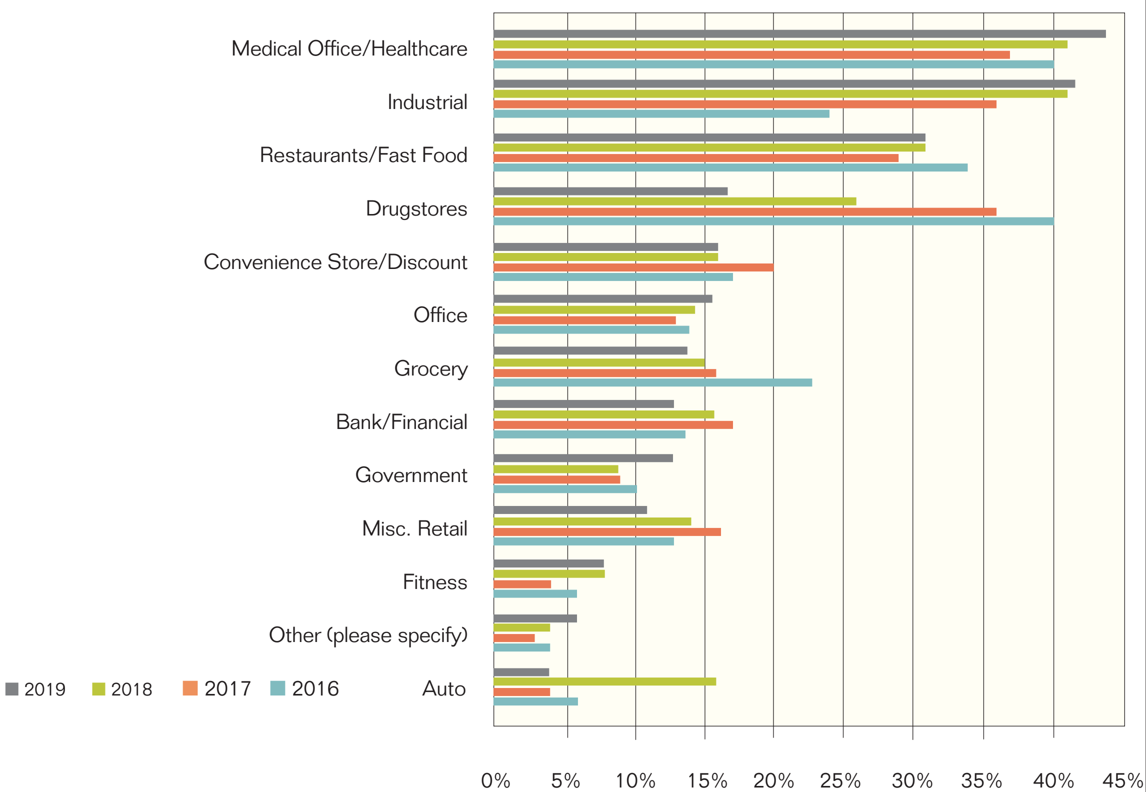
"In the U.S., retail has had a lot of headwinds recently and we tend to share that view, while in Europe we are a much stronger believer in retail," says Sabatini. W.P. Carey focuses on "mission critical" real estate for companies. For example, late last year the company completed the $41 million acquisition of a 550,000-sq.-ft. distribution facility in Kilgore, Texas leased to Orgill, a leading independent hardware distributor.

In October, W.P. Carey completed a $5.9 billion merger with one of its managed funds, Corporate Property Associates 17, which provided a number of benefits, including lowering its cost of capital and allowing the firm to do larger transactions. "As a result, our appetite for new acquisitions has grown even larger," says Sabatini.

Lenders compete for deals

There continues to be a strong pipeline of both equity and debt flowing to the net lease sector. On the equity side, 42 percent of respondents see the availability of equity as unchanged compared to 12 months ago, while 20 percent said it had increased and 18 percent think it is less available. Views on debt were comparable, with only 17 percent who consider debt to be less available than 12 months ago, compared to 49 percent who see access to debt as unchanged and 16 percent who think it is more widely available. (Nearly 20 percent of respondents were unsure of the answer.)

Figure 3: Medical offices and industrial real estate are the two property types most in demand from net lease investors in today's market. The desire for drugstores, meanwhile, continues to erode.

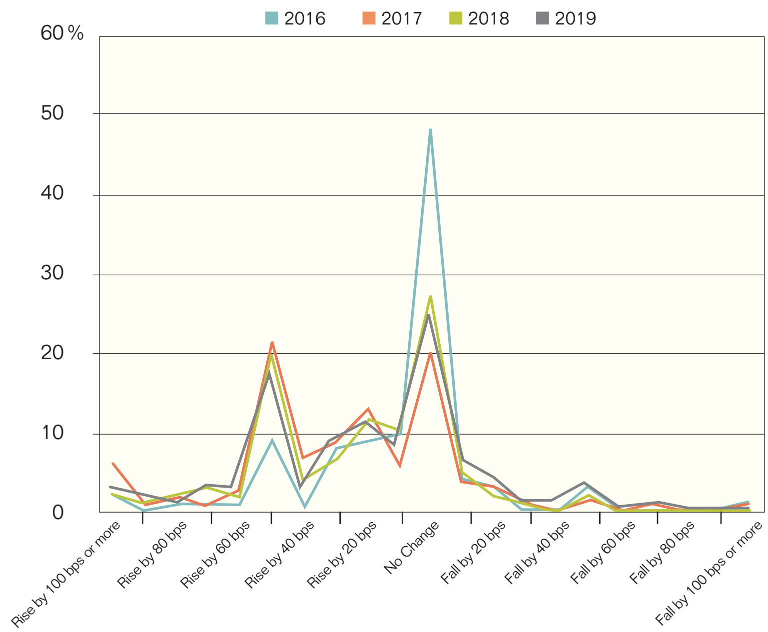


Marcus & Millichap Capital continues to see healthy lender appetite for net lease assets among local, regional and national banks. "We're building significant competition on any transaction that has decent credit with good lease term and good real estate," says Richard Katzenstein, senior vice president and national director at the firm. It is a different ball game in lining up financing for REITs, because they usually involve much larger assets or portfolios, but there is still significant interest for those bigger deals as well.

Banks are willing to provide construction financing, typically up to 65 to 75 percent loan-to-cost. In some cases, borrowers can push leverage higher with financing from debt funds. However, that capital is also more costly. "As long as you have a good site with a firm lease, there are plenty of people willing to finance it," says Katzenstein.

More than half of respondents believe that LTVs and debt service coverage ratios are likely to remain the same over the next 12 months at 60 percent and 61 percent respectively. Specific to LTVs, 20 percent think ratios could increase, and an equal amount predict a decline. More respondents (28 percent) anticipate an increase in debt service coverage ratios as compared to 11 percent who expect a decline.

Figure 4: A majority of respondents say that cap rates on net lease properties will increase in the next 12 months.



Surveying the coming landscape

Compared to the past three years, the 2019 survey results continue to show a consistent pattern of views on key aspects of the net lease investment market as it relates to financing, cap rates, supply and favored property types. Anecdotally, 2019 survey respondents also reported a variety of changes in the net lease sector compared to 12 months ago, including cracks emerging in the U.S. economy, greater sophistication in net lease properties related to tenant credit and a pricing gap between buyers and sellers. "Buyers aren't as confident. They ask more questions. They want more and offer less, and they re-trade after the contract has been signed," wrote one respondent.

Respondents also voiced a number of concerns for the market in the coming year, ranging from the economy and Fed policy on interest rates to oversaturation in the fast-food sector and additional retail store closures. One respondent noted apprehension about the expansion of the "Amazon effect" into other property types, such as drug stores. Another respondent wrote that the biggest concern in the coming year is likely to be the lack of knowledge of accounting changes and the impact on net lease real estate. "It will be cheaper for a corporation to use a finance lease and own the property at the end of lease term. This will be heartburn for developers and investors."

Because of the lack of new construction and higher construction costs, there could be some buying opportunities among some older vintage properties that might have shorter remaining lease terms and below market rents, says Blankstein. "I know people that own some 20- to 30-year-old Kmarts that are looking at rents that could go up 300 to 400 percent if they get the stores back," he says.

That fine line between challenge and opportunity speaks to the importance of evaluating the underlying real estate when making decisions to buy—or sell—net lease assets in the coming year.

Survey methodology:

The NREI research report on the net lease sector was completed via online surveys distributed to readers of NREI in January. The survey yielded 419 responses. Survey respondents are active across different property types with the biggest percentage who are involved in retail at 59 percent, office at 58 percent, multifamily at 57 percent and industrial at 48 percent. Nearly half (46 percent) are actively involved in the net lease sector as investors, developers or lenders.