# NATIONAL REPORT

Marcus & Millichap

NET-LEASED RETAIL

SUMMER 2019

## Thriving Single-Tenant Sector Offers Stability and Yield Alternatives; Tax Clarification Prompts Investors to Use Long-Term Vision

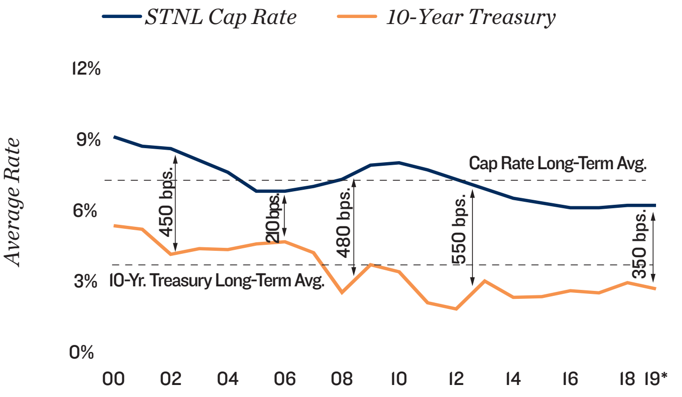
**Investment blueprints modeled around new tax provision.** Recent clarification on the 20 percent pass-through deduction that was introduced with the Tax Cuts and Jobs Act is impacting investment strategies. While the low maintenance needs of single-tenant retail assets has long been a benefit, the pass-through deduction requires active management so these properties may not qualify for this provision. Some investors are taking a shorter-term decision-making approach to this, opting for different property types if their current business practices don't meet the new criteria. Conversely, others continue to favor the long-term stability of single-tenant retail. Taking a big-picture approach will be crucial for investors as they re-evaluate strategies and analyze potential outcomes.

**Property dynamics shift but end result remains the same.** The hands-off nature of single-tenant assets can be limited for investors seeking qualification of the 20 percent pass-through deduction. For tax years ending prior to Dec. 31, 2023, at least 250 hours of rental services must be performed on the property each year, including tasks that maintain or enhance the asset. While this can be difficult for investors to achieve under net-leased terms, the bond-like quality of these properties remains the same even if the qualification is out of reach. Owners still receive a steady cash flow from these corporate-backed assets, producing returns that can be more stable than those of other property types. Through accelerated depreciation using cost segregation analysis, yields for single-tenant assets can be boosted in the early years of the investment, paving the way for stronger long-term returns.

**Sustainability of sector overshadows relatively compressed cap rates.** Retailers occupying single-tenant space have outperformed over the past few years, driving consumer spending and reinforcing stability in the sector. Bars and restaurants, pharmacies and home improvement retailers continue to perform well even with the retail industry rapidly transforming. These assets' relative insulation to outside noise can outweigh the risk associated with other sectors of commercial real estate despite initial yields that may be lower than management-intensive options. Buyers ineligible for the 20 percent pass-through deduction must look at the long-term benefits in terms of credit-backed passive yield versus value-add real estate opportunities. Although other commercial property types may come with a modest yield premium, their management requirements produce operational risk.

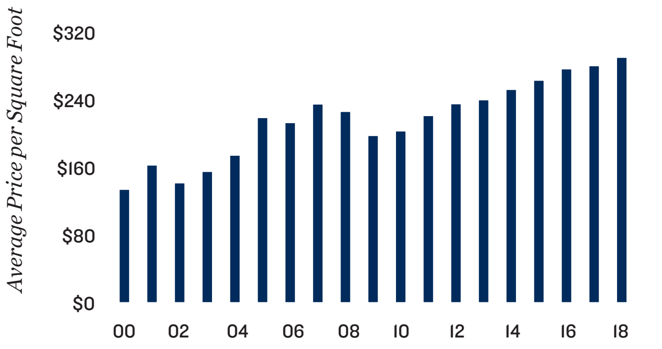
**Flourishing single-tenant retailers growing at strong clip.** Many retailers in the single-tenant sector continue to expand despite the recent wave of store closures. Gyms are swiftly broadening their footprints as memberships continue to rise. Planet Fitness recently announced it will open 225 locations in 2019, while Blink Fitness remains intent on introducing roughly 200 more gyms over the next four years. The fast casual restaurant segment is also aggressively growing, with Blaze Pizza and Shake Shack leading the way. While some aspects of the retail sector hold uncertainty, many single-tenant-oriented retailers are thriving, producing viable investments able to withstand different economic climates.

### Single-Tenant Cap Rate Trends

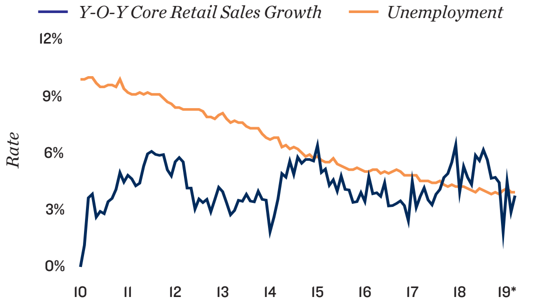


* Through March

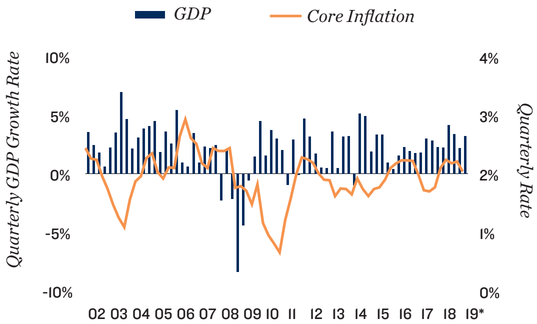
### Pricing Sits on Steady Incline Amid Prolonged Cycle



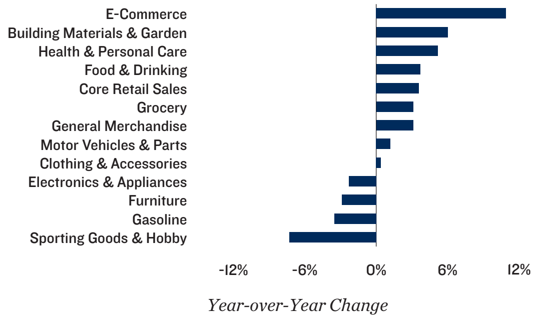
## Tight Job Market Keeps Consumption Stable



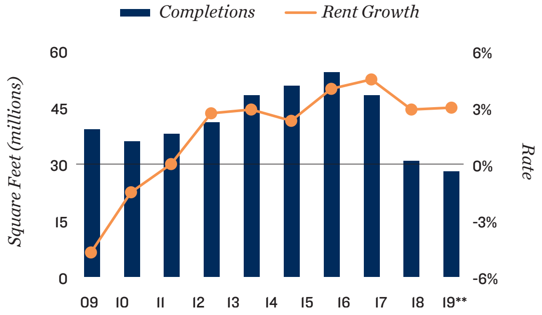
## Inflation Softens While GDP Climbs Back Up



## Retail Sales Growth*



## Limited Supply Growth Keeps Rents Steady



* Through March ** Forecast

## Economy Posts Solid Start to Year; Moderating Interest Rates Reignites Single-Tenant Demand

**Domestic growth back on track but obstacles still on horizon.** Economic momentum picked back up to start the year as GDP growth registered 3.2 percent in the first quarter. Tight labor markets nationally and strengthening wages are driving this metric near levels witnessed in mid-2018. Core retail sales have also logged resurgent growth, settling in the mid-3 percent range on an annual basis. While the national economy appears to have regained some stability, implications from trade tensions as well as slowing international economies could moderate GDP growth in the coming months, lowering it into the low-2 percent range for the year.

**Investor demand picks back up amid falling interest rates.** Declining interest rates should help buoy demand for single-tenant properties after some investors stepped to the sidelines late last year. More stability surrounding interest rates has boosted investor confidence in addition to modestly easing the buyer-seller expectation gap. Cap rates rose 10 basis points to 6.1 percent on a yearly basis ending in March largely due to the short phase of climbing interest rates in which buyers and sellers were out of sync. Overall demand for single-tenant assets should remain steady moving forward given the large number of buyers seeking more stable investment options. Tenants offering experiences such as restaurants, entertainment retailers and fitness centers may be in particular demand as they are capable of providing customers with an experiential setting unable to be mirrored by the internet.

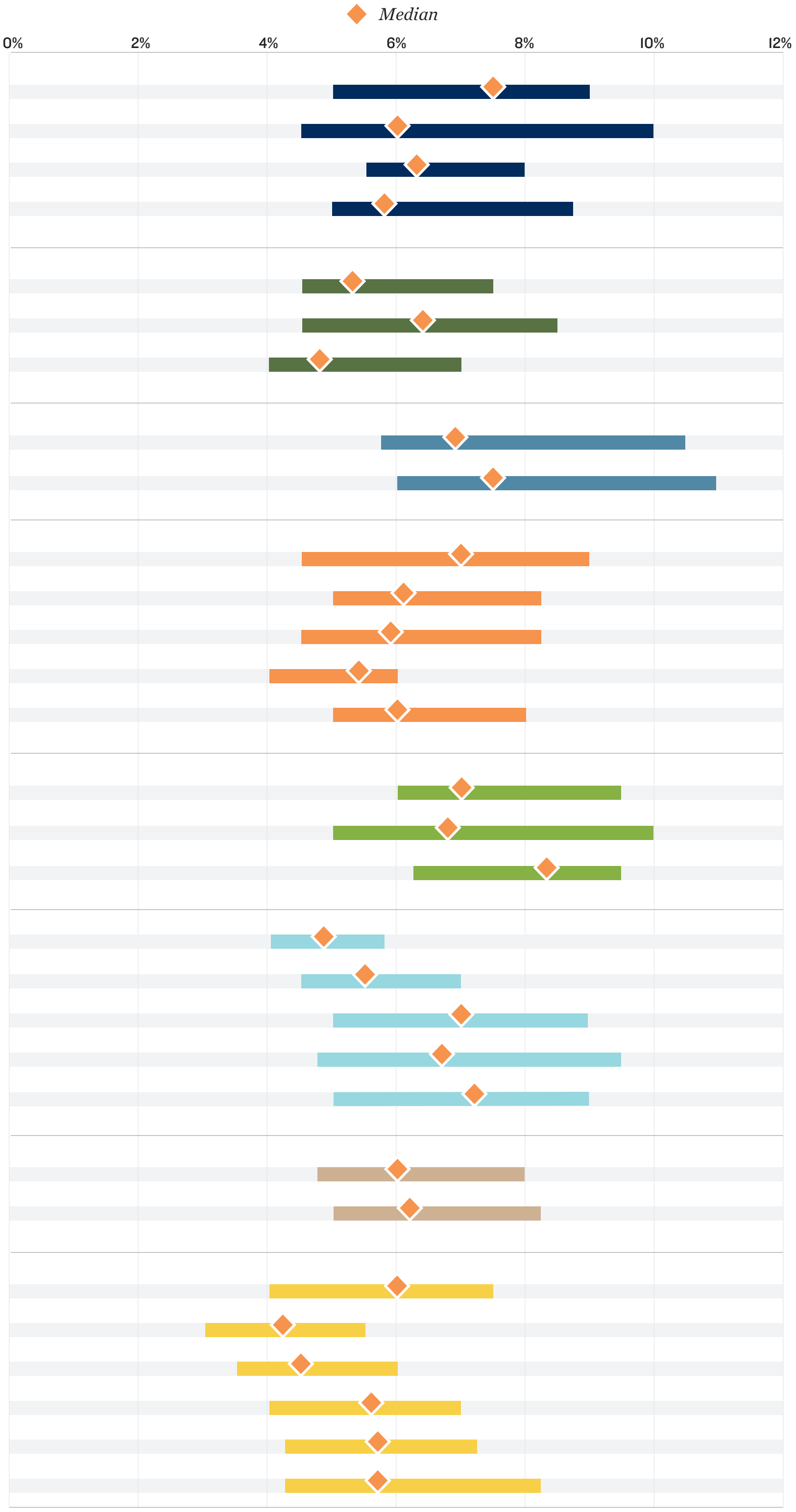
## Retailers Focus on Remodels as Consumers Evolve

**Tempered construction paving the way for steady rental growth.** The single-tenant pipeline will further contract this year as retail construction again stays limited. In 2018, single-tenant development tallied just 31 million square feet, roughly 60 percent of total retail construction — much lower than the previous 10-year average share of almost 80 percent. This trend continued in the first quarter of 2019 as multi-tenant development reached 4.7 million square feet, nearly matching its single-tenant counterpart. Sparse construction should allow rents to advance steadily this year as retailers vie for the limited remaining space. Rents should progress at a pace similar to 2018, driving the average asking rate more than $2 above last cycle's high of $19.78 per square foot.

**Retailers making changes to account for modern consumers.** With development costs rising, many retailers are focusing on reinventing layouts in response to evolving consumer trends. For pharmacies, this includes adding primary care clinics and dental services, as well as incorporating more grocery items. Dollar stores are also including grocery sections at some locations, creating competitors to local grocery stores in many financially struggling and rural areas. Other dollar store locations are implementing a convenience-oriented design, with the goal of broadening their customer base. These changes continue to improve the sector while at the same time boosting property performance for many investors.

| Brand | Locations* |
|---|---|
| **Auto Parts** | |
| Advance Auto Parts | 4,348 |
| AutoZone | 5,633 |
| Caliber Collision | 650 |
| O'Reilly Auto Parts | 5,239 |
| **Convenience Stores** | |
| 7-Eleven | 8,415 |
| Circle K | 5,756 |
| Wawa | 833 |
| **Dollar Stores** | |
| Dollar General | 15,184 |
| Dollar Tree/Family Dollar | 15,309 |
| **Fast Casual Restaurants** | |
| Applebee's | 1,717 |
| Bloomin' Brands | 1,234 |
| Chili's | 1,238 |
| Darden Restaurants | 1,788 |
| Red Lobster | 705 |
| **Fitness Centers** | |
| 24 Hour Fitness | 437 |
| LA Fitness | 709 |
| Planet Fitness | 1,610 |
| **Grocery & General Retail** | |
| Aldi | 1,865 |
| Safeway | 1,093 |
| Sherwin-Williams | 4,620 |
| Verizon Wireless | 2,330 |
| Walmart | 9,785 |
| **Pharmacies** | |
| CVS | 9,865 |
| Walgreens | 7,578 |
| **Quick Service Restaurants** | |
| Burger King | 7,515 |
| Chick-fil-A | 2,350 |
| McDonald's | 15,380 |
| Starbucks | 16,217 |
| Wendy's | 6,209 |
| Yum! Brands | 18,595 |

## Closed STNL Cap Rate Range by Brand**



*Cap rates shown above are representative of transactions that closed in 2018. Actual yields will vary by locations, tenant, lease terms and other considerations. Locations sourced from Creditntell for public companies and company websites for private companies.*

** U.S. and Canadian locations*
*** For transactions closed in 2018*
*Sources: Marcus & Millichap MNET; CoStar Group, Inc.; Creditntell; company sources*

# Capital Markets

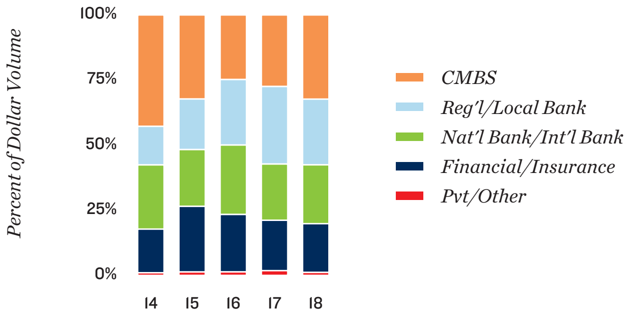
By David G. Shillington, President, Marcus & Millichap Capital Corporation

## Patient Fed Eyes Slowing International Economies;
## Underwriters Stick to Moderate Path as Retail Sector Evolves

**International pressures weigh on domestic outlook; Fed takes cautious approach.** Amid ongoing trade disputes between the U.S. and China and slowing growth throughout the European economy, the global economic outlook has begun to wane. Financial market volatility, combined with elevated caution, has sponsored a flight to the safety of Treasurys, pushing the 10-year yield below 2.5 percent. As a result, the Fed has decided to cease reducing its balance sheet through quantitative tightening by September and weakened the potential for rate hikes through the remainder of the year. The bond market has priced in a more moderate Fed policy, with declining interest rates reflecting increased caution. Fed officials will likely focus on the intersection of a global economic slowdown and resurgent domestic growth to spell out their plans moving forward.

**Underwriting landscape remains relatively optimistic despite conservative practices.** Volatility in the broader market has begun to seep into the underwriting environment, with lenders more cautious and conservative than previous years. Active lenders include local, regional and national banks and credit unions as well as insurance companies, which often provide some of the most competitive rates. Financing for tertiary assets remains tight, while net-leased properties, well-located shopping centers and urban mixed-use structures in primary and secondary markets are highly desired by lenders. This has created a varying market structure, with loan-to-value (LTV) ratios in the 55 to 70 percent range, highly dependent on borrower, asset and location factors. Mezzanine and bridge loan structures have been more frequently used in this environment, with owners undertaking capital improvements at higher leverage ratios using short-term debt before refinancing upon completion.

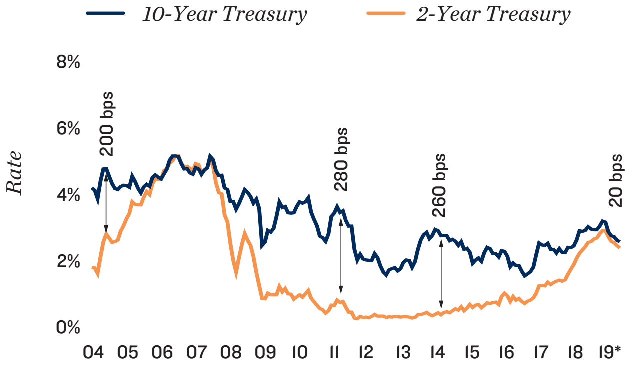
### Retail Mortgage Originations By Lender



** Trailing 12 months through 1Q19*

*Include sales $2.5 million and greater*

### 10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



** Through April 30, 2019*

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*Price: $250*

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