NATIONAL REPORT

Marcus & Millichap

NET-LEASE RETAIL

2H19

Single-Tenant Investments Continue to Deliver Stability; Retailers Tame Expansion Plans as They Monitor Economic Outlook

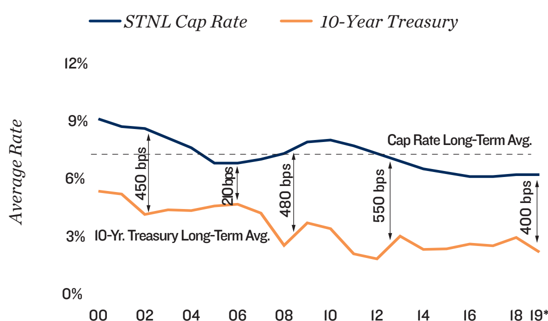
Yield spreads benefiting from economic headwinds. The stability of single-tenant net-lease retail continues to attract investors, with an increasing number of buyers coming from other property types. The 1031-exchange remains a common gateway to the sector as roughly 44 percent of STNL buyers in the past four quarters utilized the tax-deferred exchange. Apartment and retail investors have popularized this acquisition strategy as they seek assets with less downside risk amid increased economic uncertainty and concerns of cycle maturity. Falling interest rates and decreasing Treasurys have provided additional boosts to the sector's appeal, breathing more life into potential deals that had lost vigor just a few months ago. Investors can now capture higher leveraged returns as the yield spread between the average STNL cap rate and 10-year Treasury widened to 400 basis points at the end of the second quarter.

Single-tenant sector proving itself amid volatility in broader market. Recent financial market turbulence reiterates the stability of STNL retail. While this has the potential to attract additional capital to the sector, it also provides current commercial real estate investors an opportunity to reevaluate existing portfolios. With the economic outlook moderating, investors may consider more defensive asset allocations that favor STNL retail assets with a strong credit backing and favorable lease terms. These bondlike assets could provide owners increased security in weaker economic conditions, maintaining steady portfolio performance. Though a resolution to the trade war in the short term may alter the financial metrics, analyzing current portfolios will still prove beneficial as the current cycle extends.

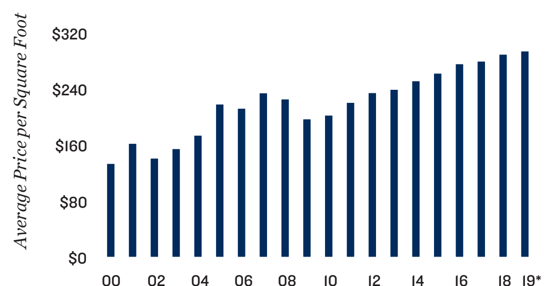
Premium placed on stability in mature cycle. Transaction velocity remained steady over the past year as available assets were ample and the buyer/seller expectation gap further stabilized. Investor interest across all market types was consistent, but bidding climates varied among asset classes. With economic momentum softening, many investors put a heavier emphasis on acquiring the highest-quality properties in some of the best metros to help mitigate risk. As a result, price appreciation among Class A assets soared 15 percent over the past year, while Class B/C properties logged just 2 percent growth. During that time, the national average cap rate remained at 6.1 percent as buyer composition counterbalanced the discrepancy in price appreciation.

Retailers explore ways to boost sales. Retail sales growth has been relatively strong in recent months, sitting in the high-3 to low-4 percent range for the majority of 2019, with single-tenant-oriented retailers remaining primary drivers of consumption. Rising levels of discretionary income have led to consumers spending more on dining options than at grocery stores. This has increased spending at bars and restaurants by 4 to 5 percent over the past several months on an annual basis. General merchandise retailers like Target and Walmart are also witnessing sound growth, particularly as they expand their omnichannel capabilities to capture a larger audience. Pharmacies are implementing similar strategies, in addition to broadening product selections to boost front-store sales. While spending at these vendors remains strong, other types of retailers have witnessed sales growth taper in conjunction with the economic outlook.

Single-Tenant Cap Rate Trends

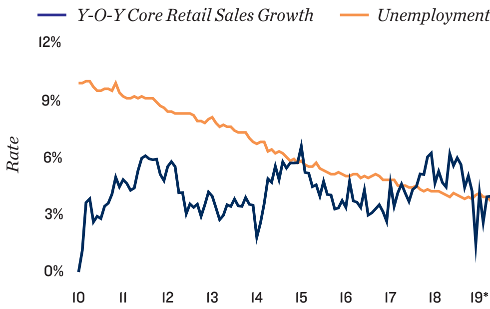


STNL Retail Pricing Continues to Climb

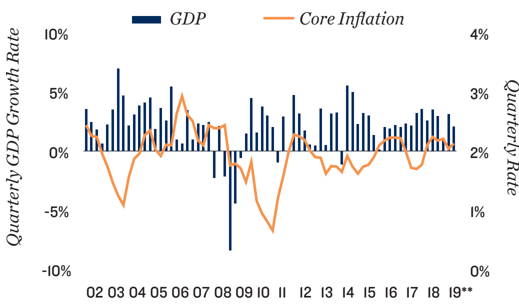


* Through 2Q

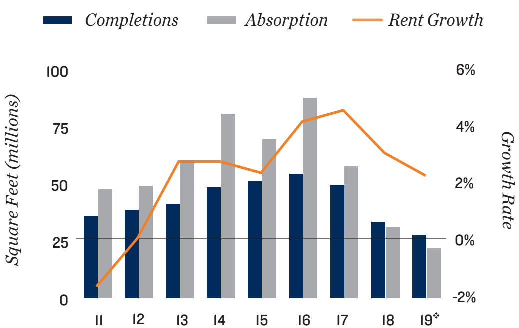
Tight Job Market Keeping Consumption Stable



Inflation Remains in Check Amid Moderating Domestic Growth



Single-Tenant Retail Supply and Demand



2018 Net Store Growth

* *Through July*
** *Through 2Q*
* *Trailing 12 months through 2Q*
Source: CoStar Group, Inc.

Underlying Fundamentals Keep Economy Sturdy; Trade Negotiations Key to Economic Outlook

Fed takes additional action to extend economic growth cycle. Sturdy underlying fundamentals continue to support domestic growth, expanding the economy by 2.1 percent in the second quarter, but headwinds are emerging. Growth has moderated over the past several months and some international forces are weighing on momentum, prompting the Federal Reserve to cut the overnight rate by 25 basis points in September for the second time in 50 days, seeking to further extend the economic runway. These modest cuts may have fallen short of what was needed to offset the escalating trade war as the 10-year/two-year Treasurys remain tight following a yield-curve inversion in late August. Sustained economic uncertainty has the potential to erode the positive economic forces such as steady job creation, low inflation, sound wage growth and strong consumer confidence. In addition, continued recruiting demand has resulted in a 20 percent surplus of job openings relative to job seekers, enabling many people with weaker skills and education to find work. Reflective of this, organizations are becoming increasingly competitive in their recruiting efforts, opening additional locations to tap new labor pools and boosting compensation packages to attract new staff members and retain existing workers. This has provided a bump to household and disposable income levels nationwide.

Uncertainty restraining some growth drivers. Though economic optimism remains strong, consumption and corporate investment have tapered relative to 2018. Unresolved trade talks, slowing international economies and the hangover from heightened interest rates last year are pressuring domestic markets, prompting some consumers and businesses to act more cautiously until additional clarity emerges. These factors have restrained leasing activity for some property types in several markets during the first half of the year, but lower interest rates could spark a recovery. Still, the recently inverted yield curve and uncertainty surrounding trade will weigh on the outlook.

Leasing Activity Softens as Companies Rethink Expansions

Retailers adjust growth strategies as they gauge headwinds. Space absorption in the STNL segment totaled less than 5 million square feet in the first half of the year, the lowest level in more than a decade. Decreased construction in response to the moderated economic outlook is driving this trend as many retailers are now taking a more conservative approach after witnessing strong growth earlier in the cycle. This has put some upward pressure on the national vacancy rate, ticking up 10 basis points on a year-over-year basis each of the past three quarters and putting the reading at 4.5 percent at the end of June. Rent growth has also shifted, easing into the low-2 percent range, with the average asking rent clocking in at $21.02 per square foot.

Companies increasing focus on business model refinement. With late-cycle dynamics causing some companies to pause expansion plans, investment into current operations is becoming a more common retailer strategy. Companies like Aldi and Target are remodeling many existing locations, adding amenities and improving product selection. This is further supported by the evolving retail landscape, which has prompted retailers to refine business models as consumer preferences transform. The rise of e-commerce has helped some companies — most recently CVS, Pizza Hut and Walgreens — realize they're overstored, encouraging them to cut excess locations to optimize operations. The combination of these factors is boosting the efficiency of single-tenant retail, benefiting investors in the long term.

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
Kroger	1,292
Safeway	1,093
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

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

Fed Gives Economy Another Boost; Lenders Still Favor Net-Lease Retail

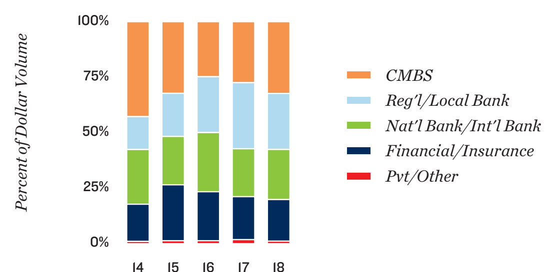
Fed drives rates lower yet future policy still undecided. The Federal Reserve cut the overnight rate by 25 basis points in September, the second reduction in 50 days amid muted inflationary pressure and continued trade tensions with China. Though the rate cut supports an extension of the economic growth cycle, the market remains cautious as the Fed declined to commit to additional rate cuts through the remainder of the year. While some Fed members are advocating further reductions, others hold a different stance, citing positive economic indicators like sound retail spending, sustained job creation and strong consumer confidence as reasons to maintain the current target rate. These factors have helped moderate recession risk, putting the 10-year Treasury back in the mid- to upper-1 percent range and above the two-year note following a yield-curve inversion in late August. While recession risk remains, the economy's solid foundation points to continued domestic growth in the near future. Global developments including the trade war with China as well as the progression of Brexit and its potential aftermath will help determine future Fed decisions.

Lenders zero in on retail business models. The evolving nature of the retail sector is providing opportunities for investors, giving underwriters more confidence in the long-term outlook of retail. Lending habits remain relatively conservative; however, a wide range of financing is available for strong proposals. Underwriters are beginning to focus more on tenant mixes, heavily emphasizing the inclusion of tenants with sustainable business models before they sponsor a deal. Active lenders include local, regional and national banks, and insurance companies, with a primary lender focus on net-lease assets and premier mixed-use structures being highly desirable. Meanwhile, outlying malls and non-credit tenants will undergo much more scrutiny. This has produced loan-to-value (LTV) ratios in the 60 to 70 percent range and typical debt service coverage (DSC) ratios above 1.3 depending 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 on the short-term debt before seeking long-term financing options once their operations have been proved.

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

* Through Sept. 20, 2019

Retail Mortgage Originations By Lender



Include sales $2.5 million and greater

Sources: CoStar Group, Inc.; Real Capital Analytics

Net-Lease Properties Group

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