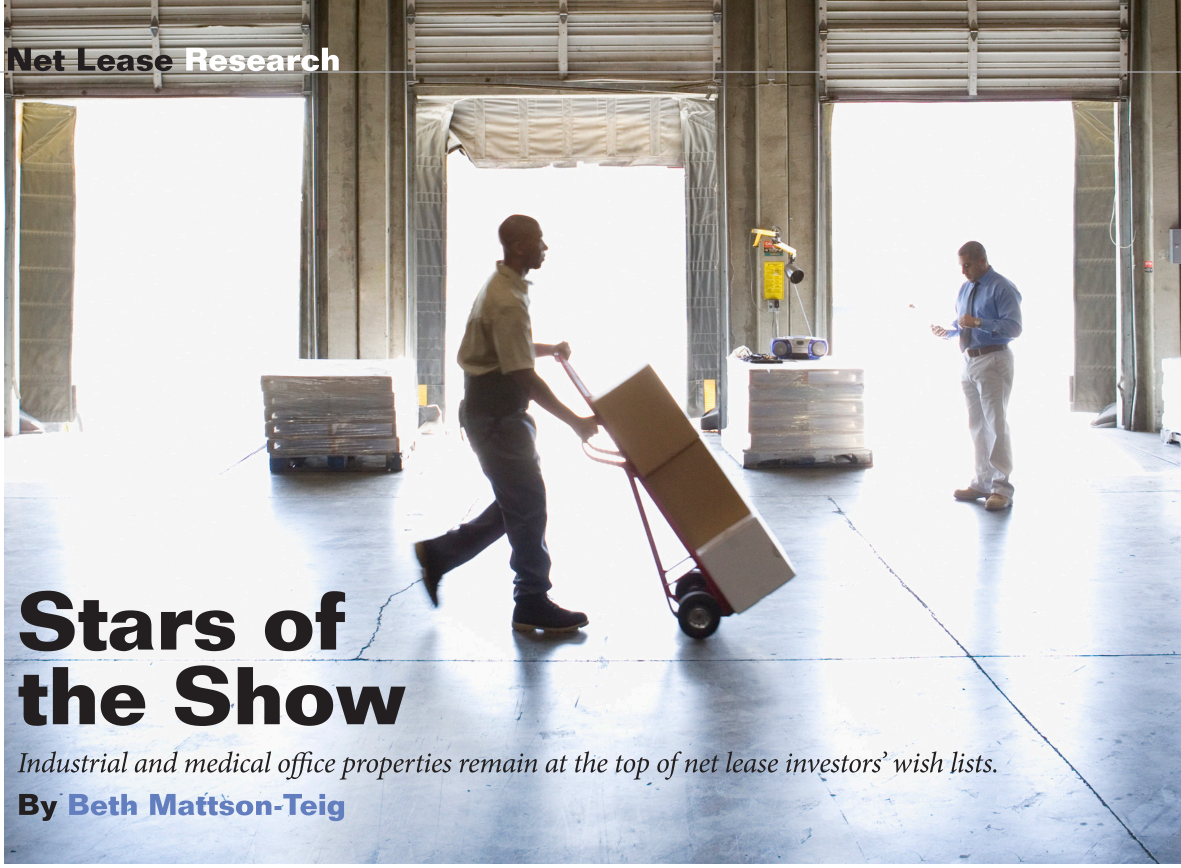

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Stars of the Show

Industrial and medical office properties remain at the top of net lease investors' wish lists.

By Beth Mattson-Teig

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Low interest rates have delivered a boost of confidence and jolted sales activity in the net lease investment market, and *NREI*'s latest research indicates that industry pros are bullish on all fronts, expecting capital to continue to flow freely, cap rates to hold steady and developers to deliver a healthy supply of inventory in the coming year.

Following a series of Fed rate cuts, it is no surprise that views on interest rates have changed dramatically since *NREI* last conducted this research. A year ago, nearly all respondents (97 percent) banked on rates rising or remaining flat for the proceeding 12 months. Instead, it was the 3 percent who predicted a rate drop a year ago who were spot on.

The 10-year Treasury kicked off the start of February hovering at about 1.7 percent—about 100 basis points lower than 12 months ago. Today, nearly three-fourths of respondents (72 percent) in the 2020 survey believe the Fed will continue to push for rates to remain the same, if not lower, over the next 12 months.

Clearly, one of the biggest changes impacting the net lease investment market over the past 12 months has been the drop in interest rates, notes Gary Chou, senior vice president and senior director of single-tenant net-leased business at Matthews Real Estate Investment Services. "Fed policy has really kept the wind in the sails for the net lease sector, as well as other real estate types," he says. According to Real Capital Analytics, single-tenant property sales volume increased 10 percent to $76.7 billion in 2019, which represents a new post-recession high for the sector.

In particular, transaction volume was juiced by some sizable portfolio deals, such as Realty Income's $1.25 billion acquisition of a 454-property net lease portfolio from CIM Real Estate Finance Trust in September. In another deal announced in September, Broadstone Net Lease, which has traditionally been more retail-focused, acquired a portfolio of 23 net lease industrial and office/flex assets for $735.7 million.

The low rates set the stage for what could be another strong year of sales ahead in both single-asset and portfolio sales. "In the context of what is generally perceived as continuing low interest rates in the year ahead, we think the market is going to remain very active in 2020. In our opinion, we see no reason for rates to move dramatically," says Gino Sabatini, head of investments at W. P. Carey. For its part, W.P. Carey acquired $870 million in net lease assets in the U.S. and Europe in 2019. "One trend that we have seen in deals in our own pipeline is the increasing role of sale-leasebacks as part of the capital stack for both M&A and PE [private equity] deals," adds Sabatini.

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Industrial, medical remain top choices

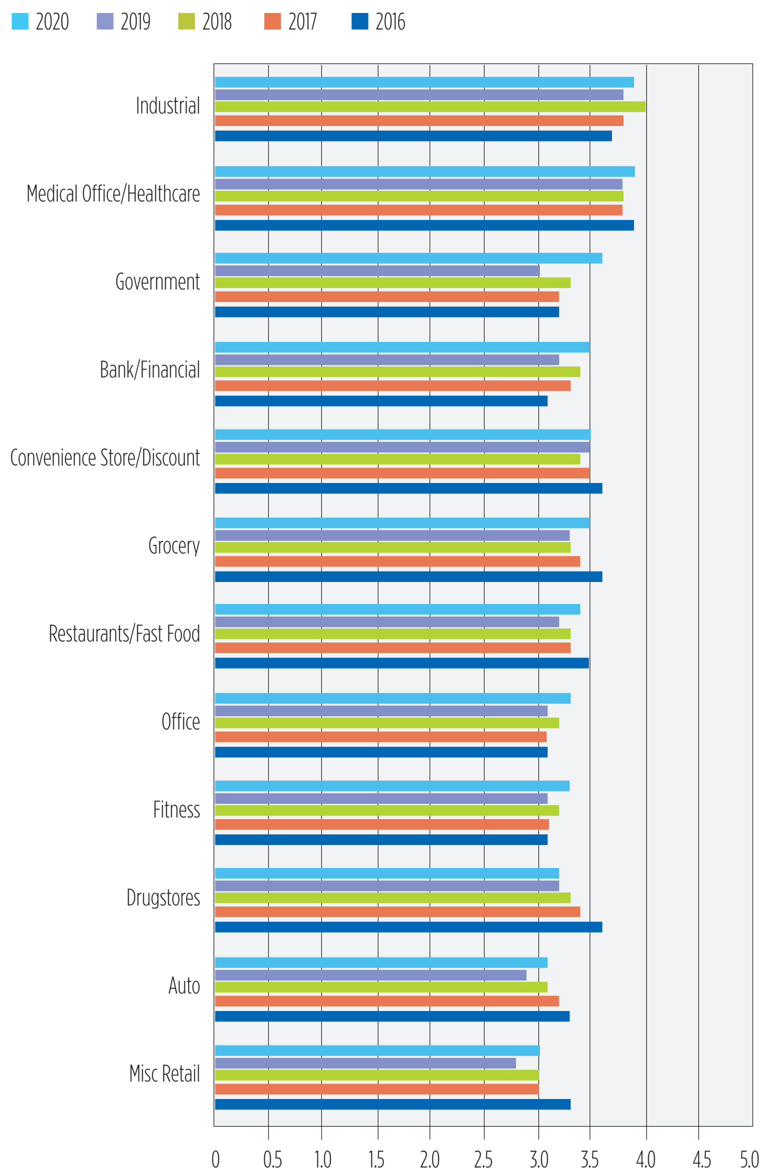
Net lease is a broad category that includes a mixed bag of different property types. Similar to surveys over the past four years, industrial and medical office/healthcare are commanding the most interest and capital. When asked to rate the outlook for each net lease property type over the next 12 months on a scale from 1 to 5, with 5 being the highest, industrial and medical office/healthcare each generated the highest mean score of 3.9. That shows a slight uptick from *NREI*'s 2019 survey where the two were in lock step at a 3.8. Government buildings saw the biggest move in year-over-year sentiment, rising from 3.0 to 3.6. Meanwhile, convenience/drug stores maintained a stable favorable rating at 3.5. The two sectors that scored the lowest in the rankings were miscallaneous retail at 3.0 and auto stores at 3.1.

It is not surprising that industrial continues to rate high with steady demand for space coming from rising e-commerce sales.

"Our view is that, despite recent reports that overall supply in the industrial sector is now greater than the demand, we see the factors driving industrial demand continuing into 2020," says Sabatini. In particular, the demand for last-mile properties in high-income areas is resulting in high occupancies and growth in rental rates. In addition, companies are making strategic moves to improve their supply chain efficiencies, which continues to propel demand for logistics infrastructure and a more efficient distribution network, he adds.

Similar to the broader commercial real estate investment market, most respondents view industrial as being the hottest segment within the net lease sector. More than half of respondents (51 percent) think industrial is the most in-demand product, which is up from 44 percent who held that view in the 2019 survey. Medical office/healthcare and restaurants/fast food also continue to rate consistently high for demand at 39 percent and 28 percent respectively.

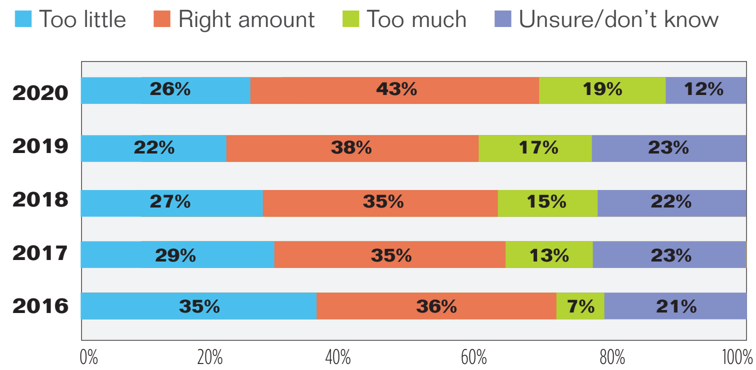
Figure 1: Respondents were asked to rate the outlook for each property type for the next 12 months on a scale of one to five.'



Industrial net lease assets are certainly the "flavor of the day," thanks to e-commerce, while in the medical space dialysis clinics and hospital-operated medical clinics and urgent cares are highly sought after, says Daniel E. Herrold, senior director, corporate finance, at the Stan Johnson Co. in Tulsa, Okla. On the retail front, buyer demand has softened for industry types that are more susceptible to Amazon or other internet competition. Property types that remain in favor are convenience stores, food service, fitness and auto service businesses, he adds.

There continues to be robust demand for restaurants, and plenty of buying opportunities with national brands such as Starbucks, Burger

Figure 2: A plurality of respondents continue to believe that the supply of net lease properties is "right" relative to demand for investment.



King, McDonald's, Chipotle still on a growth track. For many net lease investors, tenant credit remains just as big of a focus as the quality of the real estate.

"Any strong credit and internet resistant tenants receive favor by the buyer community in our space," notes Herrold. At the same time, investors continue to place a strong emphasis on unit level performance and weigh this heavily in their property underwriting, he adds.

According to Real Capital Analytics, industrial assets accounted for a bigger share of single-tenant property sales in 2019 at 41.3 percent, followed by office at 36 percent and retail at 22.7 percent.

"Office and industrial both shined in 2019," says Mark West, senior managing director, capital markets, at JLL in Dallas. From an overall volume perspective, office may have the edge in 2020 as industrial volume growth came largely on the back of a surge in portfolio deals in 2018 and 2019, which may not be available to the market in 2020, notes West. Strong employment will likely continue to drive interest in office assets in 2020, especially in primary markets where buyers can access more liquid assets that provide downside protection from any unexpected slowdown in growth, he adds.

Supply-demand balance improves

Industry participants are keeping a close eye on the balance of supply and demand of net lease properties, both on the sale market and in the development pipeline. In addition to interest rates, a number of respondents cited shifts in supply and demand as the biggest changes in the net lease sector over the past 12 months. Opinions varied, with some respondents who noted an increase in demand, including from 1031 buyers and apartment sellers. Other respondents noted a decrease in demand coming from foreign investors in their local regions.

Overall, respondents have a more favorable view of the available supply of net lease properties on the sale market. In all, 43 percent think the current volume is the "right amount" as compared to 35 percent who held that view a year ago. However, those who believe there is "too little" ticked higher from 22 to 26 percent, while 19 percent said there was too much supply and 12 percent were unsure of the answer.

There are record amounts of dry powder on the sidelines and still strong demand for net lease assets with no signs of waning interest heading into 2020, notes West. The interest rate environment is favorable for the sector, and investors also have renewed confidence in supportive Fed policy, he adds. That being said, deal flow could be more front-loaded in the first half of the year, with sellers looking to bring properties to market early to take advantage of low rates and to get ahead of an uncertainty that could arise closer to the presidential election, he says.

Nearly half of respondents (49 percent) believe there is a healthy balance of development activity as compared to 38 percent in the 2019 survey. Views did not change substantially on whether there is too little (21 percent) or too much (16 percent), whereas the number who said they were unsure of the answer did decline from 23 percent last year to 14 percent in the current survey.

"The supply of net lease will remain strong, particularly in the industrial, medical and retail categories," says Brandon Duff, managing director of investment sales at the Stan Johnson Co. in Chicago. That supply is coming from both existing, second generation properties and new build-to-suit construction. In retail, for example, there has been an increase in build-to-suit activity over the past several years across categories that include grocery stores, quick service and fast casual restaurants, health and fitness concepts, dollar stores and other service-oriented retailers. "That said, we are currently seeing investor demand outweigh supply as the depth of the buyer pool is strong across all buyer types—institutional, family office, private equity and private investors," says Duff.

In fact, Duff believes the current buyer pool is the broadest in size and scope that he has seen over the last decade, if not longer. There has been a spike in demand for all product types from 1031 exchange buyers over the last 12 to 24 months as investors continue to exit out of more management intensive asset classes. "Additionally, we have experienced a new wave of private, non-exchange investors that have flooded into the market seeking yield, tangible asset investments and taking advantage of the low interest rate environment," he says.

Cap rates remain on plateau

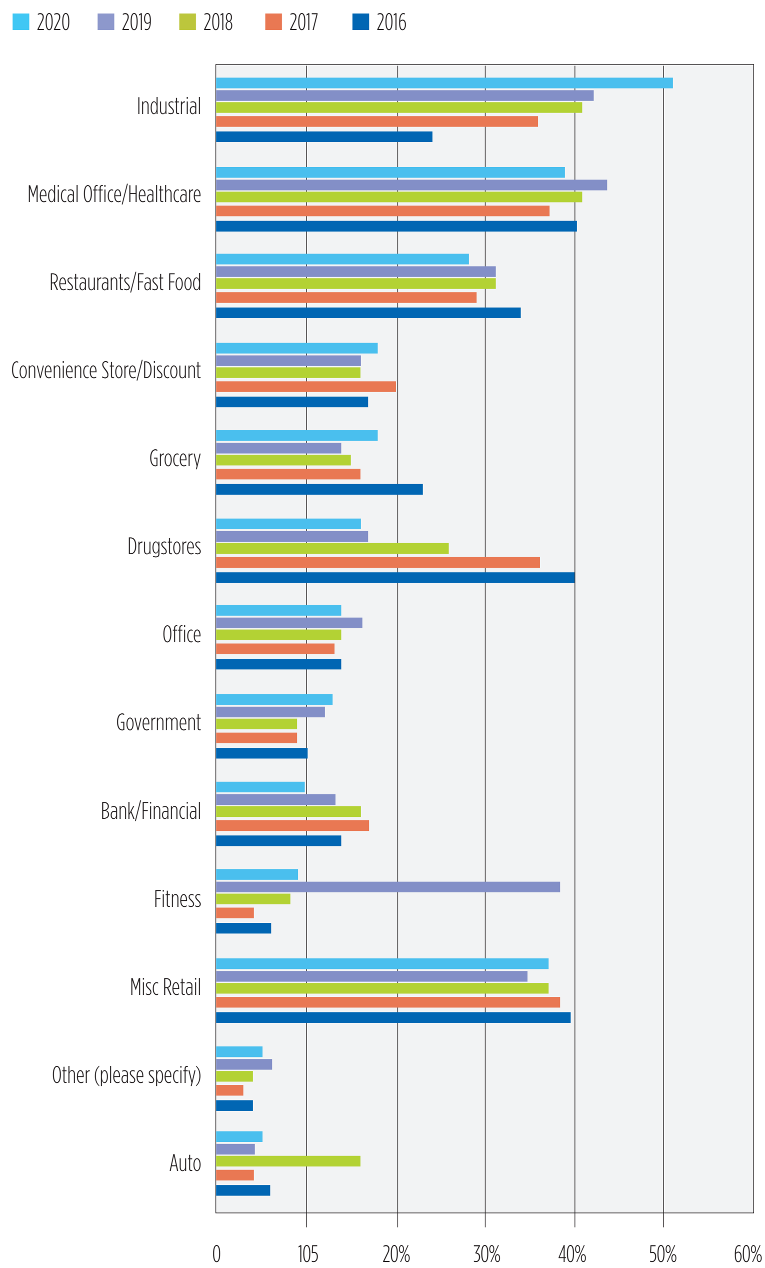
Low rates and the high demand for net lease properties have helped to keep cap rates near record lows. According to Real Capital Analytics, cap rates have been maintaining a fairly steady level. The current average of 6.3 percent has moved only a slight 10 basis points higher or lower over the past four years. "We don't think cap rates are going to change dramatically. With yield-driven investors continuing to look for solid investments, we think interest rates will remain low and investor demand will maintain cap rates at current levels," says Sabatini.

Respondents see a wide range of net lease cap rates in markets where they operate, which is not surprising considering the differences in supply and demand that influence pricing dynamics in individual markets and property types. Overall, the estimated mean for the current cap rate was 5.9 percent, which reflects a 20 basis point drop compared to 6.1 percent in the 2019 survey.

What is notable in the current survey is that more respondents anticipate no change in cap rates over the next 12 months at 44 percent. Last year, predictions for cap rates were more mixed, with 25 percent who said there would be no change. Looking ahead over the next year, a majority of respondents (69 percent) also believe that the risk premium (i.e., the spread between the risk-free 10-Year Treasury and cap rates) will remain the same.

"We expect that the net lease market will continue to be vibrant in terms of transaction flow and participants," says Christopher H. Volk, CEO of STORE Capital Corp. "Should interest rates be sustained at low levels, we believe that the need for income will attract added participants and potentially put pressure on cap rates." STORE Capital's investor guidance for 2020 called for a modest 10 basis point decline in cap rates. Cap rate movements will be dependent on the availability of debt financing and the cost of that financing. So, lower interest rates may not impact cap rates if lenders also lower advance rates or accelerate loan amortization periods, he adds.

Figure 3: Industrial surged to a 12-point lead over medical office as the property type with the greatest current demand.'

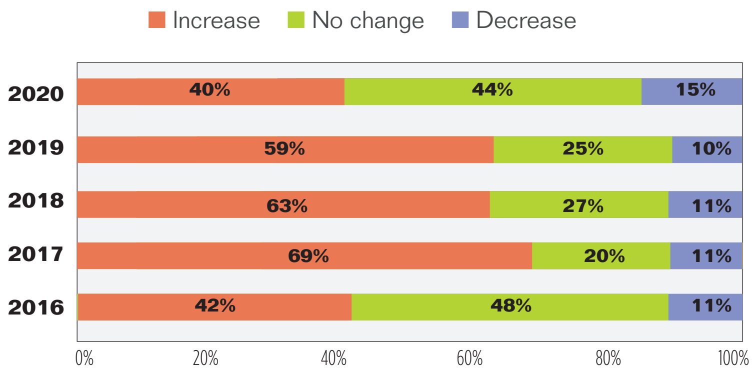


Positive outlook on liquidity

Many of the concerns that people had a year ago about slowing global economic growth, the possibility of a looming recession and negative impacts from trade wars seemed to evaporate by year-end, says Sabatini. "The outlook for 2020 has shifted to a stable, low-interest rate environment for the year ahead," he says.

The shift in Fed policy is likely contributing to more positive views on

Figure 4: For the first time since 2016, a majority of respondents are not projecting cap rate increases for net lease properties.



market liquidity even in the context of what has been a very long-running climate of favorable financing. A majority of respondents (84 percent) think that availability of debt and equity is either the same or better than a year ago. Specifically, 52 percent said that the availability of debt and equity is unchanged, while 32 percent said it is more widely available and a further 16 percent think it is either less available or were unsure of the answer. That does show an uptick in positive sentiment compared to the 2019 survey, when 62 percent of respondents believed that availability of equity was the same or better, and 65 percent said that availability of debt was the same or more better.

Anecdotally, there appears to be plenty of debt and equity capital sources that are active in the net lease industry ,ranging from large REITs and private equity funds to high-net-worth individuals and family offices. The global search for yield is also attracting foreign investors to the U.S. net lease market. According to CBRE, cross-border capital for NNN properties totaled $6.8 billion during the first three quarters of 2019, an increase of 18.8 percent compared to the same period in 2018. The most active international buyers over the past two years have been from Canada, Germany and Singapore.

On the debt side, nearly three-fourths of respondents expect loan-to-value ratios (LTVs) and debt service coverage ratios (DSCRs) to remain the same in the coming year at 76 percent and 72 percent respectively. Views were slightly less optimistic a year ago when 60 percent thought LTVs would remain the same and 61 percent thought DSCRs would increase. "Relatively speaking compared to pre-recession underwriting standards, lenders have remained fairly conservative in their lending approaches, which is good for all parties involved," says Herrold.

Respondents eye opportunities, challenges ahead

Respondents are tracking a variety of issues that could present market opportunities and challenges ahead. The possibility of rising interest rates, cap rate compression and 1031 money that is "too eager" to buy replacement assets are concerns that are top of mind for some survey participants. "The market is overdue for a correction, which has already affected the residential market in NYC, and NYC is typically a leading market indicator," wrote one respondent.

One concern is the proliferation of new and unproven investors in the net-lease sector that may not have the experience or financial strength to be able to withstand potential downturns, notes Sabatini. "The need to sell or refinance when markets are down could be unsettling for them and potentially the larger net lease space," he says.

When asked about the biggest opportunities ahead in net lease in the coming year, many noted the ability to redevelop or reposition vacant or older buildings, as well as acquire assets with shorter term leases. "Opportunities are limited because of continued cap rate compression. However, there may be some opportunities related to retail closures," wrote one respondent. It remains to be seen how the upcoming presidential election could affect overall views on the economy and the net lease sector as the year progresses. There could be some shifts in sentiment once a democratic candidate is selected and there is more clarity on the frontrunner closer to November. "The biggest headwinds ahead are more political than fiscal," notes Chou. "I would anticipate that 2020 is going to be pretty consistent to 2019." ■

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 152 qualified responses. Survey respondents are active across different property types with the biggest percentage who are involved in multifamily at 66 percent, retail at 64 percent, office at 59 percent and industrial at 54 percent. Survey respondents are active nationally, with the biggest percentages operating in the South/Southeast/Southwest at 60 percent, East at 43 percent, West/Mountain/Pacific at 40 percent and Midwest/East-West North Central at 32 percent.*