Remarkably Resilient

As the net lease sector shakes off COVID-19 paralysis, investor interest could surge.

By **Jenn Elliott**

Net lease investments are particularly appealing during times of uncertainty, and the past 15 months have been nothing if not uncertain. Faced with a global pandemic and a shaky economy, investors were eager to secure real estate properties with long-term leases, credit worthy tenants, and perhaps most important, an element of necessity.

WMRE's annual Net Lease Investment Survey confirmed the resiliency of the net lease sector and uncovered some surprising sentiments. Last year's survey was completed just prior to the onset of the COVID-19 pandemic. What's notable about the current results is that sentiments on a lot of questions remained consistent with pre-pandemic levels, although there are areas—particularly the outlook for subtypes of net lease properties—where the numbers moved considerably compared to prior years.

The net lease sector, like the overall commercial real estate industry, suffered from COVID-19 paralysis throughout most of 2020. But net lease investment volumes bounced back more quickly than for multitenant assets, attracting interest from both new and existing investors.

Though net lease investment volume decreased 24.3 percent year-over-year to $60.5 billion in 2020, that was less of a decline than the 31 percent drop in overall commercial real estate investment sales volume, according to CBRE.

"The pace of the rebound and investor resilience and adaptability were the most surprising outcomes of the 2020," says Coler Yoakam, JLL senior managing director and co-head of JLL's net Lease/CTL group, capital markets. "We went from a virtual market standstill in March and April to the highest level of transaction volume ever in Q4."

CBRE found that net lease investment accounted for 14.8 percent of total commercial real estate investment volume in 2020, above the five-year pre-COVID-19 average of 11.7 percent. The same pattern occurred during the Great Recession when the net lease share of total investment volume expanded to 15.1 percent in 2009.

Investors gravitate to net lease

Greater capital allocations from net lease investors, both institutional and private, coupled with capital from market partic-

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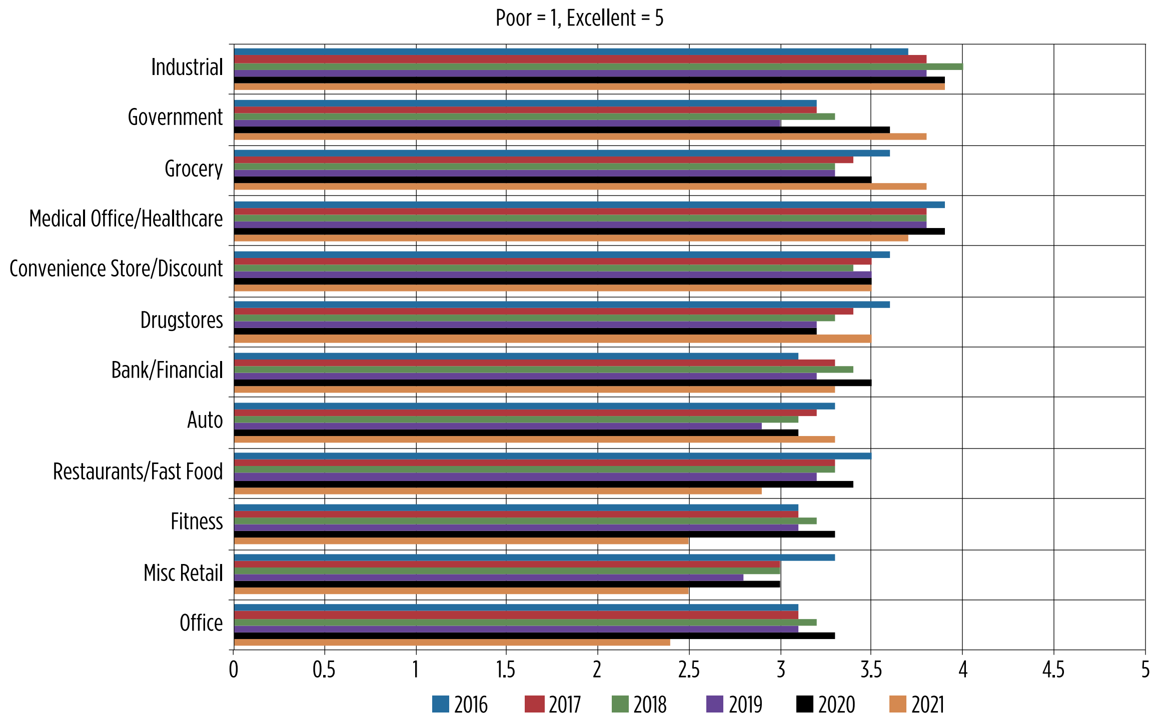
Bright Outlook

Respondents rated the outlooks for most subsectors as between a three and a four on a scale of five.



ipants, have created all-time high liquidity, according to Alex Sharrin, managing director, capital markets at JLL.

"It's important to note that dry powder for U.S. commercial real estate exceeds $200 billion as many institutions seek alternatives to low-yielding fixed-income investments," he explained. "Family office, offshore capital, and targeted separate accounts rising in prominence have also shaped the landscape."

In a new question for this year's survey, WMRE asked respondents to identify sources of new competition when acquiring net lease assets. In all, 47 percent of participants in the WMRE survey said they are seeing new faces in the market. Among those respondents, nearly eight out of 10 respondents (78 percent) identified private real estate investors as new competition, while 67 percent said 1031 buyers/individuals/high-net-worth (HNW) investors were seeking deals, 58 percent named institutional investors and 32 percent pointed to international investors.

Private investors had the largest share of net lease investment in the fourth quarter of 2020 at $10.9 billion, an increase of 78.5 percent from the third quarter, according to CBRE. The firm estimated that institutions and equity funds increased their net lease investment volume by 138 percent from the third quarter to just over $9 billion in the fourth quarter.

Meanwhile, REIT-related net lease investment volume increased by 68 percent quarter-over-quarter to $3.3 billion, according to CBRE. And foreign investments reached a high for the year in fourth quarter, increasing a whopping 336 percent quarter-over-quarter to $3.8 billion.

W.P. Carey is coming up against the same competitors it usually does—public and private net lease REITs and private equity funds, according to Sabatini. However, he has noticed a mix of other investors swooping in for deals that W.P. Carey considers to be less attractive such as those with shorter lease terms. Those buyers include foreign investors, high-net-worth investors and institutional investors.

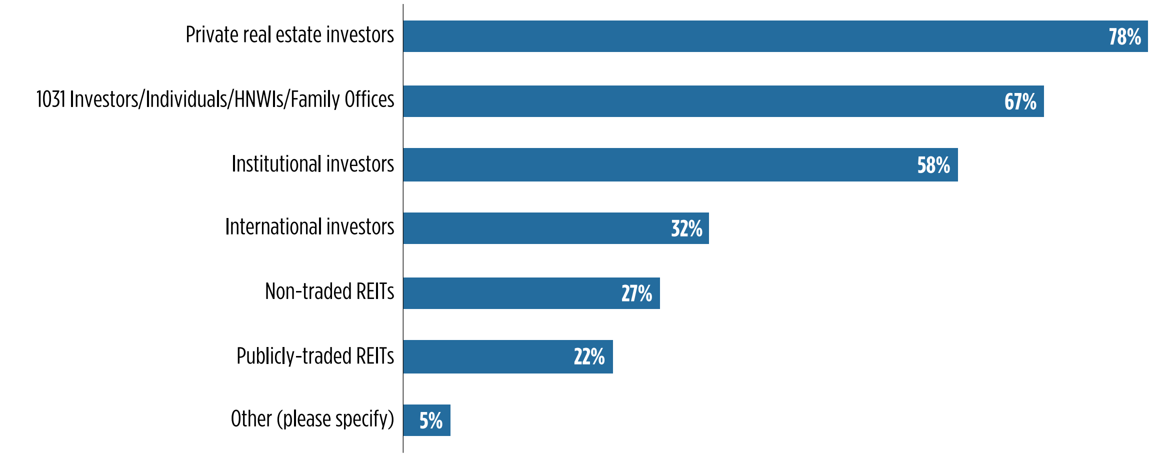
Supply-demand imbalance continues

There is no consensus among survey respondents about the current state of the supply of net lease properties for investment. In all 29 percent said there was "too little," the highest number since our 2017 survey. Meanwhile, 32 percent said there was the "right amount," down from 43 percent a year ago. Another 22 percent said there was "too much" supply—up from 19 percent a year ago and the highest level in the six years WMRE has been conducting the survey. (Additionally, 17 percent said they were unsure, further underscoring the lack of clarity on market conditions.)

Matt Bear, founder of Bear Real Estate Advisors, has a different take on the supply-demand debate. "When people say that there is not enough supply, what people are really saying is that there is not enough supply of the deals that they want to

Crowded Field

Respondents indicated they are seeing the most new competition for deals from private real estate investors.



do," he said. "There are deals everywhere, but the question is, do you want them or not?"

For certain assets, like industrial and medical, it's a seller's market. For others, like retail and office, it's a buyer's market.

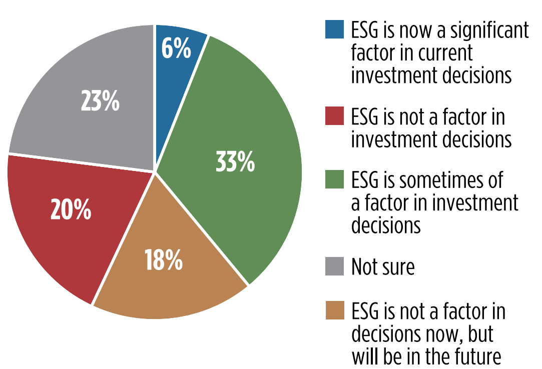
"A lot of people who wouldn't consider selling in the past are seeing the strong demand for assets and have changed their mind and are thinking about selling now," said Jon Hipp, principal of U.S. Capital Markets and head of U.S. Net Lease Group with Avison Young. "They're trying to get out of properties with shorter terms and roll into something longer term."

Regarding the current level of net lease development, respondents have little to no concern about overbuilding. In fact, 26 percent said there's too little development right now—the highest figure since our initial 2016 survey. Another 46 percent said there's just the right amount of net lease construction (down slightly from 49 percent a year ago), and only 13 percent said there was too much, down from 24 percent of respondents who were concerned about overbuilding a year ago. (An additional 15 percent said they weren't sure.)

"Development was hamstrung last year, limiting supply of new deals," noted Camille Renshaw, CEO & co-founder of B+E Net Lease. "This year developers are ready to break ground, but the cost of construction has skyrocketed, and they are having to restructure budgets and project timelines."

Growing Importance

While ESG is not yet a significant factor, many respondents said it plays some role in their decisions.



Industrial separates from the pack

Industrial properties are by the far the most in-demand net lease assets, according to WMRE's survey. (Respondents were allowed to select up to three subsectors in their responses.)

In all, 55 percent of respondents said industrial net lease assets had the greatest demand. That's up from a year ago. In fact, the response for industrial assets has risen every year we've conducted the research from a low of 24 percent back in 2016 to its current level.

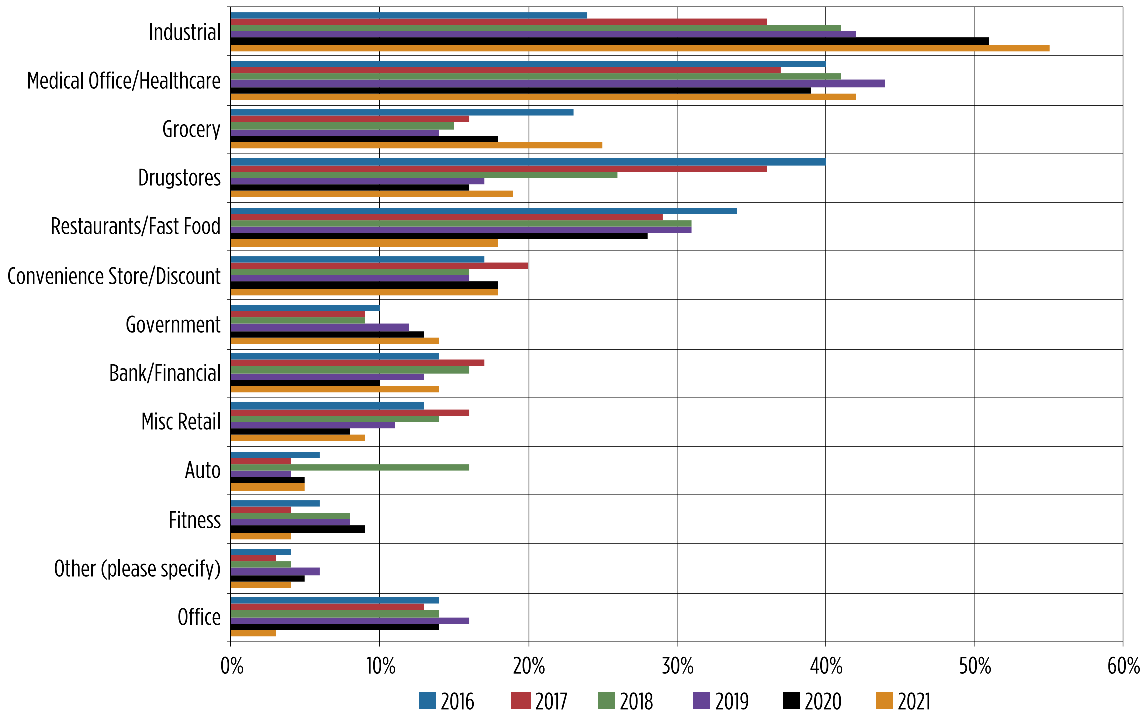
Medical office was the second most popular asset class, with 42 percent of respondents saying that asset class was in demand, which is consistent with previous years' surveys. Grocery stores jumped to third, with 25 percent saying those properties were in demand, up from 18 percent a year ago.

Meanwhile, the demand for restaurants/fast food and office net assets dropped considerably from previous surveys. For restaurants/fast food, there was a 10 percentage point drop from the 2020 level down to 18 percent. (Back in 2016, restaurants/fast food were identified as in demand by 34 percent of respondents.) In addition, office dropped to last among all the subsectors identified with just 3 percent of respondents saying such assets are in demand—down from an average level of 15 percent in our five previous surveys. (Responses for other segments were generally inline with our previous surveys.)

When asked to gauge the outlook for the same subsectors, the answers were similar, with industrial topping the list (3.9

Shifting Tides

Respondents indicated demand for industrial net lease assets reached a new peak. While office demand cratered.



on a scale of 5.0) while office finished at the bottom (2.4). The figure for industrial was generally inline with previous surveys while the score for office properties dropped from its typical number in the 3.1 point to 3.3-point range. Government net lease properties and grocery stores were second, with scores of 3.8. Meanwhile, the outlook for fitness centers and fast food/restaurants net lease assets dropped to 2.5.

"Due to the economic volatility stemming from the pandemic, investors across the board are really looking for those asset classes that support resilient supply chains and industrial has proven itself to be just that," Sabatini noted.

The industrial sector's share of total net lease investment volume in the fourth quarter of 2020 jumped by 11.3 percentage points year-over-year to 52.4 percent, according to CBRE. The office sector's share fell by 7.6 percent to 27.7 percent while the retail sector share declined by 3.7 percent to 19.9 percent.

Even before the pandemic, W.P. Carey's core focus has been on industrial assets, which now represent nearly half of its annualized base rent, according to Sabatini. "We see industrial assets as generally being more mission-critical with greater opportunities for tenant renewals. Industrial assets are now also benefiting from COVID-19 tailwinds including greater demand for e-commerce," he said.

While warehouse and distribution properties in core markets are by far the most in demand, a broad range of investors are getting more comfortable with niche industrial that is more specialized and asset intensive, Yoakam noted. He pointed to cold storage, food processing, and manufacturing as examples.

Net lease medical properties aren't as in demand as industrial, but they're still popular with investors. In fact, JLL's Sharrin described medical office as the "darling" of the net lease space nowadays.

"Investors view healthcare-oriented investments as having superior in-place lease economics, larger tenant investment into the space or 'stickier' tenancy, and more mission-critical," he explained.

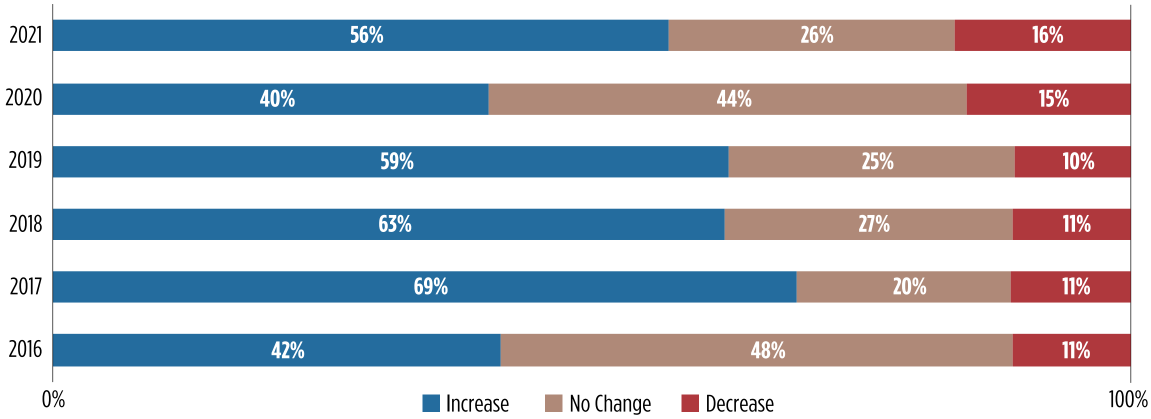
Medical properties with long-term leases in excess of nine years and backed by hospital credit are being priced very aggressively. "I've never seen cap rates for medical office this low," Bear said, adding that the strong interest in medical net lease has bled (pun intended) into life science properties.

At the other end of the spectrum, 2020 ended with office and retail recording the lowest investment volumes since 2013, according to CBRE. Some segments within retail performed fairly well during the pandemic (grocery and drugstores) while others suffered due to lockdowns (fitness, movie theaters, and fine dining).

"The traditional enclosed shopping center probably experienced the biggest COVID impact," says Randy Blankstein, principal with The Boulder Group. "We expect to see a lot of the strong retailers who historically located in malls exit to

Cap Rate Impacts

Nearly three-fifths of respondents now estimate that cap rates on net lease assets will rise in the next 12 months.



either freestanding or multi-tenant that offers greater visibility or customer accessibility. We see this as a big win for the net lease sector."

Sabatini acknowledged that both office and retail took a hit, but noted that W.P. Carey will still opportunistically invest in these assets. The firm recently closed several essential retail deals in Europe where it believes there are better supply fundamentals and pricing dynamics, as well as less competition overall.

In France, W.P. Carey closed a $119-million sale-leaseback of a hypermarket portfolio with Casino Guichard-Perrachon, one of the largest food retailers in the country. It also completed a $102-million sale-leaseback of a supermarket portfolio with Eroski, one of its existing tenants.

For example, companies such as Amazon have launched online pharmacies where people can get prescriptions delivered to their door. Even one less trip to the drugstore could hurt retail chains' profitability.

When will cap rates move?

Strong demand from net lease investors kept cap rates relatively low in 2020, especially for industrial, medical, and essential retail properties.

Respondents to the WMRE survey estimated cap rates in their markets at 5.4 percent—down 50 basis points from 5.9 percent a year ago. That figure is below the national average net lease cap rate remained of 6.2 percent measured by CBRE. Spreads between the average net lease cap rate and the 10-year Treasury rate tightened to 527 basis points in the fourth quarter of 2020 as the economic outlook improved and Treasury yields increased.

CBRE reported that net lease office, industrial, and retail cap rates were unchanged in the fourth quarter 6.4 percent, 6 percent, and 6.2 percent, respectively. For the year, industrial cap rates fell by 30 basis points, while retail and office cap rates remained the same.

Sabatini noted that cap rates are still very aggressive, particularly for high-quality industrial assets, but have remained stable so far in 2021. However, he predicts that cap rates will go up across all property types this year due to rising interest rates and the prospect of inflation.

Overall, 56 percent of respondents in the survey expect cap rates in their regions to rise in the next 12 months. That's up considerably from the 40 percent who expected cap rate rises a year ago and more consistent with figures from the 2017 through 2019 surveys. On the flip side, 16 percent expect cap rates to decrease, which is the highest level measured in the six years conducting the survey. The reason sentiment rose on both sides of the equation is that just 26 percent of respondents in this year's survey said they expect "no change" in cap rates—down from 44 percent a year ago who forecast stability in the marketplace.

For her part, Renshaw predicted that cap rates won't budge until next year. "Cap rates will only increase once the debt constant gets within a 150-basis point margin of the corresponding cap rate and supply has caught up with demand, which will be in 2022 at the earliest," she said.

No consensus on capital availability

As far as availability of equity goes, compared to 12 months ago, respondents were split about the availability of equity. In all 38 percent of respondents said it was more widely available, while 32 percent said it was the same, and another 21 percent said equity is less available than it was 12 months ago. Those mark slight shifts in sentiment from a year ago when there was a clearer consensus that equity levels were unchanged or higher compared to 2019.

The picture on debt is more muddled. Respondents were essentially evenly split with one-third of respondents saying debt was more widely available than it was 12 months ago, while another third said nothing had changed, and a final third said it was less available.

"Throughout the pandemic, lenders have generally taken a more 'risk-averse' approach, which has made it difficult for some companies to secure debt," Sabatini agreed.

However, W.P. Carey was been able to opportunistically access public equity and debt capital in 2020 and raised more than $880 million in permanent and long-term capital. This year, the firm continued to access the debt markets, completing a $425 million bond offering and €525 million Eurobond offering.

"Overall, I think public equity and debt are widely available for companies with strong balance sheets and investment-grade credit ratings," Sabatini said. "Property level debt is a different story. For investors who finance their acquisitions on an individual basis – although interest rates are low, other terms including loan to value ratios and amortization requirements are more stringent."

Looking forward, the majority of respondents expect LTVs and debt service coverage to stay the same, while 59 percent expect interest rates to increase. Respondents were split on the topic of risk-premium, with 42 percent saying it will increase and 41 percent saying it will stay the same.

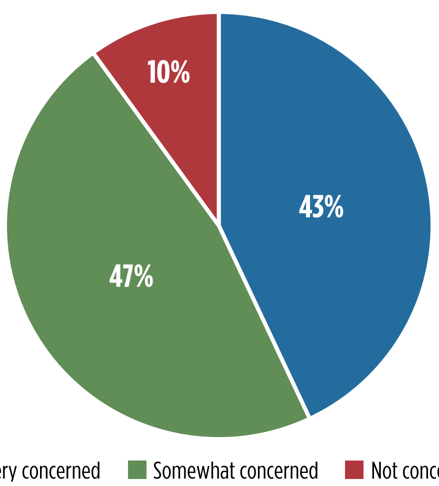
Impact of ESG imperatives

For the first time, WMRE's survey included questions about environmental, social, and governance (ESG) imperatives. Only 6 percent of respondents said it was a significant factor in their investment decisions, while 33 percent said it was sometimes a significant factor. Another 18 percent said ESG will be important in the future, but hasn't made much of an impact yet.

Among respondents who said ESG has impacted their decision, 28 percent of survey participants said it has been a factor in assessing assets, 26 percent said it has been a factor in assessing capital providers, and 27 percent said it has been a factor inside their company.

Changes Afoot

Overall 90 percent are very or somewhat concerned about the change in taxation of like-kind exchanges.



Sabatini said ESG has become an increasingly important part of W.P. Carey's overall strategy. "On the investments side, ESG due diligence is part of our underwriting process, providing a more holistic view of each transaction and ensuring our investments adhere to our high standards," he explained. "We also proactively work with our tenants on building efficiency retrofits and property-level sustainability projects to help scale our impact."

In 2020, W.P. Carey completed a $74 million, build-to-suit food production facility in San Antonio, Texas, for its existing tenant Cuisine Solutions, the largest manufacturer and distributor of sous vide food. The facility is LEED-certified and features a number of green features funded by W. P. Carey including solar panels and electric car charging stations.

An industry of worry-warts

Interest rates were a big concern for survey respondents in 2020, but this year, respondents are more concerned about taxation.

Nine out of 10 respondents are "somewhat concerned" or "very concerned" about tax treatment of 1031 exchanges. In fact, in late April the Biden administration included in The American Families Plan that it would "end the special real estate tax break—that allows real estate investors to defer taxation when they exchange property—for gains greater than $500,000." Although it remains unclear what the final language will look like in the bill or if such a provision could be approved by Congress.

If the change is enacted, an overwhelming majority of respondents (76 percent) said it would lead to fewer deals and 69 percent said it would lower property values too.

It is estimated that property sales volume involving a 1031 exchange is over $100 billion per year with a median sales price of $500,000.

Blankstein believes that any major change in 1031 exchanges would have a massive impact on asset pricing, especially in the segment of the market below $10 million. "Studies show that real estate values would decrease 12 to 17 percent," he said. "There are so many people involved in this sector, the fallout would be gigantic." ■

Survey methodology: *The WMRE research report on the net lease sector was completed via online surveys distributed to readers of WMRE in March 2021. The survey yielded 158 qualified responses with the vast majority at the executive level of vice president or higher. Nearly half (48 percent) are private investors. Survey respondents are active across different property types with the largest percentage involved in multifamily at 58 percent, followed by industrial and retail, both at 52 percent. Survey respondents are active nationally, with the biggest percentages operating in the South/Southeast/Southwest and West/Mountain/Pacific, both 42 percent, East at 36 percent, and Midwest/East-West North Central at 34 percent.*