Has Net Lease Outgrown its Niche Status?

With the increased competition for and activity in the net-lease sector, could this segment of the market become too big to be considered niche?

Investor interest in net-leased properties continues to grow in number and class, creating an ever more competitive environment for these assets. More than $300 billion of commercial net lease deals were completed in 2013—a 15% yearly increase—as one industry source quotes Real Capital Analytics, begging the question of just how much more this sector can grow and still retain its niche status. Real Estate Forum spoke with several net lease experts to get their answers to this question.

ALREADY GONE?

Due to this growth, some experts say the days of net lease as a niche sector are behind us. "I believe that with all of the activity that took place in 2012 and 2013 and the current combined market cap of approximately $65 billion, the net lease sector has already shed its niche status," Peter Mavoides, president and COO of Spirit Realty Capital, tells Forum. "Institutional investors have come into the space in size, analysts' coverage of the space has increased, and its impact on the indices has dramatically increased. While the niche status has been shed, I do think that there is more growth on the horizon as the sector continues to attract more capital due in large part to investors recognizing the attractive risk/return element of well-underwritten net lease investments."

By Carrie Rossenfeld

Jonathan Hipp, president and CEO of Calkain Cos., tells Forum that the net lease sector is moving increasingly from a "niche" market into the mainstream. "REITs continue to make large acquisitions: American Realty Capital purchased CapLease for $2.2 billion and will merge with Cole Real Estate in a transaction worth $11.2 billion, creating the largest-ever net lease REIT with an enterprise value of $21.5 billion and making it the largest acquisition of a US REIT since 2011. Overall, investment interest and activity is as high as it's ever been. The net lease sector is constantly gaining more awareness and attention and does seem to be losing some of its niche status based on the increased institutional investment and increasing market share it continues to gain."

Gino Sabatini, managing director and co-head of global investments at W. P. Carey Inc., agrees that net lease's growth within the REIT industry arguably has helped the sector transcend its niche status. "In the very near future, ARCP, O [Realty Income Corp.] and WPC will each be entities with a total enterprise value in excess of $10 billion," he tells Forum. "The sector should continue to grow in size as more companies find it an attractive source of capital and investors seek yield."

David Kay, president of American Realty Capital Properties Inc., relates that the net lease property sector is no longer on the margins of the real estate industry, but must now be considered a separate property class. "Net lease, referring to properties, is a term that currently covers $70 billion of real estate assets, and we expect this category to grow to over $100 billion. This asset pool provides consistent durable income which, especially in today's low-interest rate environment, has made it very attractive and has driven it to become the most common form of real estate investment in the United States. There will continue to be substantial demand in the market for net-leased properties, and our firm expects to review roughly $30 billion of net lease opportunities in 2014."

BRC Advisors' Sean O'Shea adds that the sector deserves its own special acknowledgement. "Over the past 10 years, it's grown in terms of acceptability and has been defined as an alternative investment," says O'Shea, who is the managing director of the O'Shea Net Lease Advisory group for the firm. "It's a bond replacement for conservative investors who like the characteristics of a bond, but like the real estate. It's matured into its own investment class. What's ironic about that is that now is a time when it's accepted as a legitimate investment, but properties are hard to come by because of the scarcity."

Gordon Whiting, portfolio manager for the net lease group at Angelo, Gordon & Co., tells Forum that net lease is "definitely a niche business, but one that everyone knows about today. Twenty years ago, people couldn't have told you what net lease is about. Whether they're comfortable playing today is another story."

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>
> **PETE MAVOIDES,** Spirit Realty Capital

Whiting adds that net lease investment is hard for the inexperienced investor to do well because two sets of expertise are needed. "There are two types of tenants: investment grade and less-than-investment grade. In dealing with the latter, you need both credit expertise and real estate expertise."

ASSET CLASS MATTERS

Expertise aside, yield in the net lease sector does seem to depend on the property sector in which investors place their capital. According to a report by the Boulder Group, a boutique investment real estate service firm that specializes in single-tenant net lease properties, cap rates for the single-tenant net-leased retail and office markets reached their lowest levels in the past decade during fourth quarter of 2013, but cap rates for net-leased industrial increased during the same period. The fourth quarter of 2013 represented the first time in the past decade that cap rates for the net-leased retail market were below 7%, and net-leased office properties experienced the largest cap-rate decline of 30 basis points in the fourth quarter.

Jereme Snyder, EVP of Colliers International and one of this year's top brokers, tells Forum, "We have seen strong fluctuations in cap rates as a direct correlation to interest-rate movement, especially on the higher price-point transactions above $5 million that require financing. There has been less cap-rate volatility below $5 million due to the higher demand for NNN retail assets and the larger buyer pool of all-cash buyers. It is difficult to read into the future; however, I am confident that cap rates will continue to move with interest rates, and strong demand for single-tenant NNN investments will remain through it all."

Lack of supply or "resource scarcity" is cited by many sources as the primary reason that cap rates have remained low in many areas of the net lease market, although many also feel the sector has the potential to grow even more. "I think it can get a lot bigger," states Craig Tomlinson, senior director of Stan Johnson Co. He says this potential is helping the sector retain its niche status, although it can't grow more than 5% and still be considered a niche. "The overall market for single-tenant net lease today as tracked by Real Capital Analytics shows it has a sales volume of around $7 billion a quarter, or $28 billion a year. But it's still in terms of overall commercial real estate in the single digits—less than 10% of all commercial real estate. The real question becomes, where does this supply of assets come from to be traded?"

Tomlinson says that there are only three ways for additional net lease assets to come to market: 1. New buildings get built that are then net leased; 2. Existing buildings are sold and leased back; 3. Third-party developers build a building that the user doesn't own from the start. "These are the only three ways to drive business in our field, and I would assume the third-party developer business would be the smallest piece of the pie for 2014. You can't force that type of transaction. Most are driven by the economy and new businesses wanting to use real estate but not wanting to own it."

Tomlinson adds that retail transactions comprise the majority of net lease deals he describes above, and the Boulder Group's report states that net-leased retail assets continue to be at the forefront of investor demand as evinced by their premium over the entire net lease market. According to the firm, retail property cap rates in 2013 represented a 55- and 130-basis-point premium over office and industrial properties, respectively, and the spread between closed and asking cap rates for retail increased 12 bps in the fourth quarter of 2013 when compared to the previous quarter. It was the first time since the first quarter of 2013 that the spread had not declined.

NEW SUBCATEGORIES

As the sector has grown, categories have changed, and some experts say new ones are emerging. Regarding these changes, Kay says, "We see new net lease property types developing including gaming, hospitality and other special purpose real estate assets. We expect to use the expertise we have in our divisions—namely, restaurants, retail, warehouse and office, industrial and build-to-suit—to explore established net lease segments and emerging ones as well. Additionally, we believe we will see more investment-grade and credit-worthy corporate tenants participating in large sale-leaseback transactions with leading net lease landlords like us, driven by a search for low-cost capital to fund business growth during this next stage of economic recovery."

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Mavoides says the net lease space has historically been defined by sector of subcategory specialist. "In the past, there were small subcategory specialists such as a movie-theater REIT, a convenience store REIT, a timber REIT, an auto dealership REIT and a restaurant REIT. Now that the space is larger and more mature, I would expect to see the large participants become more diverse and invest across a wide spectrum. So, instead of subsectors being serviced by a few focused niche players, the market will be more broadly invested by larger, more diverse players. I do not see any specific sector that isn't being serviced emerging as a new investment opportunity."

Hipp agrees that his firm can't name any completely "new" subcategories in the net lease sector, "but there have been lots of changes in the categories. Big boxes have begun a trend of downsizing their properties with a focus on smaller store structures. Dollar stores continue to be very popular and are proving to have staying power after their recent store expansion campaigns. With the rise of online banking, we expect to see fewer brick & mortar branches. Overall, there has also been a trend toward urban development for new locations—including tenants you wouldn't expect such as Walmart and Costco."

As global transactions increase in all sectors, Sabatini points out that one of the growing categories within net lease is transactions outside the US. "We have continued to see growth in Europe, where we have been active for more than 15 years and where the awareness of net lease financing is growing, and more companies and property owners see it as a financing or exit strategy. We are also building up our local expertise in Asia and South America and, consistent with the development of our strategy in Europe, we are investing on a conservative basis as we get more comfortable with local customs, regulations, taxes and exchange-rate risk-management issues."

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SEAN O'SHEA, BRC ADVISORS

O'Shea maintains that there is more differentiation being evidenced in the net lease realm, particularly in the medical real estate arena. "Aside from the traditional 'investment-grade credit' and 'below investment grade,' we see a surge in medical-related space users, whether urgent care or dialysis operations, as well as traditional medical-space users clustered around major regional medical centers."

He adds that his firm sees ethnic categories with a strong surge of Hispanic grocers and specialty users. "It's the same with Asian submarkets—not just California, but throughout the country. In the drugstore sector, not only are not all drugstores equal, but even within certain chains you will find NN Walgreens and NNN Walgreens. And the debt solutions available subject to lease terms varying from 20-25 years further differentiate these assets within the net lease niche. “

EXPECTATIONS FOR 2014

Several experts note that lease terms for net-lease transactions are getting shorter. “Going forward, successful net lease investors must have expertise in evaluating not only the tenant’s credit, but also the real estate from the perspective of the future needs of the tenant as well as a potential repositioning of the asset in the market,” says Sabatini.

He adds that rising interest rates should continue to push cap rates upward. “I would also expect the small premium which has been factored into build-to-suit pricing to increase substantially, especially on projects with build periods in excess of 12 months.”

O’Shea anticipates the competition for net lease assets to grow even fiercer. “Smaller investors find themselves competing not just with the apartment owner down the street, but because of our global economy, competing with Chinese investors, who have different investment methods than Americans. They used to say they don’t want anything less than an 8% return, but you’re now competing with people who find 2-3% completely acceptable. This is a once-in-a-generation market for sellers.”

While the base of capital sources is expanding, so are the numbers of potential buyers, O’Shea points out. “So we don’t only have traditional investors, but net lease REITs’ emergence. Going back to the first part of last year, there were roughly $15 billion of transactions and half of them were acquired by the four largest public REITs. So the language is that if we acknowledge that we have a shrinking pie, it’s being half eaten by the public REITs.”

Mavoides says he believes the sector will continue to perform relatively well in 2014, relative to the broader market. “While we will face continued headwinds from the threat of rising interest rates, I believe the continued consolidation opportunities, the growing appreciation and acceptance of the space, and the seasoning and continued performance of new market participants like Spirit will outweigh those headwinds to drive continued shareholder value. Even with an expected moderate increase, interest rates will still be low by historical standards. The category still offers yield in a world where yield is hard to come by, and until that drastically changes, I expect the net lease category to continue to prosper.”

Hipp adds that he expects investment activity to remain high and more construction to take place. “Financing will also remain relatively easy for investors to obtain, despite the increase in interest rates. It should also be noted that even with the increase in interest rates, they will still remain at historic lows.”

Tomlinson comments that the sector should grow modestly this year, although “it’s going to be challenged by the lack of product being pervasive. But we’ll probably see the resale of existing properties, new properties in construction and more sale/leasebacks.”

O’Shea concludes that the question his firm asks itself on a daily basis is, “Will the NNN marketplace begin to assign risk-adjusted returns based on historical location/tenant-credit criteria vs. the panic to chase yield in the face of inventory shortages, or will the supply/demand issues rule? We’ll see.” ◆

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