A Class Of Its Own

New players make the net lease sector a crowded, but congenial, market.

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Randall Shearin

EXP Realty Advisors sold this CVS/pharmacy in Austin, Texas, in July 2013 to a local 1031 exchange buyer. The property was well located and sold for a 5.2 percent cap rate.

The single tenant net lease retail sector continues to be on a growth path. As the most active area of retail — by number of transactions — the sector is also growing by number of investors and the size of investors. Traditionally known as an area filled with individual investors, large equity players now dominate the industry — a dramatic change from a decade ago, when there were only a handful of large companies in the space. Today, large equity vehicles that buy net lease properties are some of the most prolific real estate investment trusts (REITs), and they show no signs of slowing down.

"In three to five years, net lease is probably going to be a $100 billion-plus sector within the REIT space," says Guy Ponticello, managing director with Jones Lang LaSalle. "That has put pressure on a lot of the other buyers."

Well capitalized individual buyers are still competing with institutions for top assets, but many mid-size and lesser capitalized buyers seeking yields have changed their criteria over the past few years by acquiring assets with shorter lease terms or in secondary and tertiary markets.

While the current economy bodes well for the net lease sector, velocity in the industry is dependent on interest rates. With a direct effect on cap rates, interest rates are one of the largest controlling factors on yields when cap rates are at all-time lows.

"What happens with interest rates in the next six to 12 months, will play a major factor in what gets done and what gets taken to the market," says Jonathan Hipp, president of Reston, Va.-based Calkain Cos.

Larger Players

One noticeable change in the industry over the past five years has been the creation of many equity vehicles, including REITs, which are well capitalized and can easily buy top credit properties in top locations at top dollar. The REITs have really pushed net lease to the forefront of the investment community, serving as

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NET LEASE SECTOR	OCT 2013	NOV 2013
All Retail	7.29%	6.93%
Bank	5.97%	5.89%
QSR	7.00%	6.69%
Restaurant	7.23%	7.09%
Pharmacy	6.92%	6.06%
Dollar Store	7.96%	7.67%
C- Store	6.60%	6.23%
Automotive	7.46%	7.25%

Source: Calkain Cos. Research

an alternative to bonds and other stable investments that offer a consistent return.

"Net lease has become its own asset class," says Jason Fox, co-head of global investments for W. P. Carey. "There are a lot of public companies like W. P. Carey; we have seen a lot of new entrants as well. This is a bond-like investment; the differences are really for the positive. The investments have increasing cash flows. You are also holding a hard asset that has value in the end."

The pending acquisition of Cole Real Estate Investments by American Realty Capital will create an entity that has $27 billion in enterprise value. The resulting company will be the largest owner of single tenant assets in the United States, and it will be 64 percent larger than the next largest net lease REIT. Moreover, the resulting REIT will become one of the 15 largest REITs by equity capitalization.

"This will be the largest REIT merger in any sector over the last few years," says Ponticello. "[The merger] creates a focus on the net lease sector within the overall REIT world. The sector is now being covered by a more consistent fashion by the REIT analysts."

More than their impact on the REIT universe, large cap REIT funds allow everyday investors to own stock in net lease properties. They are an easy entrance to real estate for many investors.

Cole Real Estate Investments was the third largest buyer of single-tenant retail properties over the past 24 months, according to Real Capital Analytics. The Phoenix-based company likes to acquire real estate with credit-worthy tenants in long-term leases, according to Brian Garrigan, Cole's vice president of acquisitions – single tenant retail.

"Traditionally, we seek brand name, necessity retail and services, including pharmacies, grocery stores, home improvement stores, dollar stores, national superstores, restaurants and other leading regional retailers," says Garrigan. "We are able to pursue opportunities across the United States in major markets, as well as strategic secondary and tertiary markets that meet our criteria."

W. P. Carey has been an active buyer of net lease retail properties in Europe for a

COLE REAL ESTATE INVESTMENTS, INC.

Brian Garrigan, Vice President, Acquisitions – Single-Tenant Retail

Who are your primary buyers and sellers for net lease properties?
We saw consistent transaction activity from both private and institutional sellers, as well as an increase in activity from merchant builders, during 2013. As for buyers, there continues to be strong demand for high-quality net lease assets from institutional, private and foreign capital.

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?
During 2013, cap rates continued to compress, forcing all commercial real estate investors to refine their investment strategies. At the same time, the historically low cost of debt and limited investment alternatives have allowed demand to remain strong. We are still seeing a consistent supply of high quality assets, particularly assets under $3 million — both individually and amassed in portfolios.

How would you describe the climate in the net lease retail sector over the last five years?
The net lease sector has experienced tremendous popularity during the past five years. Five years ago lenders were on the sidelines, making permanent debt difficult to find for developers. As a result, cap rates were significantly higher than they are today. More recently, we find ourselves in a more efficient market where debt and equity are much more available and relatively inexpensive by historical standards. Demand has increased, driving cap rates lower and values upward, but the spread between cap rates and interest rates remains healthy.

What is your outlook for 2014 in the net lease retail sector?
While economic growth remains moderate, real estate fundamentals are improving due to strengthening demand and a historic lack of new construction. At Cole, we will continue to invest in necessity-based, net-leased retail, office and industrial properties leased long-term to creditworthy tenants.

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CALKAIN COMPANIES

David Sobelman, Executive Vice President and Managing Partner

Who are your primary buyers and sellers for net lease properties?
Calkain has the most diverse clientele within the net lease investment industry. There are countless numbers of clients from all corners of the globe that work exclusively with Calkain and its advisers. In 2013 alone, buyers have been procured from seven countries outside of the US and from over 30 different US States. The fact that Calkain is able to go outside of the usual investor pool for assets completely sets it apart from all of their competition. Additionally, sellers that work with Calkain benefit from the vast array of buyers that are brought to the negotiation "table." In the words of a well-known triple net REIT at one of their annual acquisition meetings it was said that "**it is difficult to buy assets from Calkain because the cap rates they ask for their clients are too low for us...and they get them.**" Calkain sees that quote as the ultimate compliment!

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?
All buyers are challenged to find assets in today's market. However, what Calkain has identified is the fact that there as many investors as there are strategies to purchase net leased properties. With a shortage of new construction investments available, both institutions and individual investors are forced to become more creative and entrepreneurial in an effort to find value within any one asset. Calkain is seeing new efforts to purchase net lease assets that will provide a return on a short term basis as well as very long term holds. In either case, there is still opportunity, as long as you have the right team in place to execute.

What is your outlook for 2014 in the net lease retail sector?
Calkain is forecasting a year of strong economic fundamentals that will lend itself well to the net lease investment market. We see cap rates stabilizing in the short term and allowing for interest rates to make their long-awaited increase. Most likely, we'll see a shift in pricing, increase in cap rates, by the third quarter of 2014 but not in a drastic sense. All in all, 2014 will still be a great opportunity for both buyers and sellers to invest given the lack of options in other investment vehicles.

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number of years. The company acquires net lease properties by strong European retailers like Agrokor, a Croatian food retailer.

"There is fewer retail square footage per capita in Europe than in the U.S., so there is more inherent long-term value of retail in Europe," says Fox. "There is also a less developed market for commodity-driven net lease assets."

Due to the less competitive environment, yields are stronger in Europe, especially on large portfolio transactions, says Fox. W. P. Carey also concentrates on portfolios because it doesn't want to get into competition on single assets.

"For us, doing one-off retail and competing with 1031 buyers is not that interesting for us; we can do larger portfolios and put some more money to work. We get economies of scale by acquiring larger portfolios," says Fox.

Inland Real Estate Acquisitions (IREA) is one of the larger players in the industry, having purchased more than $11 billion of single tenant net lease properties over the past 10 years. The company has a variety of properties it searches for, says Vice Chairman Joe Cosenza, who estimates that the company will acquire north of $2 billion of net lease assets in 2014. The company buys large — it recently acquired 12 7-Eleven stores and was in the process of acquiring a portfolio of 72 drug stores at press time.

While many buy other funds or merge, Inland Real Estate Acquisitions has chosen to build its portfolio property-by-property, occasionally buying portfolios. This process is intricate when buying the volume that IREA does. Cosenza says that is aided by the fact that IREA's reputation is such that about 50 percent of deals come directly from the sellers. About 25 percent of deals come through advisors and brokers who seek Inland as a potential buyer.

"We only buy what we want to buy," says Cosenza. "If that takes us seeking out all of these sellers, or all the representatives of these sellers, and dealing with them individually, we are doing it."

The larger players have undoubtedly set the bar for the industry, and changed what other investors can buy.

"Because the large players have a low cost capital, they can acquire for all-cash," says Ricky Novak, CEO of Atlanta-based Strategic Exchange Advisors. "As those groups raise more money and have to deploy it, they are buying more and more of the quality assets. That has pushed others down to the lower-quality assets."

Changed industry

While the big guys have changed the way investors might approach the industry, they are also changing the way the industry and new investors view it.

"Net lease has come of age; it is a recognized asset class now," says Gordon Whiting, managing director of Angelo, Gordon & Co. "Twenty years ago, I spent two-thirds of my time educating CEOs and CFOs as to what a sale-leaseback was and why it would be a benefit to them. Today, everyone understands the economics of it."

The growth in recognition comes at a strange time for the sector: Many in the industry say that the volume of development of single-tenant net lease retail buildings is about 25 percent of what it was five years ago. The constrained supply in a period of intense demand has changed the market for many who have been in it a long time.

"'Resource scarcity' is the new catchphrase in the net lease business," says

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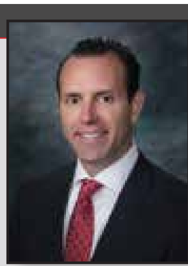

Maurice Nieman, Senior Vice President   Ian Schroeder, Senior Vice President

Who are your primary buyers and sellers for net lease properties?
Our primary sellers are developers and large institutions, and our primary buyers are high net worth individual as well as some institutions. Our main business involves us taking assets owned by institutions and moving them to the private client market, which allows us to achieve the maximum valuation for the assets that we sell

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors?
We have not found it to be difficult to find properties for individual investors, as institutions are often constrained by their rigid criteria of what they want to and are able to buy. Individual investors have a higher tolerance for risk which allows them much more flexibility.

Have individual buyers had to change their standards?
As there is more competition in the market for desirable assets, individual buyers must be able to move fast, be agile, and have in-place banking relationships if they are leveraging assets.

How would you describe the climate in the net lease retail sector over the last five years?
In the past five years, the sector has been building and we believe that it is currently overheated. Today, CAP rates have hit an all-time low and the market has become frothy. As long as interest rates remain low, we do not forsee a significant change in this climate over the next year or two.

What is your outlook for 2014 in the net lease retail sector?
In 2014, the sector will continue to be robust and we anticipate more transactional volume. There should be new inventory in the market as developers across the country are busy filling their pipelines again.

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Upland Real Estate sold this Gander Mountain location in Lubbock, Texas, for $9.8 million in 2013.

Sean O'Shea, managing director of the net lease group at Los Angeles-based BRC Advisors. "It is the result of historically low debt rates, which support historically low cap rates. When you factor in the lack of supply, the net result is a scarcity of product."

The scarcity has increased velocity for many brokers, who are finding new buyers and sourcing new sellers in many new markets. Tulsa, Okla.-based Stan Johnson Co. has seen opportunity in the market; over the past few years, the company has opened several offices nationwide, the latest in Atlanta, to pursue activity in the Southeast market. The company represents a lot of developers selling into the market.

The new activity in the market has also adjusted the way that assets are priced when they come to the market. Because of the sheer number of deals that the larger players are doing, and the critical timing of buyers in 1031 exchanges, brokers know that they usually only have one chance for a buyer to consider a property — and that the price must be right.

Hipp says Calkain advises its clients selling properties to price them right for the market the first time. Many sellers who don't get hits when a property


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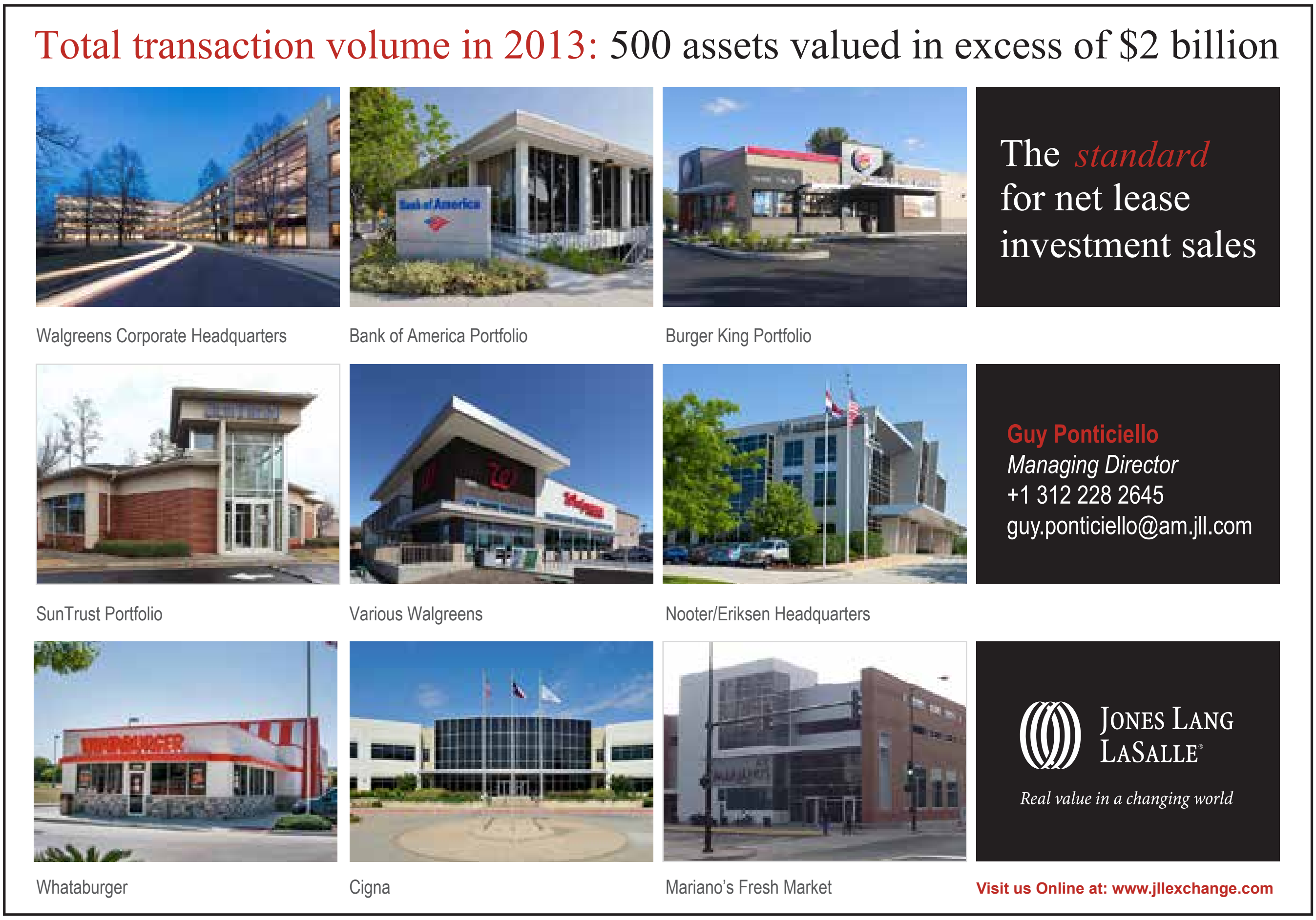
Total transaction volume in 2013: 500 assets valued in excess of $2 billion
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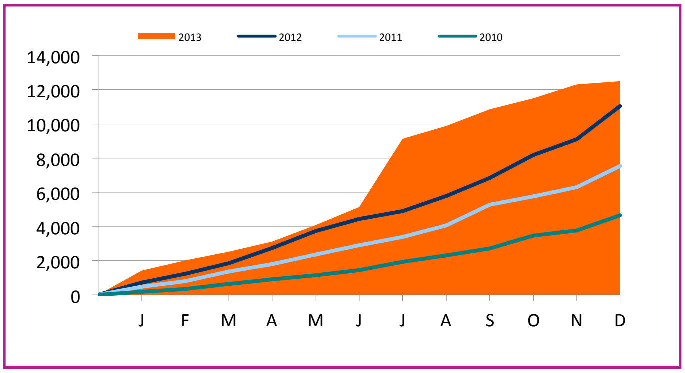
CUMULATIVE MONTHLY SALES VOLUME, 2010-2013

SINGLE TENANT RETAIL NET LEASE SALES



Source: Real Capital Analytics

is marketed often suffer from no interest when it is repriced lower and remarketed; buyers often see the property and not the changed price. Recently, buyers have tended to chase deals when price isn't fully defined or details not fully thought out.

"When a buyer senses that a seller is getting unrealistic about pricing, they lose their patience and develop deal fatigue," says Hipp. "Buyers are quicker to cut bait today than to stay and try to make a deal."

Similarly, Keith Sturm, principal with the net lease group of Minneapolis-based Upland Real Estate Group, says that his firm advises clients to price properties correctly to fit the needs of many buyers, so they are attractive when they hit the market.

"We like to price properties close to what we think the actual sales price is versus overpricing product and seeing if there is a single buyer who will fit that price," says Sturm. "In the sector, the buyers, brokers and sellers are getting more educated as far as where pricing should be."

For sellers, timing is always a factor. The fear that interest rates may change and affect the buyer's ability to close is at the forefront of an exit strategy.

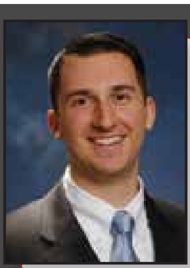
"Right now, sellers see that cap rates may move higher next year, so if they are going to get deals done, they may realize lower prices," says Hipp. "In deals of $15 million-plus, cap rate is becoming more of an issue because debt is increasing. The buyer pool just isn't as big."

Buyers and Sellers

Some in the industry say that the increased presence of the large players has created a trickle-down theory over the past few years. Large institutional investors and well capitalized private investors can still acquire top properties in top markets, but others — who used to be able to afford those properties — have now been pressed to pay up or change their criteria to achieve desired yields.

"There's no question that there's been a trickle effect," says Ponticello. "Investors are having to look beyond your traditional commodity of single tenant deals in the retail sector like banks and drug stores. They are going into niches like automotive companies and properties in secondary and tertiary markets to get their returns."

The market for deals less than $10 mil-



THOMAS COMPANY
NET LEASE CAPITAL MARKETS

Adam Christoffersen

Jeffrey Thomas

Who are your primary buyers and sellers for net lease properties?
We represent and transact with a wide variety of market participants, including public and private REITs, life companies, equity funds, developers, high net worth individuals, family offices and others. We've also been very active in the sale-leaseback arena and have represented various corporate owners of real estate, both publicly and privately held. In general, we have represented any imaginable owner of single-tenant net leased investments.

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?
The institutions currently have a veracious appetite for net leased investments. The increased institutional demand has been primarily focused on "core" assets, those leased to investment grade tenants with more than 10 years of remaining lease term. These assets are now harder to find, but they are by no means impossible to source. In 2013 we transacted on about 30 drug stores, a Home Depot and about 800,000 square feet of single tenant class-A office, most of which sold to private capital. So, while the institutions are highly active, private investors are still finding success in today's market. It's really just a matter of having the relationships with owners and a deep understanding of what investors want.

In regard to individual investors changing their standards, we believe their standards are always changing. Currently there's a disproportionate focus on core assets, so the scarcity in that subsector is pushing cap rates lower. We see some individual investors choosing to accept lower yields and in other cases taking on more risk. However, individual investors do not appear to have a dramatically increased appetite for risk.

What is your outlook for 2014 in the net lease retail sector?
We often look at the spread between cap rates and the treasuries as one indicator of where the market may be headed. The market generally becomes more susceptible to a correction when the spread narrows, which often results in a build-up of supply, the first indicator of a slowdown. At this point, however, the spread is still wider than levels seen over the past 10 years and inventory remains historically low, indicating that the market may have room to absorb a slight increase in interest rates or additional cap rate compression. Consensus estimates are predicting that interest rates will rise in 2014. One Bloomberg survey predicts that the 10-Year Treasury will climb to 3.41% in 2014, or approximately 60 basis points above where it is today. We feel that the market can absorb this increase without affecting cap rates. We expect to see continued scarcity of core assets and additional M&A within the sector. Yield hungry private investors will continue to gradually move up the risk curve. Our outlook is for another very active year.

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lion is still driven largely by the private investor market, say brokers.

"The smaller buyers have the ability to pay more aggressive pricing in some cases because they don't have the yield requirements," says Alvin Mansour, senior director of Marcus & Millichap's National Retail Group. "The private buyers are able to play in the same space [as the larger entities]. Once you get over $8 million, the institutional buyers are really stepping up right now."

"It's not that the REITs are crowding out everyone else, but based on their capital needs, they are focused on the larger transactions and cap rates that are accretive to their dividends," adds Ponticello. "That means that private investors can still play in the sub-$20 million space. However, that space has gotten extremely competitive."

The addition of many new players to the net lease sector has created a frenzy when it comes time to sell a property. Many properties are privately marketed to a select group of qualified buyers before — if need be — they are mass marketed. Investment sales executives say this is the way the industry has evolved, simply because of supply and demand. They are able to tailor the asset to the correct buyer, often.

"We have entered a new era, where there is demand from many different buyer pools," says Jereme Snyder, executive vice president in the Irvine, Calif., office of Colliers International. "There are a lot of people fishing in a very small pond."

There are three major factors in pricing, say many investment sales brokers: lease terms (including length and actual legal terms like cancellation clauses); location of the property; and the tenant's credit.

"We look at those three factors and then determine what the value of the property is," says Sturm. "Then, buyers look at the alternative properties and determine the value of the individual property to them. Pricing-wise, our sector is good at coming up with a range that works. The real difference lies in how important a buyer or seller thinks their particular location is."

Buyers who were used to acquiring top properties have moved on. They are getting comfortable with assets in secondary and tertiary markets, as well as net lease properties with lower credit tenants.

"Investors are going to tertiary markets, chasing yields," says Rob James, president of New York City-based EXP Realty Advisors. "Investors who have higher yield targets as a result of a higher cost of capital are priced out of A-quality product. Instead, they are buying tenants that are not credit rated, non-public, or tertiary markets to achieve higher yields and deploy their money."

Location has become less of a factor to some buyers, who still want credit. For other buyers, they simply want a net lease and will go for the risk of lesser credit, lesser location.

"It used to be that buyers only wanted top credit, no matter the market," says Novak. "Now, we are seeing net lease deals get snapped up regardless of their location. We are seeing some people make decisions based on the cash flow, not the underlying real estate. As you start getting into the C class assets, you are really taking on a lot of risk."

Another reason the single tenant net lease sector has gotten crowded is that retail sales — especially among commodity- and needs-based retailers — have picked up.

"Retail is coming back in popularity," says Novak. "We are seeing more inves-

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NET LEASE ALLIANCE

C. Patrick Cox, President and Chief Executive Officer

Who are your primary buyers and sellers for net lease properties?
We continue to see a relatively healthy mix of institutional and individual buyers. The mix has shown somewhat of a migration to the institutional side, but it has not been dramatic. Those individual investors are the traditional 1031 buyers, as well as first time buyers who are making the decision based on risk and wealth preservation influences. In regards to our institutional buyers, it's all the names so prevalent across the industry, but there are also numerous, and relatively large, private REITs as well.

Geographically, where are you seeing properties trade?
Relative to historical norms, we have not seen any seismic shifts in geographical preferences or prejudices. One exception we have seen are buyers becoming more comfortable with secondary and tertiary markets. Other than that, California is still a market onto its own, and perhaps the Rust Belt continues to cause some pause, but the fundamentals of the net lease sector continue on. Those "core" fundamentals cause almost all players in the project life-cycle (developers, capital partners, banks, and buyers) to evaluate and weigh the credit risk and operating history more so than the real estate itself.

How would you describe the climate in the net lease retail sector over the last five years?
Steady. Certainly cap rates and velocity have ebbed and flowed a bit; however, as a sector it weathered the Great Recession better than any other CRE group. The volatility in other sectors was extreme and, at times, devastating. Conversely, in the net lease sector, a sense of calm prevailed and was followed by (and continues in) a period of opportunity.

What is your outlook for 2014 in the net lease retail sector?
Simply put, the velocity of the net lease retail sector in the next 12 months will revolve around two things: tenants and interest rates. Every new project is always an orchestrated "dance" of timing, tenants, and capital. That dance now has more tenants clearly wanting to participate, but at what price? How will developers and capital sources anticipate interest and cap rate shifts, and will tenants still be willing to expand if rent needs a corresponding increase? With that said, the liquidity and demand in the sector will most likely allow some smoothing of any dislocations caused by interest rate concerns or outright volatility.

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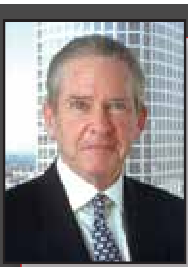

THE O'SHEA NET LEASE ADVISORY OF BRC ADVISORS

Sean O'Shea, Managing Director

Who are your primary buyers and sellers for net lease properties?
We are seeing a tidal wave of 1031 executions since sellers are achieving historical cap rates for their transactions. Finding them suitable replacement properties is the challenge in the face of "resource scarcity" in all NNN sectors. Capital coming from foreign investors, public and private REITs with their lower cost of capital; and private investors who are struggling to compete.

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?
We have stated in our mission statement from day one, that we wanted to 'craft client-specific NNN solutions.' In this market, foreign buyers have their own metrics for safety, security, as well as 'yield' in acquiring hard assets. The REITs have their stipulated or target coupon, depending on sector; it's the private investors who are continually forced to recalibrate their expected discount rate based on actual availability and their ability to execute and secure these scarce NNN assets.

Geographically, where are you seeing properties trade?
Strong stated preferences for tax-free states (getting fewer due to budgetary problems and states looking for new revenues); primary and major markets, as always; but we look for opportunities for 'best-of-breed' NNN wherever we can identify them. Not all NNN assets are alike, even within the same tenant inventories across the country. Residual valuation more critical.

What is your outlook for 2014 in the net lease retail sector?
Interest rates and cap rates stabilized; best of breed NNN properties are short supply.

Advertorial

Camping World is one of a number of retailers who have become attractive to net lease investors. Upland sold a Camping World location in Flagstaff, Ariz., in 2013 for $7.2 million (prototype store pictured).

tors look at retail as an option, so more dollars are looking to flow into retail. With high net worth individuals who are looking at real estate, net lease retail is probably the easiest asset class for them to get their arms around."

Brokers say that many entering the sector are often well educated, but may still be unfamiliar with the intricacies of net lease properties, particularly the real estate side and the debt.

"There are a few [individual] buyers who suffer from sticker shock when they go to their lenders," says O'Shea. "People who are chasing yield almost have to do that on a cash basis. To get the best rates, you have to be at a 50 to 60 percent leverage range. Real estate is still a good investment, but it is a long-term play. You can get comparative returns on real estate, even with low cap rates, but depending on how you finance it, you can't just turn around and sell it at 9 a.m. tomorrow like you can a stock."

Still, many say that net lease properties are no longer an alternative to stable, market-based investments like bonds, but a comparable substitute.

"Net lease buyers are flocking to safety and security," says Snyder.

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ENVOY NET LEASE PARTNERS, LLC

Ralph N. Cram

Who are your primary buyers and sellers for net lease properties?

Envoy's primary buyers fall into two main groups: 1) high-net-worth individuals for net lease properties under $5mm and 2) institutional buyers such as net lease REITs for properties or portfolios over $10mm. As an equity JV partner and construction lender we also see the long term debt market — both credit tenant lease and CMBS execution — as a competitor for the supply of new net lease properties.

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?

The advent of large net lease REITs, internet listings and specialized net lease brokerage firms since the early 2000s has made the net lease market very efficient. Today, the individual net lease buyer is a price taker with little room on most net lease transactions to negotiate price or terms. Also, the REITS are now pushing the one-off, high-net-worth investor out of the running for investment grade net lease properties and forcing them to lower their tenant credit standards or purchase specialty purpose properties like restaurants or daycare centers. These days, individual investors who want to avoid taking on additional risk have focused on purchasing investment grade properties with lower yields that REITs won't touch, like investment-grade ground leases with McDonalds, Chase Bank and others.

What is your outlook for 2014 in the net lease retail sector?

Our crystal ball is still cloudy, but overall we think 2014 will be better as more new properties come to market — though we doubt there will be enough new supply to change pricing for Class A net lease properties. Looking at the near horizon, we think the greatest impact for the net lease retail sector is likely to be higher interest rates, which will affect pricing the most for lower quality net lease properties and larger net lease properties dependent on longer term, fixed rate debt financing. REIT's minimum cap rates will also rise in tandem as their cost of capital increases. Yet net lease REITs still have a lot of money to invest so that will put a floor under pricing.

On the property supply side, the concern is customer disposable income growth. Earlier in 2013, retailers turned cautious when disposable income took a hit from the increase in social security withholdings. This year, retailers will be concern with the impact of increased health care premiums and deductibles will have on customers' disposable income. Stay tuned as we have another year driven by what happens in Washington, D.C.

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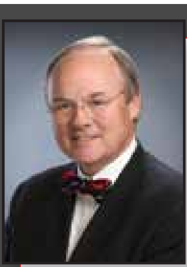

STORE Capital

Christopher H. Volk, Chief Executive Officer

Who are your primary buyers and sellers for net lease properties?
We are a buyer, a long-term principal investor and the leading company in the US engaged in net lease investments for middle market single tenant operational real estate (which is what STORE stands for). Our customers (the sellers) are middle market companies that employ real estate in their businesses and who are engaged in retail, service and distribution activities nation-wide.

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?
The total enterprise value of the publicly-traded net lease companies has grown meaningfully over the past few years, but still stands at just about $40 billion. To put this in context, that is less than 2% of the available market, making us still very much in the early phase of this institutionalization. And, on any given day, there are probably $10 billion in listed assets that are visible on the internet. So, individual buyers have a lot to choose from. As a fluid market, relative investment values move frequently, so astute investors are constantly looking to alter their investment horizons as they feel appropriate.

Geographically, where are you seeing properties trade?
We do business nationally and are engaged in fee simple assets, most of those free-standing. So, over thirty years, we have done business in about every state, but will tend to have more activity in suburban, rather than urban, markets. That would often place us throughout the Midwest and sunbelt states.

How would you describe the climate in the net lease retail sector over the last five years?
Well, 2008-2010 was clearly a time of capital contraction, with lease rated higher as a result. Between 2010 and today, capital has returned to the market, though the "great recession" left resultant risk-averse investors with a preferred taste for investment-grade tenants. As to the middle market companies, we have generally seen normalized average going in lease rates range between 7.5% and 9% over the past twenty years, which is still the case today.

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"The stock market is rallying, but that is a world where you are not sure what you're buying," says Bill Rose, national director of Marcus & Millichap's National Retail Group. "Net lease properties have residual value when the leases mature. People who own real estate are active investors; that's why this business will always remain strong."

New Subsector

With the trickle-down theory of property, many investors have discovered a new market: purchasing well-located, strong credit tenanted net lease properties that have shorter lease terms. Often, these properties are under 10 years old, but the eroding lease term makes them attractive to some buyers, who want to take a risk that the location is the property's best asset.

Joey Odom, principal at Stan Johnson Co., has seen this trend first-hand. A Walgreens in Seattle that he sold in 2010 at a 7.6 percent cap rate just sold again at a 5.95 percent cap rate.

"You see a lot of second-generation product trading hands because cap rates make a lot of sense for owners of top properties to sell now," says Odom. "Because cap rates are so low, a lot of institutions are not buying the newer product; they are letting the 1031 investors pay the lower cap rates. Instead of looking for a Walgreens with 25 years left, they will find a Walgreens with 15 years left and get a little bit higher cap rate in exchange for a little less lease term."

"There are investors who are focused on properties with shorter leases because they can achieve a better yield," adds Ponticello.

This dovetails with the efforts of many net lease investors, who don't like to hold the properties through the end of the lease term.

"We advise our clients to sell their properties while they still have 10 years or more of remaining lease term," says James. "Our experience has been that prices go down as the lease term erodes past 10 years. That mostly has to do with the debt that is available for properties with lesser lease terms."

There are also companies in this realm who will, once a property is under contract, approach the retailer about extending the lease. If negotiations are successful, the buyers have already increased the value by the time they get to the closing table.

The market for properties with shorter lease terms is strong, but since less debt is available and the risk is higher, many buyers are willing to take a chance.

"A lot of the product we have seen the past couple years has been existing assets from owners who bought three years ago. There has been significant cap rate compression, and the lease terms they have are still viable," says Ponticello.

Investors who look at this market are banking on the future. The first option with this is that the current tenant renews at a higher rent. The second gamble is that they must rely on the fact that the real estate is so strong that, should the current tenant leave upon lease expiration, they can secure a new tenant at a higher rent.

"There's less competition, but still robust demand," says James. "People are starting to get comfortable with shorter remaining lease terms if they are sophisticated investors. The buyer has to have a grasp of the store's performance and the quality of the real estate must give the store decent prospects for redevelopment in the event that the tenant left."

"The benchmark for the net lease market is really the 10-year Treasury rate,"

TOP SELLERS OF SINGLE-TENANT RETAIL PROPERTIES
(PRIOR 24 MONTHS)

TOP SELLERS (prior 24 months)

Rank	Seller	Location	Disp $ (mil)	# Props	Avg Price $ (mil)	Total Global Disp $ (mil)	# Props
1	Cole RE Investments	Phoenix, AZ	3,476.3	325	10.7	8,315.3	425
2	AR Capital Trust	New York, NY	899.6	302	3.0	2,679.4	516
3	CVS	Woonsocket, RI	501.4	101	5.0	4,717.7	1,184
4	WP Carey	New York, NY	464.7	38	12.2	6,103.5	427
5	Inland Real Estate Group	Oak Brook, IL	440.5	224	2.0	12,898.9	1,049
6	Sears Holding Corporation	Hoffman Estates, IL	316.2	16	19.8	1,189.3	53
7	BJ's Wholesale Club	Natick, MA	290.7	16	18.2	966.4	42
8	CVC Capital Partners	Luxembourg	283.5	15	18.9	312.7	16
9	Leonard Green & Partners	Los Angeles, CA	283.5	15	18.9	283.5	15
10	CapLease	New York, NY	270.4	13	20.8	2,193.7	62
11	Onassis Foundation	Athens, Greece	194.4	2	97.2	499.0	4
12	Retail Properties of America	Oak Brook, IL	193.2	21	9.2	753.1	51
13	Safeway Inc	Pleasanton, CA	179.9	19	9.5	1,090.1	80
14	KBS Realty Advisors	New York, NY	176.2	80	2.2	4,910.8	360
15	Walgreens	Deerfield, IL	158.3	28	5.7	781.8	144

Source: Real Capital Analytics

adds Jonathan Wolfe, principal of Chicago-based STREAM Capital Partners. "As investors see higher rates on the horizon, they will look for better lease structures, even if they are at shorter terms. Three years ago, everyone wanted 10 or more years on the lease; now there is more of an appetite for the right risk-adjusted return."

The trend is so prevalent that even larger companies are getting in on the act. Inland Real Estate Acquisitions is starting a fund to acquire properties with top locations, strong retailers, but with lease terms less than 10 years.

"We have the same standards with the properties that we do with properties that have 15- and 20-year leases," says Cosenza. "The real estate, to the best of our knowledge, has got to be just as good as the real estate that has a long-term lease, and you have to believe that if your tenant never renews, someone else will come into that property."

Retailers

The favored retail sectors for single tenant net lease investments continue to be high credit tenant drug stores, banks, dollar stores, big box retailers, auto parts retailers and quick service restaurants. Strong, A-rated retailers like McDonald's and Walgreens are trading at strong cap rates. Other strong retailers, including bank properties like those of Wells Fargo, Chase and Bank of America on new 15-year leases, are trading at extremely low cap rates. However, there are users like medical, convenience stores and grocery stores that have become popular with investors.

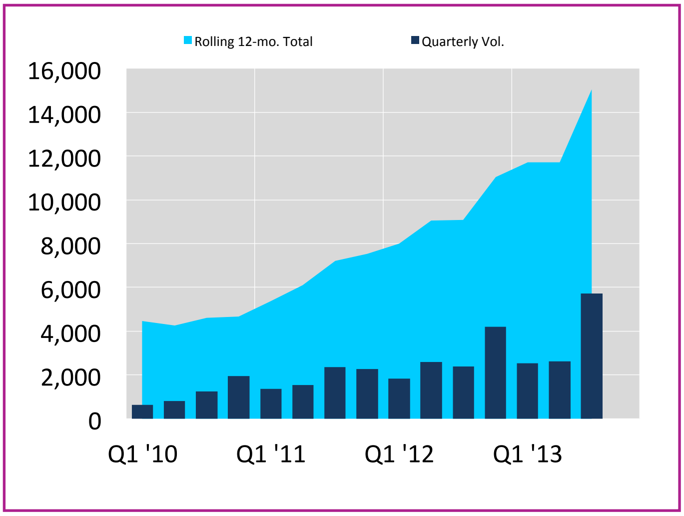
"At the end of the day, this business is always about location," says Rose. "If you are a private client and you are buying for yield, then you are going to have to go with a non-rated net lease property, but you make sure that you know the real estate. That way, when the lease matures, you have the opportunity for a new tenant at a higher rent."

Rob James of EXP says that drug retailers have also returned to the market somewhat, which has helped to ease supply. The company is selling 7-Elevens in the low 5 cap rate range.

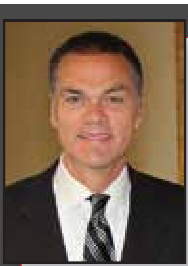
"Cap rates are moving down for tenants like Dollar General," says James. "Many tenants have grown to become investment

Article continues on page 68

SINGLE TENANT RETAIL NET LEASE SALES BY TOTAL DOLLARS
(MILLIONS)



Source: Real Capital Analytics



RED ROCK DEVELOPMENTS

William C. (Bill) Smith, Jr., Chief Executive Officer

Who are your primary buyers and sellers for net lease properties?
In the past 7-8 months, the universe of buyers has really opened up for us. Right now, our product garners interest from diverse set of investors including institutional investors, public and private REITs, 1031 exchange buyers and individual investors depending on the fundamentals of the underlying asset (e.g. tenant credit, lease term, location, etc.) and the size of the project.

With the increased institutionalization of the net lease sector, how difficult is it to find properties for individual investors? Have individual buyers had to change their standards?
As the competitive landscape has evolved and institutions have become a bigger part of the investment universe, the private or individual buyer has had to adapt and change their investment parameters to focus on non-core or secondary markets. We have expanded our strategy to accommodate these investors, so it has not been difficult for us to find properties for these investors in markets where institutions are not as eager to play.

Geographically, where are you seeing properties trade?
The southeast is growing due to retiring baby-boomers. It is interesting to note many retirees are settling into smaller towns that do not fit the traditional retirement community mold. As a result, many of our smaller towns are attracting retirees and retailers are following.

How would you describe the climate in the net lease retail sector over the last five years?
A lot has transpired over the past five years. Much like the broader economy, we saw a period of contraction where very few retailers were committed to expansion. Today, we are seeing retailers who weathered the economic downturn emerge more nimble and with stronger balance sheets. They are pursuing aggressive growth plans and looking to gain key market share through new development.

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TOP BUYERS OF SINGLE-TENANT RETAIL PROPERTIES
(PRIOR 24 MONTHS)

Rank	Buyer	Location	Acq $ (mil)	# Props	Avg Price $ (mil)	Total Global Acq $ (mil)	# Props
1	Spirit Realty Capital	Scottsdale, AZ	3,376.6	310	10.9	7,546.0	391
2	Realty Income Corp	Escondido, CA	1,748.3	432	4.0	5,326.7	930
3	Cole RE Investments	Phoenix, AZ	903.2	231	3.9	13,864.2	1,454
4	American Realty Capital	Jenkintown, PA	590.3	153	3.9	9,143.9	978
5	Inland Real Estate Group	Oak Brook, IL	485.1	100	4.9	27,682.1	1,789
6	National Retail Properties	Orlando, FL	469.9	175	2.7	1,775.7	436
7	WP Carey (REIT)	New York, NY	426.9	33	12.9	7,380.9	437
8	General Growth Properties	Chicago, IL	345.0	14	24.6	20,870.4	244
9	Jeff Sutton	New York, NY	308.5	5	61.7	2,652.4	42
10	Crown Acquisitions	New York, NY	302.8	5	60.6	4,022.5	36
11	ARCP	New York, NY	283.9	16	17.7	2,582.6	101
12	STORE Capital	Scottsdale, AZ	230.3	32	7.2	451.8	64
13	The Landes Group	Dallas, TX	222.5	45	4.9	1,851.3	420
14	Ladder Capital Finance	New York, NY	219.2	21	10.4	475.9	26
15	Thor Equities	New York, NY	212.6	4	53.1	4,649.9	80

Source: Real Capital Analytics

ANGELO, GORDON & CO.

Sale-Leaseback Financing

$105,047,230 **Headquarters** **$43,625,191** **Structured Parking** NYSE: GT	**$76,000,000**	**$158,600,000** NYSE: MOH	**CAD 54,000,000** An operating unit of IMP Group Limited
$39,990,499 a wholly-owned subsidiary of	**$57,000,000** NYSE: ED	**$30,008,000** A wholly owned susidiary of Liberty Media	**$31,216,041** A portfolio company of Cerberus
$45,000,000 NASDAQ: MAT	**$27,000,000** A portfolio company of Sterling Partners	**$26,448,321** A portfolio company of Oaktree Capital	**$18,200,000**

Sale-Leaseback Financing From AG Net Lease

AG Net Lease is actively seeking to invest in long-term, net-leased corporate real estate in the US and abroad in transactions ranging from $10 million to $300 million. AG Net Lease is seeking to purchase in excess of $500 million in real estate assets annually. We believe Angelo, Gordon's credit and real estate underwriting expertise ensures highly competitive pricing and speed of execution to tenants and sponsors.

Acquisitions Criteria

- Size: $10 - 300 million
- Location: North America and other established markets
- Lease term: 15 - 20 years, plus renewals
- Property Type: Industrial, office, retail, flex/R&D and special-use
- Tenant Credit: Rated and unrated
- Lease: Single tenant, triple net
- Additional: Build-to-suit and expansion

Contact Gordon J. Whiting, Portfolio Manager • 212-883-4157 • gwhiting@angelogordon.com
Angelo, Gordon & Co. • www.angelogordon.com/netlease

EXP Realty Advisors sold this Pollo Tropical in Ft. Myers, Fla., for $2.625 million in 2013. The sale was at a 6 percent cap rate.

grade. Once that happened for Dollar General, cap rates for those stores went down 100 basis points."

A brand new Walgreens with a 20-year lease will sell for a 5.75 percent cap rate, says Ponticello, who is marketing a new Walgreens in Southern California that he estimates will sell for a 5.25 percent cap rate.

Large buyers prefer tenants that have a needs-based consumer. Drug stores and banks are the most obvious in this category, but savvy investors are good at finding new categories of retailers who fit the bill. In addition to its 7-Eleven purchase, Inland Real Estate Acquisitions has also been acquiring Mariano's grocery stores around the Chicago area. The company has purchased several Pathmark grocery stores in New Jersey and New York as well, particularly ones with high sales volumes, says Cosenza. It also likes BJ's Wholesale.

Mansour, of Marcus & Millichap, has seen a lot of development activity from retailers like Walmart Neighborhood Market and from natural food grocery stores.

"We are also seeing a lot of growth and cap rate compression in the two-to-three tenant strip centers," says Mansour. "We will continue to see a lot of growth there in 2014. More buyers are stepping up in this area."

Another area where Mansour has seen expansion is net lease medical users, like urgent care centers. Many of these are second-generation space users. Discount retailers, like dollar stores, are another area of growth.

"Dollar General is a tenant who has consistently increased its credit rating, its net worth, and its profitability since we have been working them," says Inland's Cosenza.

"We are not seeing expansion in the mid-range retailers, but we are seeing expansion of the discount retailers," says O'Shea. "This is really reflective of the new economy."

Beyond retailers, small strip centers — so called convenience or service centers — with two to four tenants are also coming to market as triple net assets. Exp Realty Advisors was marketing a center with Panda Express, Slim Chickens and Elegant Nails in Arkansas at the time this article was written.

"Some of our buyers are okay with a two-tenant building," says James of EXP Realty Advisors. "If they are equipped for it, such as a family office who can do some property management, it works well."

1031 Activity on the Rise

Because of the popularity of other real estate sectors — most notably, multifamily — the increase of 1031 buyers who trade into net lease properties is on the rise. The 1031 like-kind exchange — part of the IRS tax code — allows sellers of property to re-invest the proceeds into a like property within 180 days. The trick of the 1031 has always been the timing, says Novak of Strategic Exchange Advisors.

"From the day you sell, you have 45 days to identify the new property," he says. "The minute a seller's property goes under contract, they are starting to look. As soon as earnest money goes hard on their sale, they are immediately trying to put the replacement property under contract. In this kind of net lease market, properties will go quickly. They are being very conscious of the timing."

That can sometimes lead to finding a property on the double, and paying a little more for it or trading certain wants for the need to close on time and avoid paying capital gains tax.

"The individual 1031 buyers have time constraints related to their exchange, and they are looking to fit a need," says Sturm. "Some buyers change their parameters, like location or return expectations, to work within their exchange requirements."

1031 exchanges continue to be a strong business line for many in the net lease industry.

"Half of our sales are due to individuals completing 1031 exchanges," says James. To facilitate that, EXP Realty Advisors has a co-brokerage model to help it identify 1031 buyers. The company was originally known as Kimco Exchange Place before splitting off into its own entity a few years ago. The company still valuates nearly every net lease property that Kimco has acquired over the past few years, says James, and it maintains a close relationship with the REIT regarding its net lease business.

"The only people beating the institutional investors on pricing are the 1031 exchange buyers," says James.

As an example of that, EXP sold a CVS/pharmacy in Austin, Texas, in July 2013 to a local 1031 exchange buyer. The property was well located and sold for a 5.2 percent cap rate, despite interest by a number of institutions. James says to his estimation it was the lowest cap rate for a CVS/pharmacy at the time.

"At the end of the day, we sold it to the exchange buyer," says James. "Those guys can still beat out the institutions with the low cost of capital because they have to buy something."

2014

Signs are positive for 2014, say many experts that *SCB* spoke to for this article. Most of the larger funds, whose appetites are based on contributions from investors stated — while not giving specifics — that they anticipated being active acquirers over the next year. Investment sales brokers also say that they see signs toward another strong year. The only looming question remains interest rates.

"If interest rates do pick up, cap rates will follow pretty quickly thereafter," says Mansour.

Ponticello, of Jones Lang LaSalle, believes that 2014 will see more consolidation in the net lease sector.

"There have been a tremendous number of acquisitions by private companies over the past five years. Those companies are now starting to get scale and will ultimately need to have a liquidity event. That is probably going to come in the form of a public exit or a merger or sale to a publicly traded entity." **SCB**