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Single Tenant Net Lease Sector Segues Into A Positive Outlook for 2017.

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Sector Segue

As institutional investors right-size their portfolios and The Fed moves on interest rates, the net lease market experiences cap rate adjustment.

Randall Shearin

The market for single-tenant net lease retail properties had a steady year in 2016, despite some hesitation related to world, economic and political events. Entering 2017, investment sales brokers are seeing a lot of demand from exchange buyers and a variety of properties coming to market. For the first time in a long stretch, cap rates have adjusted slightly. That, in turn, has caused supply — tight for many years — to loosen slightly and make more desirable properties more attainable for some buyers. On the sell side, some large institutions are balancing their portfolios by shedding some properties so rents from similar retail categories are proportional and numbers are working to their advantage, creating some supply in the market. At the same time, they are keeping their eyes open for portfolios and assets that they desire to grow their returns.

Many investment brokers and buyers say the market still favors the sell side, but it was more even-keeled in 2016, tempered by lulls in activity throughout the year. The rising interest rate environment toward the end of the year — the 10-year Treasury rate rose steadily after the election in November and the Federal Reserve Bank voted to raise interest rates in mid-December — has also tempered many buyers who must place debt on new acquisitions.

Brokers and buyers agree that the outlook is favorable for 2017, with many forecasting a year similar to 2016 for the sector. For this article, *SCB* spoke to more than 15 investment sales brokers and buyers active in the single-tenant net lease sector, to get a pulse on the industry.

SRS recently sold this Walmart Neighborhood Market in Columbia, South Carolina.

SUPPLY AND DEMAND

For the first time in a number of years, sources active in the single-tenant net lease industry are reporting that supply is better than it has been in recent years. Some report the supply situation is better because the gap between buyer and seller expectations was wider in 2016. Among the most active buyers in the market have been 1031 exchange buyers — those that have sold other properties and are seeking to defer capital gains taxes by placing their proceeds in a similar asset. Most of these buyers, report sources, are selling multifamily assets and trading to less management-intensive properties like single-tenant net lease retail assets.

"There are certain property types, like multifamily, that are moving at aggressive cap rates, which are forcing people to look into doing 1031 exchanges," says Jonathan Hipp, CEO of Calkain Cos. "Net lease properties line up well with 1031s."

"We are seeing a major push right now of people disposing of their multifamily assets," adds Sean O'Shea, managing director of the O'Shea Net Lease Advisory group at BRC Advisors in Los Angeles. "That is partially because they've achieved great rent accretions over the past few years and they're really not sure that they're going to see continued rent raises because there's a lot of new multifamily product coming online in many markets now. We are seeing a lot of these owners transition into net lease investments."

Institutions are also active buyers, but most were net sellers in 2016 as they right their portfolios [see "Buyers and Sellers" on page 58].

While supply overall may have increased, A-quality assets in top tier markets still command top pricing from sellers and top attention from buyers.

"The supply has been tight for quality, there's no doubt about it," says Robert Horvath, executive vice president with Horvath & Tremblay, a firm launched in 2016 to serve several real estate sectors, including net lease. "There are plenty of secondary and tertiary market assets and non-credit deals, as well as dollar stores and other product, but the supply is still pretty tight."

Another reason supply is seemingly better is that deals are taking longer to trade.

"Our average days on market across

100-plus individual sales in 2015 was approximately 160 days from beginning of marketing to close of escrow," says Patrick Luther, managing principal of the national net lease group and senior vice president of investment properties with SRS. "That number will likely end up closer to 200 to 210 days for 2016."

Similarly, other investment sales brokers are seeing deals that started in 2016 stretch into 2017.

"We're going to have a fifth quarter of 2016 because of the number of transactions that are dribbling over into the first quarter of 2017," says Sean O'Shea of BRC Advisors.

Whereas single-tenant net leased properties traded in between cap rates of 6 percent to 9 percent pre-recession, some top credit properties in primary markets went below 4 percent in the recession. That change was due in part to rising demand as new investors entered the market seeking properties with lower price points that they could buy in all-cash transactions. Many in the industry now feel that the sector has peaked in terms of demand, with pressure on cap rates now lessening a bit. With the rising interest rate environment that is expected to continue in 2017, many feel that the sector may be heading toward a more stabilized period.

"We've seen some pricing adjustments already," says O'Shea. "I'm assuming two things: that sellers are trying to price in some presumed increase in cap rates and that we are past the peak of the bubble market that we've been in."

"A lot of owners want to take advantage of the market," says Chris Sands, founder and CEO of Sands Investment Group, based in Santa Monica, California. "There's definitely some speculation on what is to come, following the small interest rate uptick that we saw in the fourth quarter. Owners that were on the fence but that were leaning towards selling are trying to take advantage of the cap rate compression that the market has enjoyed over the past three or more years."

Because of financial concerns, many sellers are seeking to list properties to avoid a rising cap rate environment.

"There's an assumption that there's going to be some adjustment in cap rates, so sellers would like to sell right now in the current market, and the buyers are, to some degree, hoping that there will be an adjustment," says O'Shea.

Many sales brokers feel that a lower cap rate environment is being sustained by investor demand for the asset class.

"There is still more demand than there is supply, which is obviously helping keep us in this low cap rate environment," says Bob Moorhead, managing partner in the Dallas office of Trivanta. "I don't see that changing, at least in the short term of the next six to 12 months."

Because of the anticipated rising cap rates, many investment sales brokers are advising their clients who are acquiring to go for quality rather than settle, a factor that may be adding to the length of time that properties are on the market since that could extend the search for the right target property.

"We are suggesting to people that they should be more focused on investment-grade assets rather than just the normal triple net assets," says O'Shea. "We're

SPERRY COMMERCIAL GLOBAL AFFILIATES
THE O'SHEA NET LEASE ADVISORY OF BRC ADVISORS

Sean O'Shea
Managing Director

Q: What issues are you watching as we enter 2017?

A: Subject to the impact in the debt markets of the Fed rates in December, there will be some adjustment in debt rates in Q1 2017; and eventually on cap rates. Historically, it has taken the markets three to six months for cap rates to adjust. Buyers hope for an identifiable uptick in cap rates; and Sellers, hope for modest changes or no change in cap rates. Also, the implications of Tax Reform Act, and specifically, Section 3133 of the current House Ways & Means and Senate Finance Drafts relating to possible repeal of IRC 1031 Exchange provisions.

Q: Cap rates have risen slightly in some markets. What is this reflective of? How is it shifting the market?

A: Monitoring the data closely from Real Capital Analytics; as well as, a granular sense of the NNN market on a daily basis, we see some adjustment is 'Pricing in' the Fed rate raise; but, of equal importance, the growing view, that we have, in fact, passed the peak of this NNN market cycle. Rates will adjust accordingly over time. They have been moving north, no doubt.

Q: With 2016 as a good year for the net lease sector, what do you predict for 2017 for the sector?

A: The role of securing acceptable debt solutions, combined with securing the "best-of-breed" net lease assets will be mission critical due to the spreads. Net leased assets which are well-located, with credit worthy tenants and lease structures that limit investor liability, will continue to serve as a bond equivalent investment providing predictable, stable income streams...but, "Not all net lease are the same." Protecting and preserving client wealth is paramount for us.

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Thomas Company recently sold this CVS/Pharmacy location in New Orleans.

recommending that they really need to review the structure of the leases to understand all of the implications during their holding period, checking out early termination issues or signing issues. Not all net leases are the same. It's helpful to have a good net lease advisor providing assistance on these transactions."

"The market is still very healthy," says Horvath. "There is still a lot of capital flow coming into net lease, whether it is private clients who are looking for yield, 1031 buyers, or institutions; there's a good amount of activity."

INVESTOR INTEREST

What piques an investor's interest in a particular property? It depends on what they are looking for, of course. Topping the list for many is the old adage "location, location, location."

In 2016, the net lease market saw ups and downs in the levels of investor interest at times, said a number of sources that *SCB* interviewed. Some speculated that the November election and other political or world events throughout the year, like Britain's Brexit vote, had to do with the timing of the slow periods.

"I couldn't put a single deal in escrow in October," says one investment sales broker describing the most recent period. "For about four or five weeks, all of the buyers just went on vacation, disappeared or climbed into a hole. It seemed like the first week of November, everything started to pick up again; all of the active buyers returned, and I probably put 10 deals in escrow in the first two weeks of November."

"There seem to be micro blips in the market at times, where you are wondering, 'All right, what's going on?'" says Moorhead. "When you try to figure out why the market is soft, activity is great again and you have offers again. Overall, buyer demand has been very strong from exchange buyers and all-cash investors."

"Deal velocity has slowed down a little bit," says O'Shea. "There was an atmosphere of uncertainty before the election. There's also a bit of sticker shock to some investors in terms of cap rates. Overall, people are being more deliberative about their investment decisions."

The rise in the value of the U.S. dollar versus the euro and pound has caused a pullback from some foreign investors.

"Foreign capital used to represent a majority of our buyers for our product in Southern California," says Luther. "Today, that's not so. They have definitely taken a step back. The private, 1031 exchange buyers coming out of apartments and office tend to be the buyers willing to pay the highest premium for these deals."

For many investors, interest rates are tempering their willingness to execute. With the 10-year Treasury rate ramping up, followed by the Federal Reserve Bank raising interest rates 25 basis points in December, investors are re-examining yields to see if targeted properties still make sense. Some may evaluate their criteria and see if now is still the time for an acquisition.

"The one thing that has changed — really over the past few weeks — is the increase in the 10-year Treasury rate, which has impacted some deals where financing hasn't been locked. There's some re-trading going on in the marketplace," says Horvath. "In my high net worth client base, they are probably not as optimistic as they were a month ago."

O'Shea says, "We see the rates beginning to move up a little bit and the underwriting criteria for loans is getting a little more stringent. Those two aspects conspire to make effective debt executions a lot more questionable. With compressed cap rates, the spreads are fairly thin to start with so now more equity may be required while folks still think they can get 70 or 75 percent loan-to-value."

As with activity, cap rates were also spotty in 2016 [see "Cap Rates" on page 66], likely because of waning buyer interest at times. During periods of waning buyer interest, established long-term buyers — like Inland — love to be active in the market.

"I love volatility," says Joe Cosenza, vice chairman of Inland Real Estate Acquisitions. "Immediately after the election and immediately after the rates started to jump, we get the phone calls that, 'We had a deal signed with another buyer, but they have backed out and even though you weren't the highest bidder, are you still interested?' The sellers go to certainty instead of the high price."

Sellers will likely push more product to market before interest rates rise further in the future.

"Our clients' motivations to sell are varied," says Jim Gibson, regional director in the Houston office of Stan Johnson Co. "Our merchant developer clients are very consistent in their model of building and selling. Realizing a fair profit now and eliminating market risk in the long term is typically a strong motivator to sell."

For buyers, getting in line with the numbers and having the right expectations with a deal is important. With cap rates fluctuating, buyers are taking longer to make sure now is the time to execute.

"Investors continue to move forward as long as they're comfortable with what they believe is happening with rates and in the market in general," says Moorhead. "If there is any kind of uncertainty, investors take this wait-and-see approach, which really isn't good for selling net lease investments. Right now, it appears that investors feel comfortable with the overall direction. People feel like rates are going to tick up and I think everyone is comfortable with that, so we are seeing good activity."

ENVOYNNN

Ralph Cram
President

Q: With cap rates rising slightly, have you altered your investment criteria, or changed the assets you are acquiring?

A: We are making sure that the margin between the developer's return on costs and projected cap rates remains robust. While new net lease properties will have the lowest volatility in cap rates due to their longer lease terms, we believe that the larger ($4M+) special-purpose net lease properties (day care centers, movie theatres, urgent care centers) might need higher cap rates to sell. On the other end of the market, the investment credit ground leases, trading at sub – 5% cap rate, are another area of concern as even an increase of 25bps in cap rate can cause the sales price to drop by 5%.

Q: What do your investors expect from your firm?

A: Our investors are seeking higher short-term returns than they can find in other fixed income assets with similar investment periods (1-3 years). They also expect us not to lose money.

Q: What are your predictions for 2017?

A: We believe that the demand for long term, high quality net lease properties will remain strong with a small increase in cap rates. New buyers continue to enter the market, especially foreign capital. That said, we believe that shorter term, poor credit quality net lease property offerings might need to significantly increase their cap rates to sell in a market full of other such offerings. The days of indiscriminant buying of net leases are coming to an end. Sellers of B and C class net lease assets will need to adjust their sales expectations.

Tax reform is the other wild card for 2017. Nearly everyone believes it's going to happen now that Republicans control all three branches of government. Just because Donald Trump has been a big user of 1031 tax deferred exchanges in the past doesn't mean that he won't swap this tax benefit for the grand compromise to get tax reform passed.

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BUYERS AND SELLERS

Since the Great Recession, the net lease sector has been riding a rising wave. Because of the constraint with capital in the early part of the recession, many buyers sought properties they could buy with cash. Because most single-tenant retail properties trade at $5 million or below, the asset class saw a swarm of new investors, driving up demand in a time that was already supply constrained.

"The net lease space has become such an asset class that there are a variety of buyers," says Sands.

Today, those include wealthy private individual buyers, both international and domestic, and institutional buyers like REITs, fund-based investors, and entities offering pooled investments, like Delaware Statutory Trusts (DSTs).

"Public and private REITs and funds remain active in the market," says Jim Gibson at Stan Johnson Co. "They provide sellers with a high surety of close."

Inland Real Estate Acquisitions continues to be a big buyer of net lease properties. Over the past two years, the company has acquired $3 billion in commercial real estate, and 39 of its 115 deals over the past 24 months involved single-tenant net lease properties. Much of what Inland acquires is done in single property transactions, meaning the company has to cull through a lot of properties and meet a lot of sellers to find the ones that fit its criteria.

"The sellers in the marketplace today are pension funds, insurance companies and many of the listed REITs," says Cosenza of Inland. "In addition, you've got the individual and small companies who are able to develop one or two net lease deals on their own."

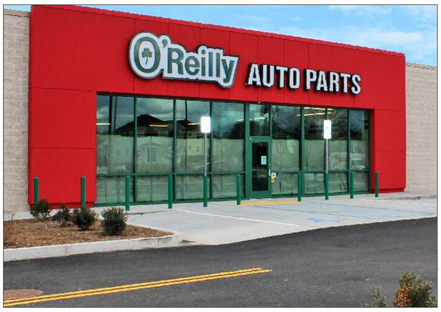
VEREIT, another large owner, was a net seller in 2016, selling $2 billion of commercial real estate from April 2015 through the third quarter 2016. The company's investment management arm, Cole Capital, has $7 billion of real estate assets under management held in numerous REITs. The Cole REITs acquired $500 million in the first three quarters of 2016. VEREIT has 4,200 properties comprising 98 million square feet. The Cole-controlled entities have 1,500 properties with 30 million square feet. Because of its volume, VEREIT closely tracks the commercial real estate market.

"It is an extremely active market," says Glenn Rufrano, CEO of VEREIT. "There were $17 billion worth of properties offered to us over the first three quarters of 2016; that means there are a bunch of sellers out there. The fact that we sold $2 billion shows that there is a lot of activity in the triple net market for office, retail and industrial."

Many larger companies are rebalancing portfolios, sending properties to the market. VEREIT, for example, acquired a portfolio of Red Lobster restaurants in 2014 for $1.6 billion, which represented 12.5 percent of the company's income. The company doesn't want any one tenant to be greater than 5 percent of income, so it has shed some of those properties.

"Even though it was a very good transaction and we like the business, we just have too much of it," says Rufrano.

VEREIT is also balancing its diversifications among real estate categories so it



Horvath & Tremblay recently arranged the sale of this O'Reilly Auto Parts in Fall River, Massachusetts.

want to move away from that and not have as much exposure," says Sands.

The bulk of acquisition activity in 2016 came from individual investors, many of whom are buying a replacement property in a 1031 exchange after selling another asset.

"1031 trade buyers are active, as are private clients because there are not a lot of good alternative yields out there, so real estate is still a good investment," says Horvath.

"Usually about 50 percent of our business is 1031 related, but it was more than that in 2016," adds O'Shea.

Value-add buyers — those who will look at properties that have shorter terms left on the leases or that may have other quality-related concerns — are another category that have been active acquirers in 2016.

"There do not seem to be a ton of institutional buyers that are chomping at the bit," says Jereme Snyder with Colliers International. "A lot of opportunity-driven buyers who are looking for properties that have some sort of value play are active. No one is buying net lease deals just to get the 5 percent yield; they are looking for some sort of extend or re-tenanting play. The majority of our buyers are 1031 exchange-driven."

Those who drive activity in the market also control the balance of the market. Right now, the balance is strong, say our sources.

"Supply is somewhat abundant, particularly in the dollar, drug and big box store space," says Luther. "There are over 100 available drug stores on the market with 10-plus years of remaining lease term. The same is true for dollar store product. Sourcing that supply at the ideal buyer target cap rate and yield expectations is the issue."

Among the institutions actively acquiring are fund-based players, like Minneapolis-based AEI Funds and Miami-based United Trust Fund; companies that assist retailers and other entities with recapitalizing their business by acquiring their real estate assets like STORE Capital; and large institutions like VEREIT and Inland, which acquire for various investment entities within their organizations.

For STORE Capital, helping retail-driven businesses with about $25 million in revenue capitalize their businesses by acquiring their real estate assets is the goal. The company has stepped in to fill a void to provide long-term capital for many companies. About one-third of STORE's business for the past few years has been repeat business with existing clients.

"We're helping retail-oriented businesses expand organically; we are helping people expand their businesses through acquisition, and we're helping them expand locations when they need to and it is all part of us trying to help our tenants make their businesses more viable," says

Chris Volk, president and CEO of STORE Capital.

Like STORE, many large institutions consider their core mission to serve tenants through a financing vehicle.

"Our business, primarily, is the real estate equity finance business," says Rufrano of VEREIT. "Our primary products are sale-leasebacks to corporations and companies where we're basically providing capital to them and they are leasing back their housing, whether it's retail, industrial or office, for long periods so they can control it."

Many investment sales brokers, too, have moved from beyond the traditional property sales function to build relationships with tenants to help them figure out how to best capitalize their real estate assets.

"We've expanded to work with a lot of operators and I think the tenants that have been benefiting from cap rate compression and taking a look at what their next strategy is or looking at their growth plans and figuring out their next locations," says Sands. "We've seen a big push in the sale-leaseback sector. It's nice to work with tenants as they are looking to expand and match up relationships, whether it be developers with tenants or private equity firms with tenants who are looking to expand and grow. It's definitely more than a brokerage business today. You really have to have relationships, creating opportunities by introducing concepts to people who want to invest in them, and grow with the relationships you've cultivated."

Fund buyers have also continued to be active in the market. AEI Funds, active in the market since 1970, continues to acquire net lease retail on an all-cash basis for its many funds. The company was about to close a fund as of press time that, at $150 million, is the largest in the company's history. AEI also now has a DST vehicle that was created to attract 1031 exchangers.

Crowd funding platforms are a relatively new form of buyer. These often form DSTs and other ownership entities that pool small amounts of capital from many investors to acquire assets.

"Crowd funding platforms acquiring net lease assets allow investments for as little as $1,000," says Luther. "To some extent, there are no longer barriers to entry by asset size or equity required, for an investor to gain exposure to net lease products. This liquidity will continue to hold down yields and cap rates within the sector."

CAP RATES

Because demand has been spotty throughout the year and supply has remained steady in the net lease retail sector, cap rates have risen or fallen slightly at times. Other factors, like decreasing demand from international buyers, have also enabled a number of buyers to acquire better assets at more favorable prices. Many investment sales brokers feel that it may not be that cap rates have changed all that much, it is just the rate of change has been affected by the changing activity in the market.

"The days of everything being a 4 cap rate are gone for now," says Snyder with Colliers International. "Cap rates adjusted a bit last year. It started off slow, but

SRS
Real Estate Partners

Matthew Mousavi
Managing Principal,
National Net Lease Group

Patrick R. Luther, CCIM
Managing Principal,
National Net Lease Group

Q: How well did the net lease sector perform in 2016, from your perspective?

A: The overall net lease sector continued to perform well in 2016, and in our view, we experienced a continuation of the past few years within the sector. Our platform transacted net lease property sales in 42 states, continued to transact within compressed cap rate ranges, in some cases in the low to mid 3.00% range, and generated interest from a wide range of investor profiles, private and public, with continued demand from the exchange investor. Note, however, we did realize a decrease in offer activity and overall market velocity, particularly in secondary and tertiary markets, and with properties backed by flat leases. The softening was in part due to the pricing level of net lease properties in both core and secondary markets, as well as the increase in overall net lease supply on market. Lenders, and particularly conduit lenders, pulled back due to pricing levels, and in the case of the conduit market, the implementation of new regulations that impact their ability to sell tranches of their loans to the secondary market.

Q: What issues are you watching as we enter 2017?

A: The new administration is widely expected to bring substantive changes to taxation, infrastructure, defense, banking and international trade. It is expected that the incoming President Trump, backed by a Republican-controlled Congress, will reduce personal and corporate taxes, and increase spending on defense and infrastructure. These measures are designed to increase growth and in turn, inflation. The Fed will be forced to take a more hawkish approach to be in front of this curve via increases in interest rates that will result in higher borrowing costs, albeit at a slow rate. Nonetheless, we see a positive trend for commercial real estate given the incoming President's business-friendly approach to taxation, spending and reduced regulations. Higher rents, increased construction, higher wage growth and consumer consumption, all bode well for our industry.

E-commerce and its impact on net lease property is also something we are watching, and we expect this to continue to shape investor sentiment in 2017. Investors are bullish on food, entertainment, lifestyle, fitness, and healthcare uses, which tend to be e-commerce resistant and utilized heavily by millennials and a younger demographic. Compared to soft goods, electronics, and other retail uses more susceptible e-commerce pressures, necessity based net lease retail property should continue to experience healthy demand.

Advertorial

things started picking up in early March and then it was great, but there were small adjustments to cap rates throughout the year: they have gone up a little bit. That being said, there have been some anomalies. There are still a few unique deals that will sell at a crazy cap rate."

"It does feel like cap rate compression has slowed and maybe we are at a bottom," says Moorhead. "But, we said that the past few years and cap rates have continued to push lower."

Thomas Company has a number of drug stores that it is marketing. The company measures cap rates by asking prices and has seen cap rates rise slightly throughout 2016, with more aggressive pricing coming in the fourth quarter as buyers seek to close before the end of the year.

"The moments when we saw sub 5 percent cap rates and high 4 percent cap rates on drugstores consistently were a while ago," says Thomas. "We've definitely seen cap rates move. It's hard to really say that cap rates have moved a lot one way or the other, especially when you look back year-over-year and the average ask that we are tracking; in the middle of the year it moved up a bit, but it has gotten tight again."

One factor that will change cap rates is the rising cost of debt, for borrowers not in an all-cash position.

"Cap rates will have to go up to reflect the increased cost of money," says Hipp of Calkain. "When you finance a property, if your debt is more expensive and it costs you a higher payment, you need a better cap rate to get the same kind of cash-on-cash return that you could have gotten before."

"Historically, when there has been rate change with the Fed, there is a corresponding cap rate adjustment, but it usually takes three to six months," says O'Shea.

In addition, velocity has slowed over the past year.

"We're still seeing good velocity, but maybe it has slowed from where it was earlier in the year," says Thomas. "I'd say that slowdown would need to be more persistent for a few more quarters before you're going to see a big movement in pricing or any movement in cap rate."

Many of the properties that are selling below 6 percent cap rates are those brought to market by merchant developers. That market is dependent on one type of buyer for their properties because the margin between entry and exit is so thin.

"As retailers drive return on cost for these developers to 7 percent and under, or are only allowing — in some cases — 100 to 125 basis points of spread between return on cost and exit cap rate, these developers specifically rely on exchange investors to exit their projects," says Luther. "Without the exchange market, developer spreads would be reduced further and, in some cases, would allow virtually no profit for development risk."

HOT PROPERTIES

Buyers have targeted properties that meet their specific criteria. That criteria changes based on market conditions — what they can afford and what supply is on the market. Geographic location also tends to be a concern for many buyers; individual buyers like to acquire properties in locations familiar to them, while institutional acquirers often will be more forgiving on a property's specific location.

"Investor interest is high for core, top tier credit, top 10 MSA product and would appear to remain so despite rising interest rates," says Luther of SRS. "It's a function of have and have not. Tertiary product remains challenging to sell."

"There is a decent amount of inventory, but people are looking for safety and security in return in a well-located trade area," says Snyder. "It's difficult to bring all of those variables together and find a property that fits perfectly."

SRS recently marketed five Sherwin-Williams locations with identical 10-year lease terms in various markets. Two of the properties – one in the Boston MSA and the other in Austin, Texas – received more than five offers each and ended up trading within 90 days at cap rates of 5.70 and 5.75 percent, respectively. The remaining assets, in rural Missouri and Georgia, have been on the market for more than 180 days and Luther estimates these will sell at cap rates close to 6.5 percent.

"The spread in the yield created by geographic inferiority was approximately 75 basis points in cap rate, or about 12 percent in additional yield required, with an identical lease," says Luther. "Many investors are saying that they won't take the tertiary locations without similar adjustment for risk."

Most new construction today is found in secondary and tertiary markets, where retailers see plenty of opportunity for growth in sales and locations. While some investors shy away from these areas, others see them as opportunities. Many 1031 investors will buy in smaller markets, especially if they are near their primary residence. Drug stores, especially, have been going to smaller markets to seek new store locations.

"If you are looking for a $3.5 million to $7 million exchange property where it's very passive and strong credit, you're almost, by default, going to be following tenants into those secondary and tertiary markets," says Thomas. "Most investors are comfortable with that. They understand that these corporations have long-term obligations, so they're taking a big risk at opening up and committing to a 25-year lease at a certain location. Investors understand that these companies have done their homework and that they're going to be paying rent for the whole term."

"Depending on the return on cost and the spread that a developer has in a project, many are choosing to put new product on the market well before construction has been completed, often 90 to 120 days," says Luther. "They are seeking to have a buyer in hand and recycle their capital very quickly into a new project or back to investors. Speed of execution and sales drive their internal rate of return and hedges against the concern of rising interest rates. Many of our clients have stated that they would prefer to own the asset once complete for the shortest time possible."

Drugstores continue to be in demand from investors of all types. For many owners, drugstores are about as management-free as it gets: the perfect triple-net lease asset, especially when in top locations. Inland purchased a portfolio of 24 CVS/pharmacy locations in 2016, all with 25-year leases.

"They are dynamite," says Cosenza. "We don't have to worry about managing all of these properties around the country because they are bonded leases and CVS does everything."

From a lender's perspective, Ralph Cram, president of Envoy Net Lease Partners, is seeing credit become increasingly important to investors.

"Over the past six months, we are seeing more credit, higher quality net lease deals coming to us," says Cram. "Banks are pulling back from advancing more than 75 to 80 percent loan-to-cost financing on credit net lease deals and for non-credit deals, it's even worse – probably 65 to 70 percent – which is about 5 to 10 percent less than last year this time."

As well, Cram says he sees more room for cap rate flexibility in secondary markets, where a lot of growth is occurring.

"The secondary properties are starting show a little bit of pricing flexibility," says Cram. "If you need to sell a property, you need to be flexible on price at what you get off the top. If it's an A-quality net lease deal, it's still getting prices pretty close to where they were last year, but when you get off the quality and you have shorter lease terms, in secondary markets, those issues are starting to be priced in and properties are starting to trade in the 7 percent cap range instead of the 6.5 percent range. It is a different market. For new properties, there's still fairly good demand just because there aren't that many new properties in the market except for dollar stores."

Dollar stores, as investors know, are considered a sub-category within net lease. Many deals have little rent growth built in, and while the fundamentals are strong, most of the locations tend to be in secondary and tertiary markets. For some net lease investors, dollar stores are can't miss investments that satisfy a need for income stability in their portfolios. However, many smaller investors are seeking yields and growth over the lease term and look for properties that will yield greater income over the lifespan of the lease.

"Dollar stores work for many investors, but if you look at it from an institutional standpoint, most of the institutions are already fully allocated – they've filled their buckets with that category," says Hipp. "The people who are buying the dollar stores today are those who are trying to match equity. It's not because it's the dollar stores, it's because it fits the amount of equity that they have or the trade need that they have."

Quick-service restaurants (QSRs) and fast casual/fast food restaurants continue to be in demand with investors. They are among the hottest assets on the market and generally do not spend much time on the market.

"We sold more than 70 restaurant deals in 2016 from Chick-fil-A to Texas Roadhouse to Jack in the Box," says Chris Sands.

Luther adds: "QSR and fast casual restaurant concepts are highest in demand, by far, as a function of 15-plus year leases and rent growth either annually or every five years, and their cap rates reflect this. Automotive parts retailers like Advance Auto, O'Reilly and AutoZone are among the other favorable categories as their leases are typically 15-plus years and have some rent growth. Third-tier would be your retailers that choose to sign with only 10-year leases, or flat leases with minimal rent growth."

Investor interest has also continued to grow in gas and convenience store chains. In a recent deal, Sands Investment Group brought to market a portfolio of 30 gas station locations in the Southeast, which sold for $40 million in a sale-leaseback structure. Sheetz and Wawa are among the large players in the sector with aggressive growth plans.

Properties with consumer-facing medical-oriented uses are also quickly becoming a favorite of net lease buyers, especially institutional investors. Many of these retail-like medical users are owned and operated by large corporations who see the value in consumer-friendly locations. They include dialysis providers like DaVita and Fresenius, and plasma centers like BioLife. AEI Funds is one institutional owner that has purchased a number of these properties.

"Medical has become a new retailer," says Ian Harrison, vice president of acquisitions at AEI Funds. "The sites we are buying are retail-esque locations. They have high traffic flows and high visibility. We typically want the sites we buy to be either near other medical uses or near high-traffic flow grocery concepts. We believe in the hub-and-spoke model that many of the hospital systems are trying to take advantage of."

According to Sands, "Medical has definitely become the hot tenancy right now in the marketplace. There is a lot of comfort in these assets from investors. You have urgent care and ambulatory outpatient type concepts that have pretty significant tenant improvement requirements that need a lot of capital; there's some certainty that the tenant is staying versus relocating, since alternative space is not necessarily readily available as it would be for a fast food concept or dollar store. There's also a gravitation to the credit behind these leases."

The quick evolution of the medical sector in net lease has caused investors to consider a variety of properties within that band, stretching beyond those that are retail-oriented.

"People like anything in the medical space," says Hipp. "Not only medical office but also urgent care, or Fresenius or DaVita. Anything that has a medical component to it seems to attract not only institutional investors, but also private, high net worth buyers, and even 1031 buyers. Medical is something where it doesn't matter if it's recession or prosperity. It just seems to garner all buckets of opportunity from all types of buyers."

To expand their options and find acquisitions with better yields, many investors are going further afield from single-tenant net lease retail. Some are including other options, like ground leases and corporate sale-leasebacks for office and other properties, in their portfolios.

"We've seen a lot of investors going after ground leases. We're selling a lot of ground leases under pretty interesting assets, whether they be hotels or office buildings around the country or larger infill assets," says Thomas. "It is another product type within net lease. We are seeing more investors become comfortable with a leasehold interest as long as they are being rewarded on yield." **SCB**

CREATING EFFICIENCY IN THE MARKETPLACE

As part of our article, *SCB* spoke with Scott Scurich, managing director at Ten-X. The company's new platform, Offer Select, is working with brokers, buyers and sellers to help buyers and sellers transact more efficiently in the net lease space.

SCB: How is Ten-X active in the net lease space?

Scott Scurich: I'm the managing director of our net lease business. Ten-X created a product last spring called Offer Select, which utilizes the same technology and infrastructure as our auction product, but is geared more towards a traditional real estate transaction. There's a due diligence period and there is some level of negotiation between buyer and seller. This platform is ideally suited for net lease assets because of the way that they should, in theory, trade. It should be more of a liquid transaction and a faster transaction, and it's one that really benefits from using technology to make it more of an efficient trade, almost like you would see something trade on the NASDAQ.

SCB: Who are the target buyers of those type of products?

Scurich: It's the full spectrum of buyers. It is really designed to make the process more efficient for the 1031 exchange buyer and the private investor. The transparency we're adding to the process and the front-end due diligence that we are exposing the buyer pool to — prior to them being under contract — expedites the ability for a transaction to close more quickly. The buyers are more educated about the asset when they enter into a purchase and sale agreement.

SCB: How is that different than a broker-direct relationship?

Scurich: It's standardizing the sales process. In a typical process, you're dealing with all sorts of different types of sellers from your private individual to an institution, and all of those different types of sellers behave a little bit differently in the sale of an asset. Different brokers run a different process for their transactions. That's very difficult for a 1031 exchange buyer when they're on a very tight time frame and they have a specific need that they're trying to fill in a short amount of time. A lot of them are not experienced or repeat real estate buyers, so this may be the first time that they're transacting in real estate. We're standardizing the process and making that process look the same from every type of seller. We're working with every broker that is on the platform so every property has the same level of due diligence, and every property has a sale agreement, every property has a title commitment run at the beginning of the process. We're taking the uncertainty out of the asset that we're marketing and we're making a very similar process for all of these buyers so they can come to the site and have full transparency on each asset. If they like something they can make an offer online, they can find the purchase and sale agreement online and they're not waiting on the back and forth of a seller being reactive to providing those documents. It really adds a lot of efficiency to the marketing timeline. Every asset that we have on the platform is marketed through a broker, so we're very broker-friendly and we're really trying to add to the brokers marketing process with out platform and with our process and with our firepower that we bring to the marketing of each asset. We're very broker-friendly, but we're also discussing these agreements with sellers and reaching out to sellers, so we're talking to both parties, but every transaction has a broker on it.