

National Net Lease Market Investment Sales Overview – Q2 2020



Investment in triple net lease assets reached new highs in recent years, driven by falling interest rates and Treasury yields. The spread between cap rates in the net lease market and Treasury yields widened to 400 basis points in Q2 2019, allowing for higher-leveraged returns. As COVID-19 plagues the market one year later, market participants are aggressively seeking quality, credit-tenanted properties in core markets to minimize risk in a time of economic volatility.

This report analyzes topics and sales trends in the National Net Lease market from January 2019 to June 2020.

FEATURE: COVID-19 and its Impact on the Commercial Real Estate Market

The global COVID-19 pandemic surfaced in the United States in Mid-March and Federal, State, and local governments responded by issuing strict stay-at-home orders to help to reduce the spread of the virus, negatively impacting most property types. However, a significant portion of the net lease retail market falls under essential business. The pharmacy, quick-service restaurant, convenience store, grocery store and dollar store sectors of the net lease retail market have remained in operation throughout the Pandemic and have largely been the focus of investor attention.

National Net Lease Market

The net lease market offers a wide range of investment opportunities. Stability is the most important element in this market. As most tenants are affiliated with public

companies, financial reporting is required, which offers greater transparency into operations. Long-term leases offer rental escalations, which present NOI upside. Additionally, property insurance, taxes, and maintenance are paid by the tenant, sparing the landlord the burdens of property management. Investors seek corporate-backed leases, in which the national corporation will guarantee the rent payments on the lease. Investment grade tenants have credit ratings of BBB- or higher and have greater ability to satisfy debt obligations. COVID-19 has underscored the importance of tenant mix, as many local and regional tenants have been unable to make rental payments in lieu of business closures. Thus, investment grade tenants and corporate-backed leases provide a hedge during economic downturns.

Market Sectors

Boulder Group categorizes the different sectors of the net lease market into casual dining, bank, auto parts, big box, medical, drug store, QSR, and dollar store. Fast food (QSR) and bank leases are typically the smallest in size and stipulate the highest rents per square foot, with annual escalations. Auto parts stores and big box stores are much larger and typically offer fewer escalations. Medical properties are broken into dialysis, urgent care, general doctor, and other segments. Trends in consumer preference, discretionary income and economic conditions influence the desirability and performance of each net lease sector.

Overview

We tracked investment sales for net lease properties over the past six quarters from Q1 2019 to Q2 2020. The search parameters include triple net sales only, excluding portfolio and multi-property sales. Number of transactions and dollar volume is broken out by region, encompassing the Midwest, Mountain, Northeast, South, and West regions. We then presented price per square foot and capitalization rates for these transactions over the same period. Based on the data, it is evident that the number of sales and dollar volume have declined significantly, although the fundamentals behind these transactions have largely held steady.

Number of Sales Transactions

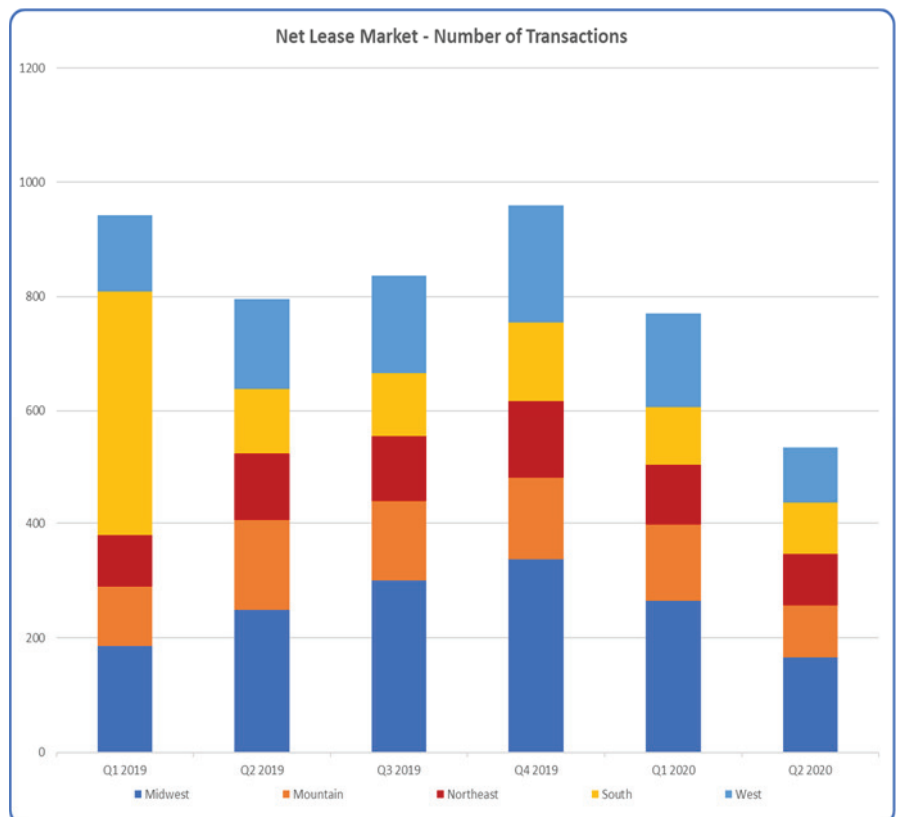
The number of quarterly net lease sales recorded in the US are segmented by region as seen below. From Q1 2019 to Q1 2020, number of sales ranged from 770 to 959, averaging 861 sales per quarter. In Q2 2020, following the onset of COVID-19, there were only 532 recorded transactions. The drop-off was most significant in non-essential retail sectors, as investors waited for financial disclosures and re-opening timelines.

Historical Transaction Volume - Net Lease Market								
Number of Transactions	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Total	% of Total
Midwest	186	248	300	337	264	166	1,501	31.0%
Mountain	103	158	138	142	133	90	764	15.8%
Northeast	90	116	114	138	105	90	653	13.5%
South	430	116	114	138	105	90	993	20.5%
West	133	158	170	204	163	96	924	19.1%
Total # Transactions	942	796	836	959	770	532	4,835	100.0%
% Change from Prior Month	-	-15.5%	5.0%	14.7%	-19.7%	-30.9%		

In terms of number of transactions, the highest number of quarterly transactions occurred in Q4 2019, with the Midwest region, the largest region geographically, accounting for 35% of all transactions. Transaction volume per quarter fluctuated during the first five quarters of analysis but fell off nearly 31% in Q2 2020. It is also important to note that Q1 2020 saw the second lowest transaction total, as the first shock waves of the Coronavirus gripped the market in the last few weeks of the quarter.

The Midwest region saw 31% of all transactions over the prior six quarters. The percentage share for the remaining regions was more uniform, ranging from 13.5% in the Northeast to 20.5% in the South.

With continued uncertainty related to COVID-19 but economic re-openings well underway, we should see the number of transactions start to rebound in Q3 2020.



Dollar Volume of Sales Transactions

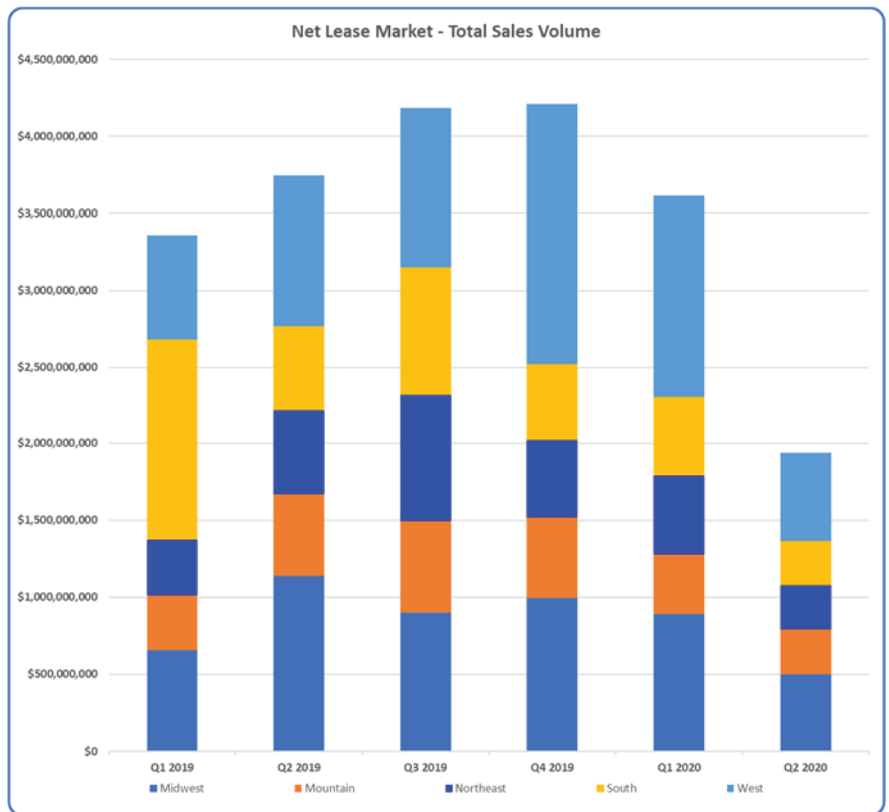
As seen below, we have tracked the dollar volume of quarterly net lease sales by region. Total transaction volume ranged from \$3.36 to \$4.21 billion between Q1 2019 and Q1 2020, with the peak occurring in Q4 2019. Comparatively, quarterly sales volume in Q2 2020 was \$1.94 billion, reflecting a decrease of 46% from the prior quarter.

Historical Transaction Volume - Net Lease Market (in Millions)								
Dollar Volume	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Total	% of Total
Midwest	\$655.4	\$1,139.9	\$901.5	\$993.8	\$890.2	\$498.2	\$5,079.2	24.1%
Mountain	\$355.0	\$529.5	\$592.9	\$522.6	\$385.3	\$293.3	\$2,678.5	12.7%
Northeast	\$363.2	\$548.8	\$827.2	\$502.3	\$515.6	\$287.2	\$3,044.4	14.5%
South	\$1,305.5	\$548.8	\$827.2	\$502.3	\$515.6	\$287.2	\$3,986.6	18.9%
West	\$678.8	\$976.6	\$1,033.4	\$1,689.1	\$1,307.8	\$573.9	\$6,259.7	29.7%
Total Dollar Volume	\$3,357.9	\$3,743.5	\$4,182.3	\$4,210.2	\$3,614.5	\$1,939.9	\$21,048.3	100.0%
% Change from Prior Month	-	11%	12%	1%	-14%	-46%	-	-

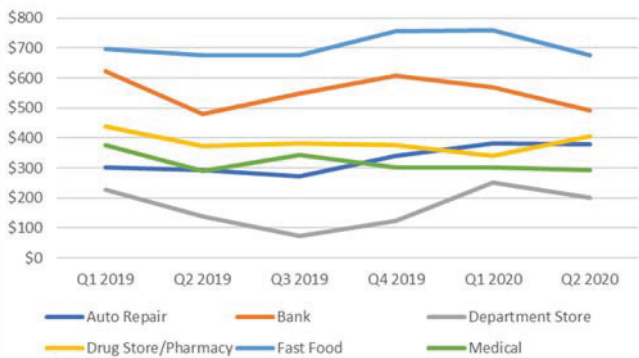
Over the analysis period, the West and Midwest regions saw the highest dollar volume in sales. Not included in this analysis is sale leaseback of the Bellagio Hotel and Casino in Las Vegas, Nevada by MGM Resorts International for \$4.25 billion. This transaction was a net lease recorded in the hospitality/gaming specialty sector, which is not covered in this analysis. Dollar volume dropped considerably in all regions in Q2 2020.

Amid the significant decrease in dollar volume was an emphasis on quality, lower-risk investments. CVS, 7-Eleven and McDonalds, three businesses that remained open during the Pandemic, registered some of the lowest cap rates on long-term leases. Conversely, non-essential net lease properties saw the brunt of the market decreases.

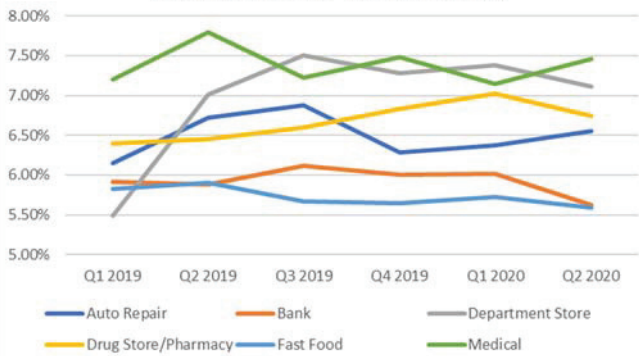
Market participants will be monitoring policy on re-openings and potential shutdowns as the COVID-19 Pandemic continues, and financial health of tenants will remain on the forefront. Below are sales trends pertaining to the key property sectors within the NNN market.



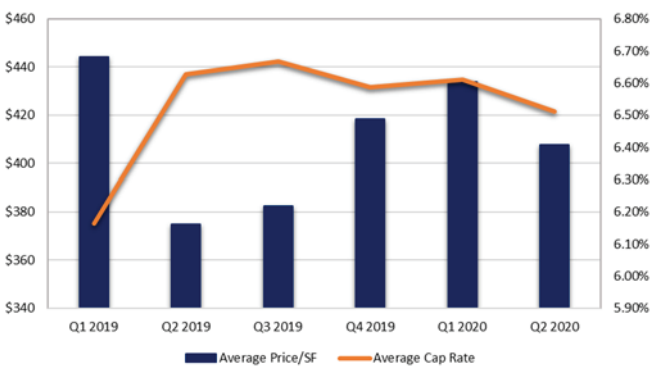
Price Per SF- Net Lease Market



Historical Cap Rates- Net Lease Market



AVERAGE \$/SF & CAP RATE - NET LEASE MARKET



SOURCE: CoStar and Marshall & Stevens



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Average \$/SF on Quarterly Transactions

Price per square foot on quarterly transactions fell 5% from \$434 per square foot to \$408 per square foot from Q1 2020 to Q2 2020 but increased 6.5% from Q2 2019. Investors have flocked to high-quality, long-term lease assets in Q2 2020, and the high demand has limited price decreases. The chart shows the department store sector achieving the lowest price per square foot at \$204/sf, and the fast food sector achieving the highest price per square foot at \$675/sf in Q2 2020. The only sector to see a price per square foot increase in Q2 2020 was the drug store sector, which increased from \$341 to \$405 per square foot over the prior quarter. This sector has performed well during COVID-19-as consumer traffic and spending has increased.

Average Cap Rate of Quarterly Transaction

With the exception of department stores, who have been struggling in recent years, the average capitalization rate for US net lease transactions has been consistent from Q2 2019 through Q2 2020. Cap rates over the period have ranged from 6.16% in Q1 2019 to 6.67% in Q3 2019. Cap rates have fluctuated by only 16 basis points over the last five quarters. The fast food sector commands the lowest cap rates due to long term leases and frequent escalations, and medical properties command the highest cap rates, as they typically offer a blend of retail and office space. Net lease office assets register higher cap rates relative to retail assets. Cap rates decreased 10 basis points from 6.61% to 6.51% over the last quarter. Cap rate and lease term remaining have an inverse relationship, with cap rates decreasing as lease term remaining increases.

Average \$/SF & Cap Rate: 5 Year Trend

Since Q1 2019, price per square foot and cap rates have generally showed an inverse relationship. Cap rates increased substantially in Q2 2019 as price per square foot dipped considerably. As price per square foot has leveled off in recent years, cap rates have shown less fluctuation. Boulder Group denotes a decrease in the bid-ask spread in the net lease sector. Retail assets in Q2 2020 closed at a cap rate 22 basis points higher than the initial asking cap rate, which is 8 basis points lower than the 30 basis-point difference in Q1 2020. This suggests increased competition for quality assets during a time of uncertainty.