

SPRING 2015

NET LEASE ECONOMIC REPORT

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Even as investors have recovered their appetite for riskier and higher-yielding assets, demand for the relative safety of well-tenanted net lease properties with longer remaining lease terms remains intense. With the exception of convenience stores, retail single-tenant net lease cap rates and debt yields declined over the course of 2014, reflecting competition for properties with credit tenants, a finite pool of assets marketed for sale, and further improvements in the availability of historically low-cost debt and equity. Apart from the obvious appeal of low operational intensity for new and smaller scale buyers, the sector's defensive characteristics remain a central feature of the investment thesis and the rationale for including net lease in a diversified real estate portfolio.

Along with the economy and job market, rents are generally moving higher across retail, industrial, and office properties, increasing the frequency of accretive lease rollovers for both multi-tenant and single-tenant assets; still, net lease properties with longer remaining lease terms are continuing to trade at significantly lower cap rates than properties with comparable tenancy but earlier rollovers. Although favored for their cash flow stability, the former will encounter headwinds over the current investment time horizon as an eventual rise in interest rates weighs on fixed-income valuations, slowing or potentially reversing appreciation for properties with smaller contractual escalations.



OVERVIEW

In the early stages of the recovery from the financial crisis, an uptick in buyer demand for well-tenanted and well-located net lease assets was fueled in large part by investors' pronounced aversion to risk. Confronted with the economy's weak underlying fundamentals and unclear prospects for commercial real estate liquidity, properties with long-dated leases and credit tenants were able to command a price premium over comparably sized and located multi-tenant assets. With passive and predictable income streams, the best net lease assets offered higher yields than otherwise comparable low-risk investments.

Nearly six years since the economy touched bottom, the underlying crisis conditions that encouraged robust capital inflows to the single-tenant net lease sector have mostly dissipated. The American economy is on firmer footing in 2015, even if the headline growth rate slowed heading into the winter months. Though wage gains remain somewhat elusive, the labor market has developed significant momentum, adding more than 3 million new jobs during 2014. Business and consumer confidence levels have returned to pre-recession levels. Across commercial property types and locations, access to low-cost financing has improved in tandem with CMBS issuance and bank lending, particularly for smaller assets. On balance, if a flight to stability worked to the benefit of net lease investment during the downturn, current indicators of market health point to a difficult reversal for net lease valuations, and yet the data shows no such reversal.

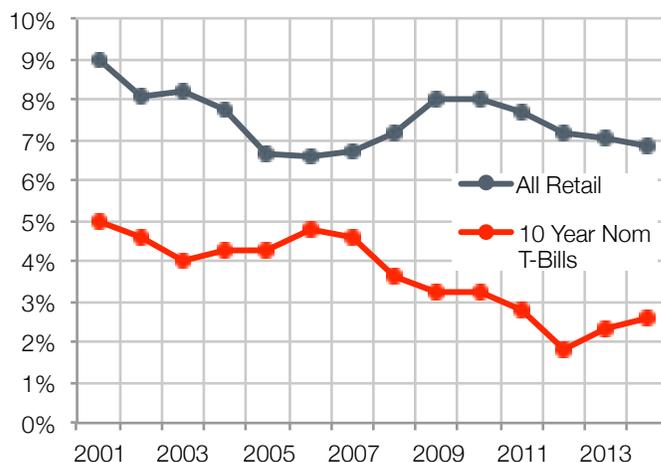
While many investors have recovered their appetite for risk, overall demand for net lease properties remains remarkably undiminished. Across the retail, industrial, and office sectors, the volume of single-tenant net lease sales, measured in terms of deals backed by secured financing, increased in 2014 for the third-consecutive year. In spite of low yields and clearer signals from the Federal Reserve that policy adjustments may be imminent, investors and lenders are generally bullish on the outlook for transaction volume in 2015 as well.

SO MANY BUYERS, SO FEW ASSETS

Like other low-risk assets, the net lease space has been characterized by a marked imbalance of investor demand and assets available for sale. Buyers easily outnumber advertised buying prospects, including sale-leasebacks. The development pipeline has offered little relief. Unlike multi-tenant properties, the single-tenant build-to-suit segment of the market is not subject to the same speculative forces. In the retail mall space, the absence of significant new development has meant fewer available pads for freestanding single-tenant properties. First-time buyers, who invariably have less access to the off-market trading of the most desirable assets, feel the supply imbalance most acutely.

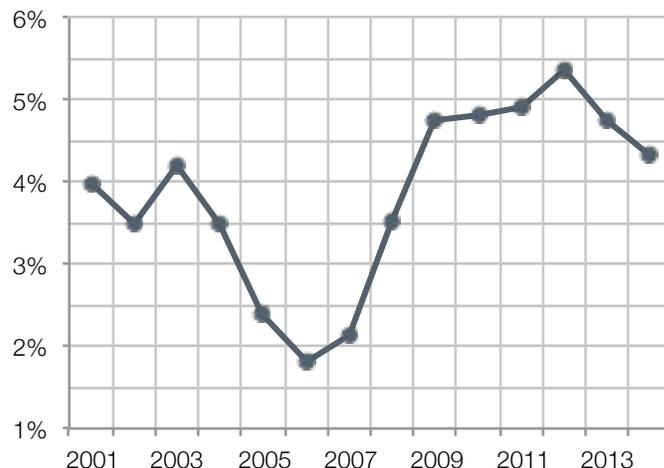
All NNN Retail Cap Rate vs 10-Year Treasury

Source: Chandan, Calkain



All NNN Retail Cap Rate Spread Over 10-Year Treasury

Source: Chandan, Calkain



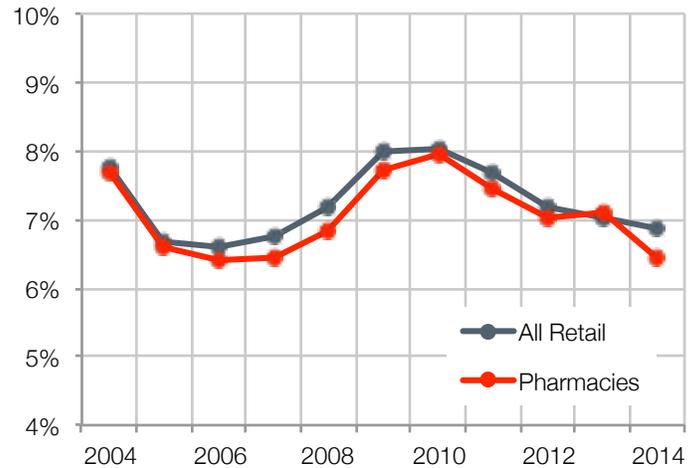
In an environment of limited supply, with low opportunity costs and consistently improving access to financing, net lease cap rates for on and off-market deals have continued along their downward trajectory. In the single-tenant retail space, cap rates dipped to an annual average of 6.89 percent during 2014, down 16 basis points from the prior year. In the fourth quarter, the average cap rate was 6.71 percent. Across lease terms, assets with longer remaining terms have maintained a significant price premium over properties with pending rollovers.

Bank branches, national chain pharmacies including CVS and Walgreens, and quick service retail all ended 2014 with cap rates at record lows. Bank branch cap rates averaged 5.35 percent in 2014 and regularly traded below 5 percent in prime locations. Some investors have expressed concerns about the attractiveness of gas stations in an environment of low retail gas prices. In fact, gas stations have generally performed well as retail prices have trended lower, reflecting that they are also buying gas at lower prices in the wholesale market. The brunt of lower prices is borne by oil companies' exploration and production business lines. In many cases, retail prices are stickier than wholesale, with the result that margins have widened and profits have increased.

While lower gas prices put more dollars back into the pockets of consumers and may spur higher retail spending, the shift in the broader commercial real estate investment market's attention to industrial properties has also benefited single-tenant warehouse and distribution space. Net lease fulfillment and logistics centers, currently in

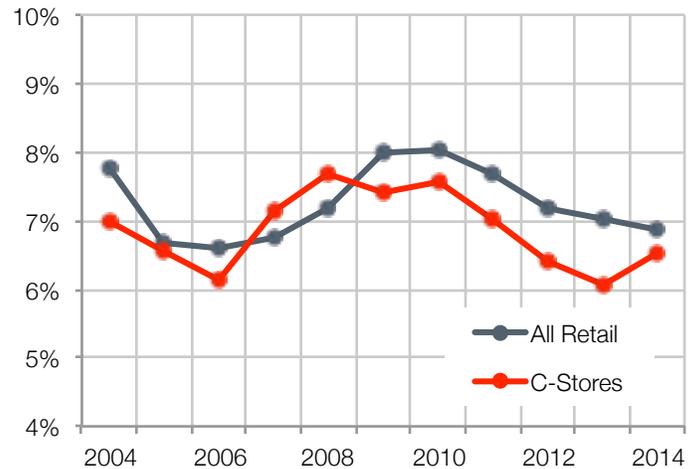
All NNN Retail Cap Rate vs Pharmacies

Source: Chandan, Calkain



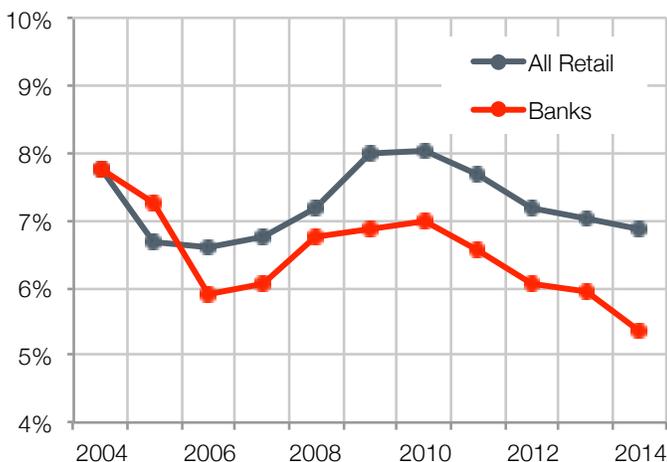
All NNN Retail Cap Rate vs Convenience Stores

Source: Chandan, Calkain



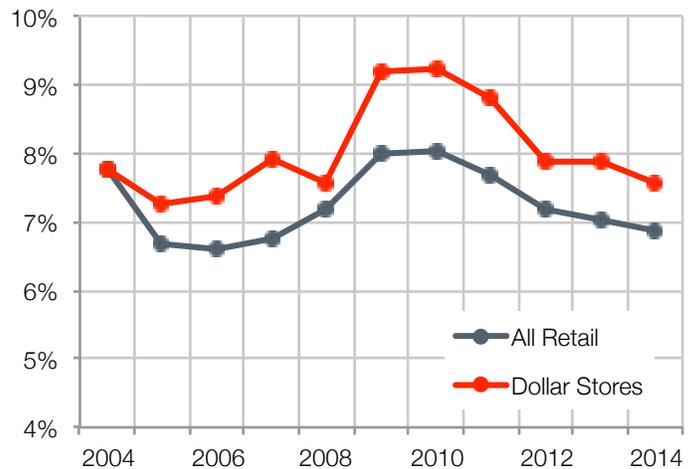
All NNN Retail Cap Rate vs Banks

Source: Chandan, Calkain



All NNN Retail Cap Rate vs Dollar Stores

Source: Chandan, Calkain



short supply for buyers as well as for prospective tenants, have garnered investor interest in tandem with growth in same-day delivery online commerce.

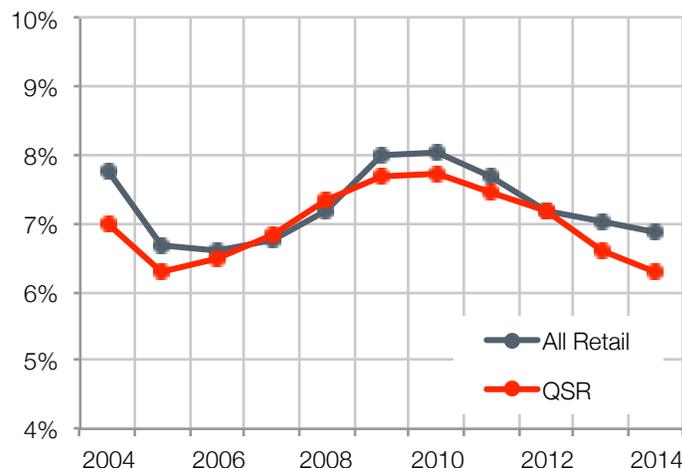
PARALLELS WITH FIXED-INCOME SECURITIES

More than traditional multitenant properties, single-tenant net lease assets are sensitive to changes in the interest rate environment because of their fixed income-like characteristics. All else equal and independent of expected and realized inflation, the market value of the property cash flow will be inversely related to interest rates. For most investors, a world where higher interest rates drag on values seems a distant reality. Economists and the markets at large have been proven wrong in their interest rate projections several years running. A year ago, consensus projections showed ten-year Treasury yields in early 2015 at double their current levels. While the persistence of low rates has left investors somewhat inured to low costs of capital, improving trends in the labor market (described on the following page) and signals from the Federal Reserve point to a turning point in monetary policy and the interest rate environment around mid-year.

Properties with rent escalations tied to inflation or other benchmarks that are correlated with interest rates will see more resilient valuations as rates trend higher. Nonetheless, stress on values remains a key consideration for the outlook.

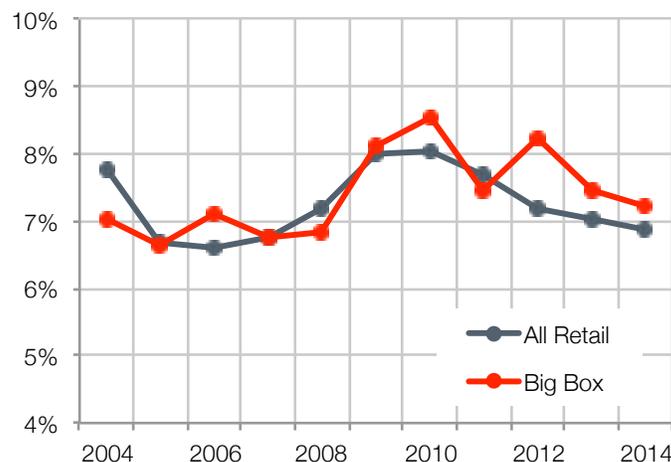
All NNN Retail Cap Rate vs QSR

Source: Chandan, Calkain



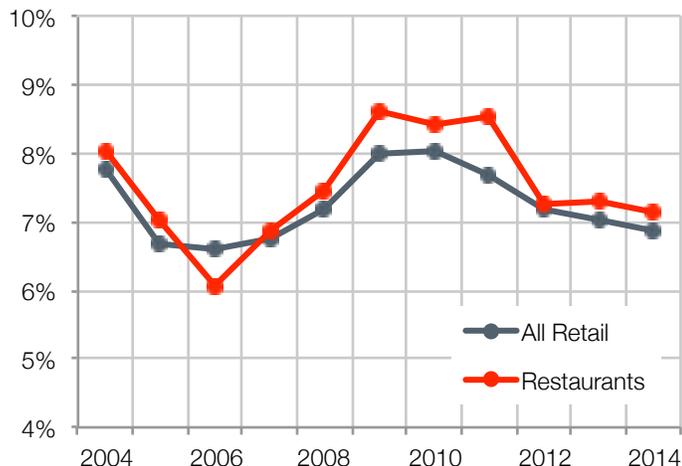
All NNN Retail Cap Rate vs Big Box

Source: Chandan, Calkain



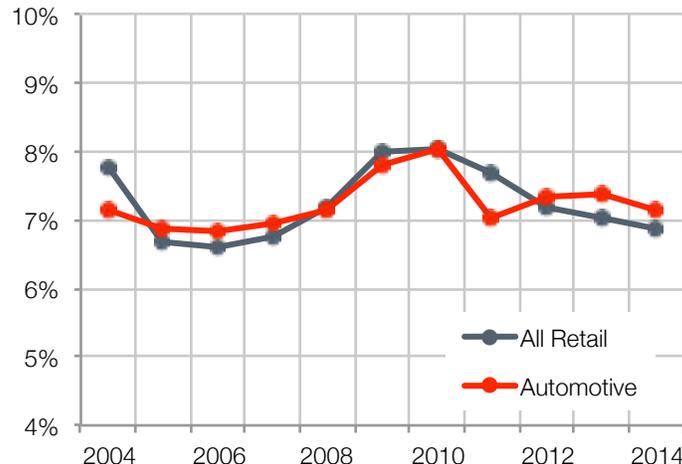
All NNN Retail Cap Rate vs Casual Dining

Source: Chandan, Calkain



All NNN Retail Cap Rate vs Automotive

Source: Chandan, Calkain



ECONOMY

In sharp contrast with its global context, the near and medium-term outlook for the United States has firmed over the last year. In Europe, fiscal and political woes persist as serious drags on the Continent's economies. In Russia, the Middle East, and Western Africa, lower oil prices and geo-political instability have altered prospects for growth, oftentimes substantially. In Asia, Japan's all-out assault on deflation is proving rather fruitless, at least as of early 2015.

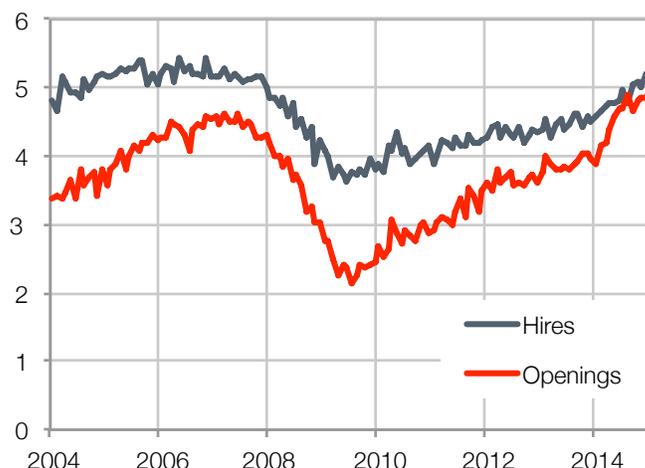
Back in the United States, business and consumer sentiment measures are pointing up, even though economic data paints a mixed picture. GDP growth slowed from an annualized rate of 5.0 percent in the third quarter to just 2.2 percent in the fourth quarter, owing in part to higher imports. In terms of this broadest measure, prospects for 2015 are only marginally better in the eyes of the Federal Reserve. Coming out of its mid-March policy meeting, the Federal Open Market Committee ratcheted down its projections for growth this year to between 2.4 percent and 2.7 percent. The outlook for corporate profits is also reserved, reflecting the impact of lower oil prices on energy companies.

Where the economic expansion has been lackluster, the big driver of optimism has been the long-awaited uptick in the labor market. Payrolls increased by 2.6 million jobs in 2014, the best result in 14 years. While the most recent data for 2015 have fallen short of expectations, the underlying trends in the job market are robust by some measures. The number of Americans quitting their jobs voluntarily, a proxy for opportunities in the job market, has been climbing steadily. Job openings have been increasing at faster rate than hiring, rising above 5.0 million in early 2015 to their highest levels since the frenzy of the dot-com boom.

Tepid wage gains and a decline in labor participation that cannot be fully explained by demographics attest to persistent unevenness in the labor market recovery, but the mood is brighter nonetheless. The University of Michigan Survey of Consumer Sentiment has come off a ten-year high recorded in January but is still firmly above its long-term average.

Job Openings and Hires

Source: Bureau of Labor Statistics in Millions



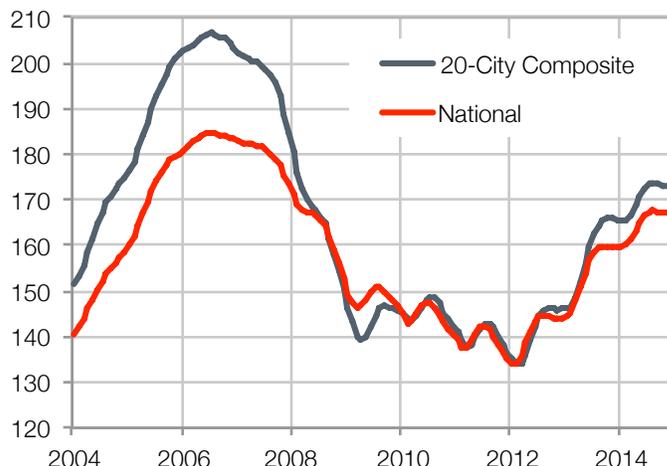
Oil Prices, Brent Crude in US Dollars

Source: Energy Information Administration



S&P/Case-Shiller Home Price Index

Source: S&P



Apart from a more stable job market, consumer psychology has been further buttressed by the ongoing recovery in home prices, which has restored a substantial share of households' lost home equity and overall wealth. Record-high stock market indices have reinforced any positive wealth effects by growing the value of investment and retirement accounts.

As the labor market tightens and wage and salary trends improve, looser purse strings should translate into higher consumer spending. As it stands, the headline retail sales numbers for early 2015 are dismal. Excluding autos, retail sales in February were just 0.8 percent higher than a year earlier, declining in real terms. The trends capture the impact of the sharp 23-percent drop in spending at gas stations, owing to lower prices as opposed to lower gas consumption. In other lines of business, the results are decidedly better. Pharmacy sales increased 4.8 percent year-over-year, while spending at restaurants and bars advanced 7.7 percent.

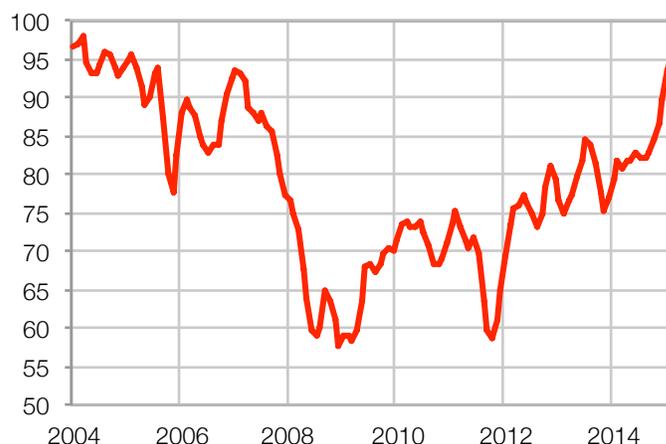
The largest increases in retail sales continue to accrue to e-commerce. Competition for the hearts and minds of shoppers has never been fiercer, as online retailers reduce shipping times to hours instead of days while largely retaining their significant tax advantage. Bricks-and-mortar retailers with a focus on the customer experience and service providing retailers are in relatively more defensive positions. All else equal, that favors net lease retailers across a wide range of tenancy, including quick service retail, bank branches, and pharmacies.

Grocery stores and grocery-anchored centers remain clear investor favorites in mitigating the risk from online competition. As compared to discretionary purchases, sales of groceries are relatively resilient to the economic cycle and to changes in consumer preferences. Groceries have also demonstrated the lowest substitution into online commerce of any major product type. If a neighborhood is growing, overall demand for groceries through traditional channels almost certainly rises; the primary risks are on the supply side, which is less prone to rampant speculation than are the arenas of multi-tenant office or industrial space.

Nonetheless, investors should keep an eye on delivery services such as Amazon Fresh and Instacart, which may yet succeed in swaying savvier consumers in higher income neighborhoods as they work to enhance the ordering and delivery experience.

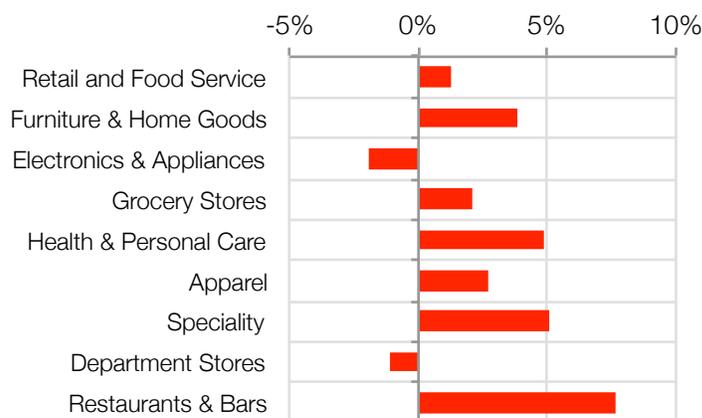
Consumer Sentiment

Source: University of Michigan



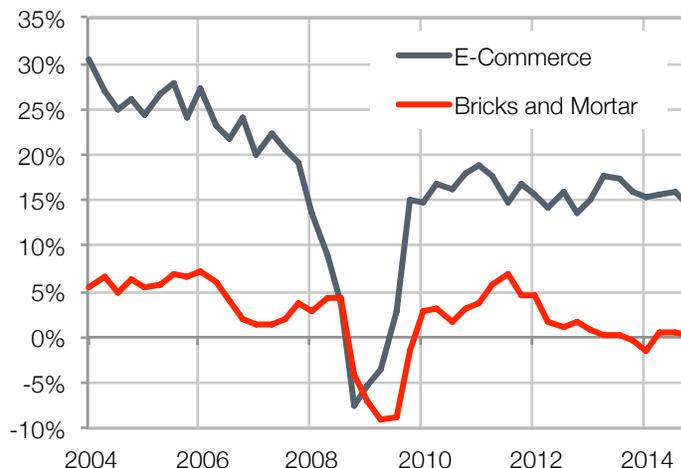
Percent Change in Retail Sales from Year Earlier

Source: Commerce, Chandan



E-Commerce and Bricks and Mortar Sales, Change From Year Earlier

Source: Census



FINANCE & INVESTMENTS

Access to financing continues to improve across the full breadth of commercial property types, with origination volume in 2014 climbing to nearly \$400 billion. Lenders' reengagement for smaller retail properties, including retail net lease assets, had lagged in the early stages of the recovery. Over the last two years, the sustained increase in CMBS volume has leveled the playing field significantly. Issuance volume approached \$100 billion in 2014 and surpassed the \$100 billion mark when measured in terms of originations. On one hand, that has enhanced the overall liquidity of the net lease market. It has also eroded the advantage of buyers able to make all-cash purchases.

Including valuations on property refinancing by banks, conduit lenders, and a small number of life company loans, net lease retail cap rates during the fourth quarter were 10 basis points lower than a year earlier. Interest rates on fixed-rate loans with a minimum 3-year term were 30 basis points lower. Buyers also had improved access to secured financing in terms of lower debt yields and higher loan-to-value ratios. Debt yields declined 50 basis points, to a national average of 10.0 percent, consistent with an increase in loan-to-value ratios from 64.2 percent to 65.9 percent.

Investors can expect continued improvement in liquidity and access to financing for small and mid-cap assets during 2015. Qualifying those trends, a larger number of institutional and private investors contesting the best net lease properties also implies greater competitive pressures amongst buyers and the prospect of further yield compression, which may offset in part the drag from higher interest rates on values.

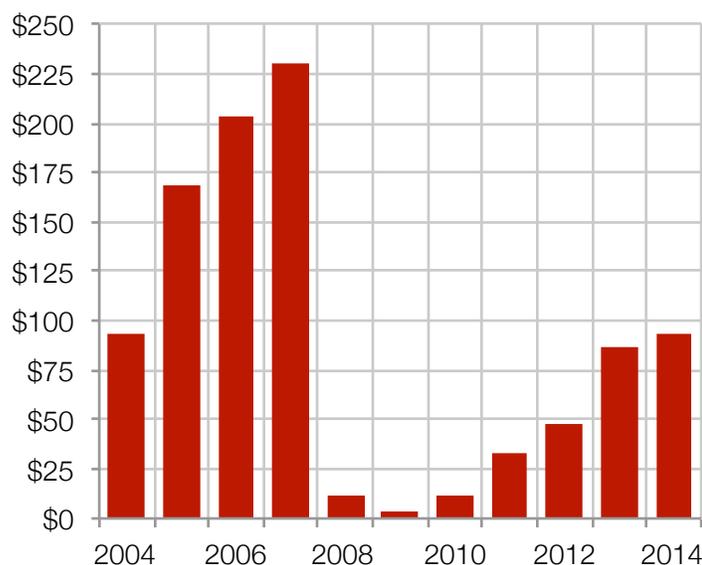
Single-Tenant Retail Financing Sales & Refinancings; Fixed-Rate Originations

Source: Chandan Economics LLC

	Q4 2014	Q4 2013	Q4 2012
Interest Rate	4.7%	5.0%	4.8%
Debt Yield	10.0%	10.5%	11.2%
Borrowing Per \$ NOI	\$9.98	\$9.52	\$8.93
Cap Rate	6.6%	6.7%	7.0%
Loan-to-Value	65.9%	64.2%	59.6%
Debt Service Coverage	1.6x	1.7x	1.7x

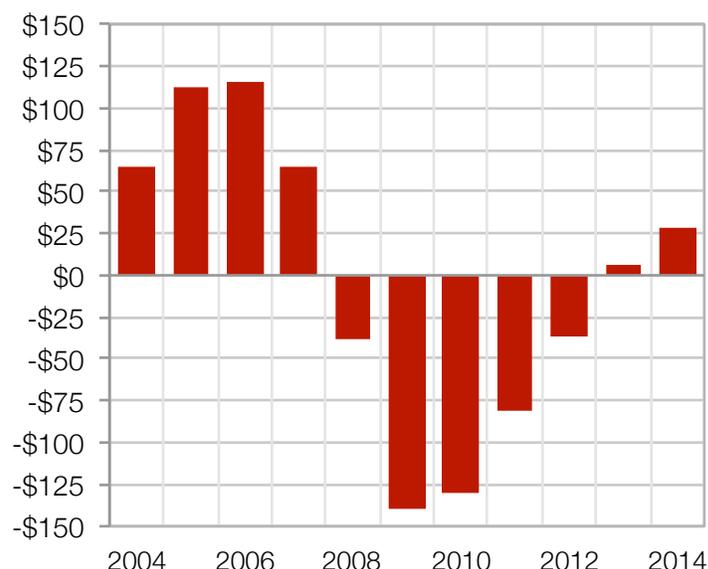
CMBS Issuance in Billions

Source: Chandan, Calkain, Issuer Filings



Net Change in Bank Commercial Real Estate Lending in Billions

Source: Chandan, Calkain, Bank Call Reports



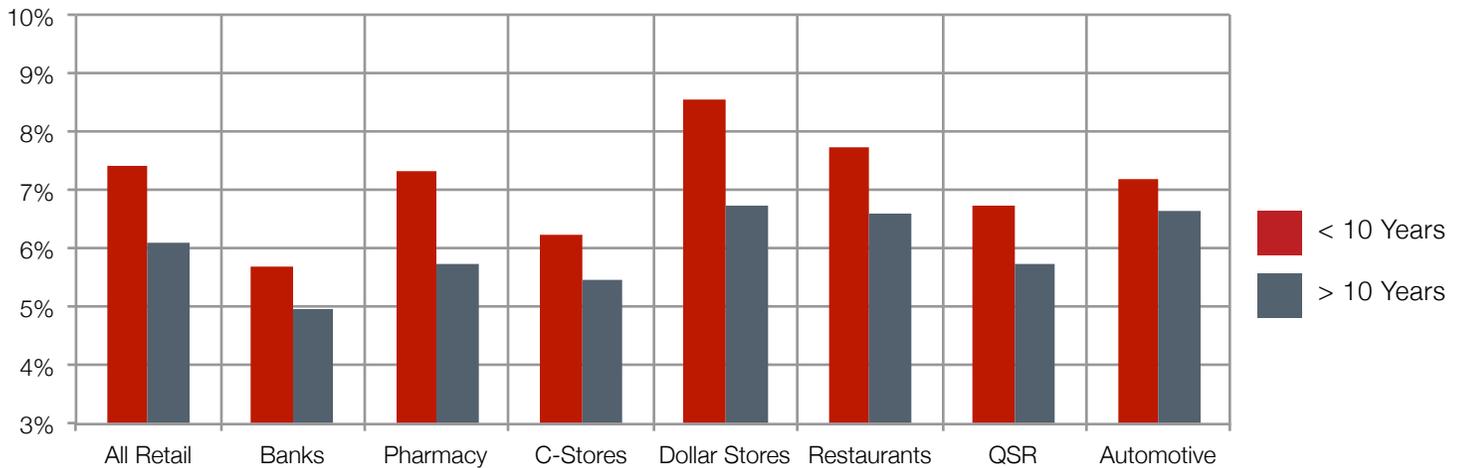
2014 CAP RATES BY REMAINING LEASE TERM

While market rents are increasing and a growing share of lease rollovers are now accretive to cashflow, properties with longer remaining lease terms still command a significant price premium. Bifurcating the pool of 2014 transactions by remaining lease terms of greater than or less than 10 years, the difference in cap rates across all retail property types was just over 130 basis points. Across the dimensions of franchise and corporate tenants and credit and non-credit tenants, the magnitude of price differences was much smaller.

Bank branches, convenience stores, and automotive centers showed the smallest differences in cap rates. In the case of bank branches, the cap rate spread across short and long leases was just 70 basis points. This relatively narrower spread suggests higher renewal probabilities on these leases or a stronger recovery in market rents. At the other extreme, the spread for dollar stores was 180 basis points, consistent with higher volatility in cash flow.

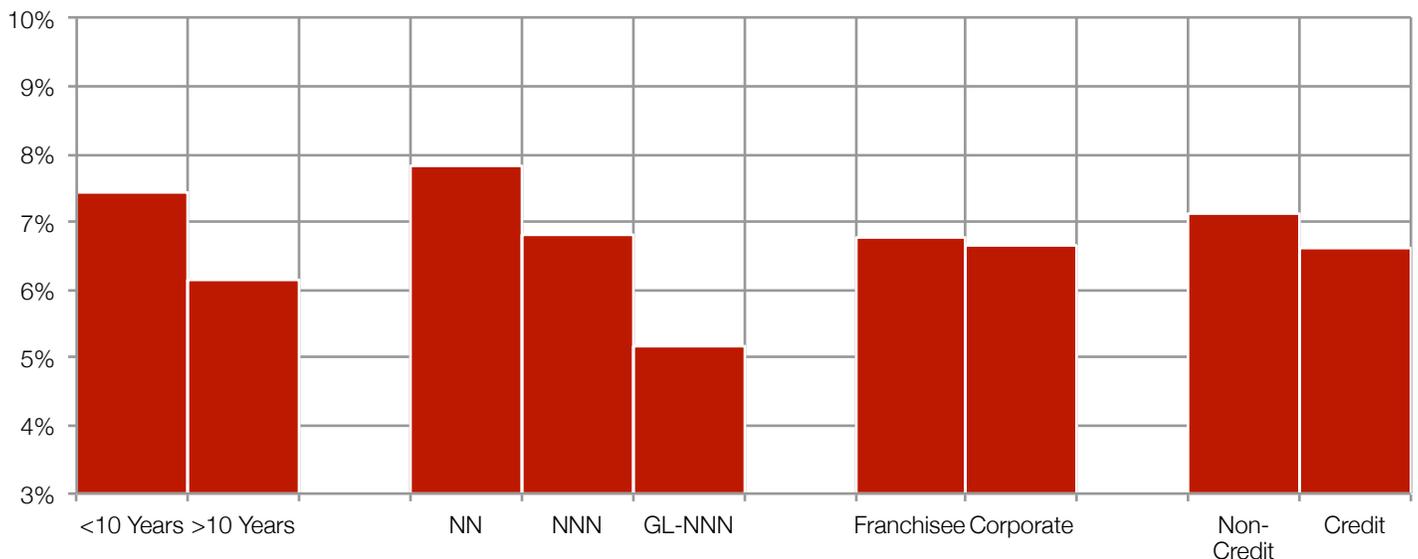
2014 Cap Rates Over/Under 10 Year Terms

Source: Chandan, Calkain



2014 Average Cap Rates Across All Tenant Types

Source: Chandan, Calkain



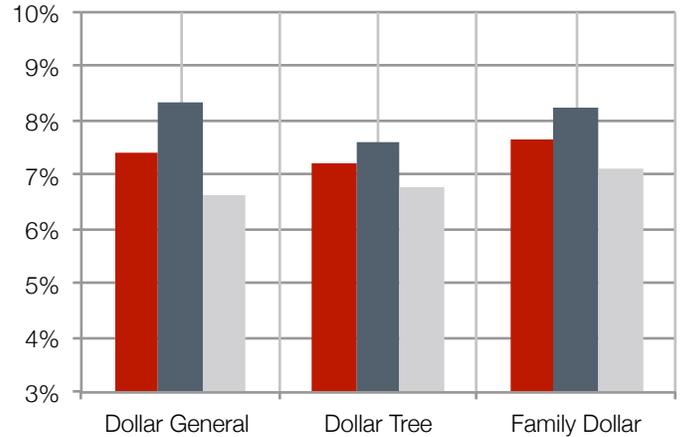
CAP RATES BY TENANT TYPE AND REMAINING LEASE TERM

Even within tenant types, the relationship between remaining lease term and prices varied across specific tenants in 2014. In the case of pharmacies, these differences were especially pronounced. For pharmacies with CVS tenants, cap rate spreads across remaining lease terms were roughly 50 basis points. In the case of Rite Aid tenants, however, the difference was more than 300 basis points. In the Quick Service Restaurant space, the spread was wider for Burger King than for McDonald's or Starbucks.

■ All
 ■ < 10 Years
 ■ > 10 Years

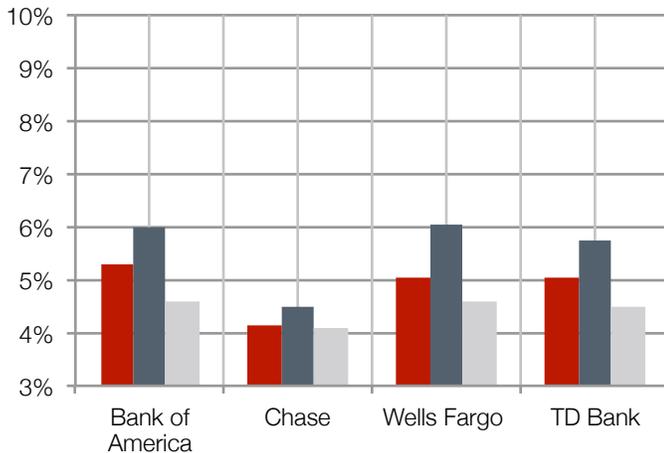
Dollar Stores

Source: Chandan, Calkain



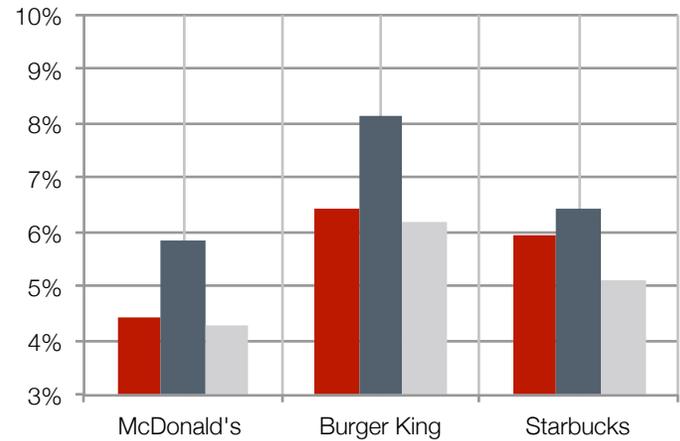
Banks

Source: Chandan, Calkain



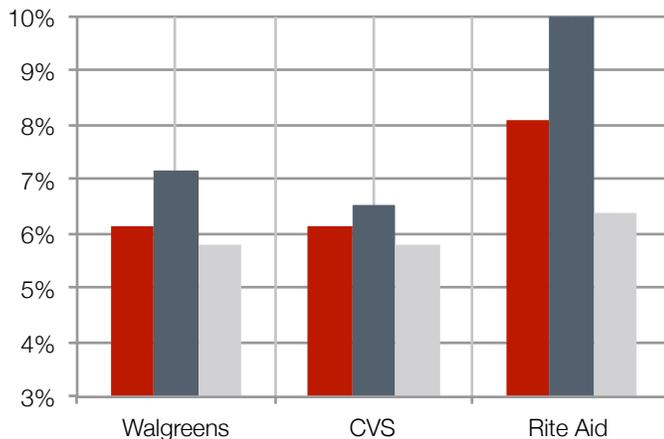
QSR

Source: Chandan, Calkain



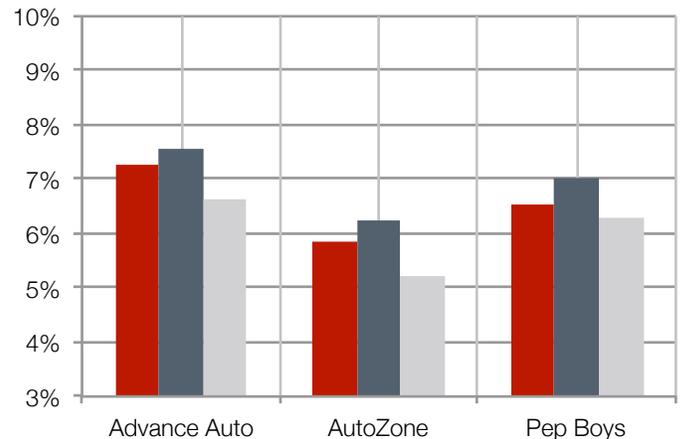
Pharmacies

Source: Chandan, Calkain



Automotive

Source: Chandan, Calkain





JONATHAN W. HIPPI is the Founder, President and CEO of Calkain Companies and is a member of Calkain's Executive Committee. Calkain is a national, commercial real estate firm which provides brokerage and consulting services for both private and institutional clientele

that specializes in assisting buyers and sellers with the acquisition and disposition of single and multitenant net lease investment properties. The company is comprised of five divisions specializing in brokerage, advisory, asset management, capital markets and research.

Jonathan is one of the leading experts in Net Lease Investments. With over 25 years of experience in Commercial Real Estate, he manages the overall strategies and growth of Calkain and has successfully completed nearly \$3 billion in investments throughout his career. Through his leadership and vision, Calkain has grown to \$10 billion in transactions.

Mr. Hipp also serves as a member on the President's Council of the prestigious invitation-only Real Estate Roundtable. His unique industry expertise is manifested in a well reviewed book he co-authored, *The Little Book of Triple Net Lease Investing*, which serves as a handbook for investors.



DR. SAM CHANDAN is the Founder and Chief Economist of Chandan Economics and Adjunct Associate Professor of Real Estate at the Wharton School of the University of Pennsylvania. Dr. Chandan's research and market commentary are focused on commercial real estate capital

markets, the structure and regulation of housing finance, and the credit performance of residential and commercial mortgages. Widely cited in the business press, he is also the editor and co-author of *Real Estate Finance*, a columnist for the *New York Observer* and *GlobeSt*, and co-host of the *Real Estate Hour* on SiriusXM Business Radio.

Dr. Chandan is the National Economist of the Real Estate Lenders Association (RELA) and has held advisory and editorial board appointments at the Federal Reserve Bank of Atlanta, the Real Estate Research Institute, the National Center for Seniors Housing, the Commercial Real Estate Finance Council, and *Multihousing News*. Prior to founding Chandan Economics, Dr. Chandan was Chief Economist at Reis and Global Chief Economist at Real Capital Analytics. He holds a PhD in Applied Economics from the Wharton School and was a doctoral scholar in the Economics Department at Princeton University. He currently teaches Real Estate Investments at Wharton and was a visiting professor in the Economics Department at Dartmouth College.

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