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AMERICA'S NET LEASE COMPANY®

QSR SECTOR

NET LEASE REPORT September 2018

QSR SECTOR

The Quick Service Restaurant (QSR) sector has continued its strong run into 2018. Cap rates remain relatively stable, although the past 12 months we've seen a slight drop, reaching 5.62%. Corporate guaranteed stores or established franchisees with strong sales are driving much of the traffic, and are quick to be scooped up upon hitting the market.

QSR net leased properties have continued to trade at lower cap rates than the single tenant net lease (STNL) average because they have attractive leases, strong locations, and are resistant to ecommerce.

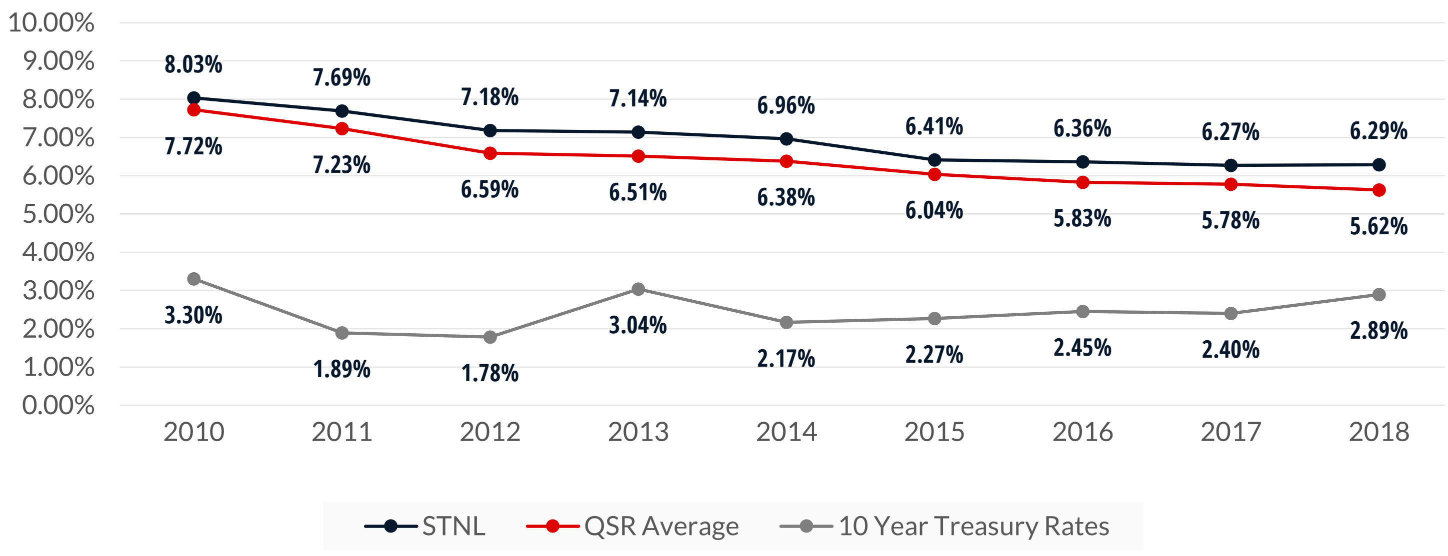
QSRs tend to sign long term leases (15–20 years) that are triple net, leaving the investor with no landlord responsibilities. The leases will usually feature some form of rental increase, the amount and frequency can vary from tenant-to-tenant and from operator-to-operator.

The location of many QSRs is another attraction for investors. Being near major roadways with good visibility will not only draw hungry people but investors too. These locations are highly desirable because of their ease and convenience. The buildings are very easy to backfill, if the original tenant were to leave. The layouts of most QSR tenants are relatively similar meaning the renovations a second QSR tenant would need to complete would be mostly cosmetic and inexpensive.

QSRs operate in an area in which ecommerce cannot. No matter the supply chain or scale, online retailers like Amazon will not be able to steal customers away by offering the same products or performing the same services at a lower cost. Shipping fully cooked cheeseburgers is unlikely to catch on.

Rising labor costs and changing consumer preference are the two largest challenges facing QSRs today. The industry has already begun adjusting. Some tenants, such as McDonald's and Panera Bread, have started testing self-service kiosks to reduce their labor costs. Consumer preferences are constantly evolving and QSRs are constantly playing catch-up. When consumers wanted healthier food, QSRs responded with new menu options.

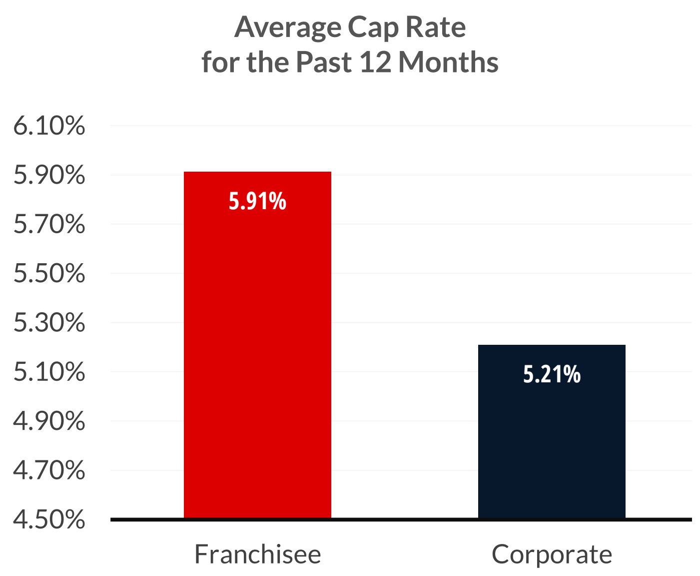
STNL Cap Rates vs QSR Sector Average vs 10-Year Treasury Rates



Franchisee vs Corporate

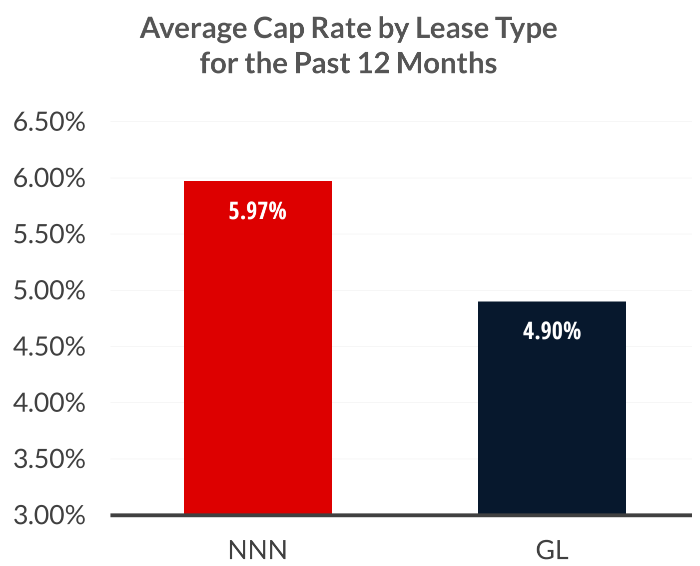
There has been a large gap in the average cap rate of franchisee backed leases and corporately guaranteed leases. These differences, a 70 bps premium in the last 12 months, arise from the perceived financial strength of the guarantor over that of a franchisee. Many corporate QSRs are publicly traded companies, allowing investors the opportunity to access financial records. These large companies have credit ratings, giving investors further information on the financial strength of their tenant.

Franchisees are a very heterogeneous group, ranging in size from a single location operator to a company that has hundreds of locations under various QSR brands. This variety makes it essential that investors look at the franchisee's financial strength before purchasing a property. Regardless, investors should expect to pay a premium for a corporately guaranteed location.



Lease Type

The type of lease tenants sign will have a large impact on the cap rate when a property trades. Most QSR tenants will sign triple net or ground leases, in both cases the tenant is responsible for the taxes, insurance, and maintenance of the property. This will leave investors with no landlord responsibilities and a passive source of income. What differentiates these two leases is what the investor owns. For fee simple triple net leases, investors own the land and building, and for ground leases, investors own the ground and not the building. The tenant must construct any improvements at their own expense. Ground leases will often have lower rent, longer lease terms, and have rental increases built in during the primary term. These factors lead to a ground lease trading at lower cap rates than triple net leases.



Typical Lease Structures

Arby's

Type: Fee Simple
Guarantee: Corporate
Lease Term: 20 Years
Escalations: Varies
Cap: 5.94%

Burger King

Type: Ground Lease/Fee Simple
Guarantee: Corporate
Lease Term: 10-20 Years
Escalations: 7.5% Every 5 Years
Cap: 5.62%

Chick-fil-A

Type: Ground Lease
Guarantee: Corporate
Lease Term: 20 Years
Escalations: 10% Every 5 Years
Cap: 4.41%

Church's Chicken

Type: Fee Simple
Guarantee: Corporate
Lease Term: 20 Years
Escalations: 10% Every 5 Years/
1.5% Annually
Cap: 6.20%

Dunkin' Donuts

Type: Ground Lease/Fee Simple
Guarantee: Corporate/Franchisee
Lease Term: 15-20 Years
Escalations: 8-10% Every 5 Years
Cap: 5.52%

Hardee's

Type: Ground Lease/Fee Simple
Guarantee: Corporate/Franchisee
Lease Term: 15-20 Years
Escalations: 5-10% Every 5 Years
Cap: 5.85%

KFC

Type: Ground Lease/Fee Simple
Guarantee: Corporate/Franchisee
Lease Term: 15 Years
Escalations: Varies
Cap: 6.04%

McDonald's

Type: Ground Lease
Guarantee: Corporate
Lease Term: 20 Years
Escalations: 10% Every 5 Years
Cap: 4.20%

Sonic America's Drive-In

Type: Fee Simple
Guarantee: Corporate/Franchisee
Lease Term: 15-20 Years
Escalations: Varies
Cap: 6.15%

Starbucks

Type: Fee Simple
Guarantee: Corporate
Lease Term: 10 Years
Escalations: 10% Every 5 Years
Cap: 4.92%

Taco Bell

Type: Ground Lease
Guarantee: Corporate
Lease Term: 20 Years
Escalations: Varies
Cap: 5.17%

Wendy's

Type: Fee Simple
Guarantee: Corporate
Lease Term: 20 Years
Escalations: 5-10% Every 5 Years
Cap: 5.33%

Most Common Tenants

Below is a chart showing the five most traded QSR tenants over the last 12 months and illustrates the difference in average cap rates for all sales and average cap rates for sales of properties with at least 10 lease years remaining. Longer leases tend to keep cap rates low.

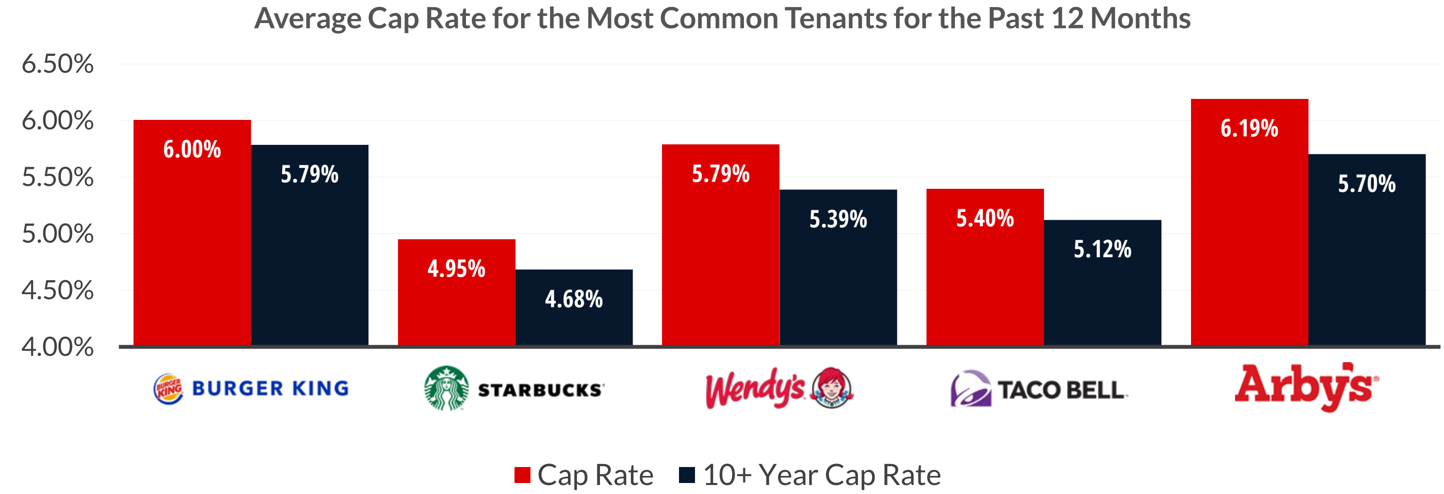
Burger King was the most traded QSR tenant for the second year in a row.

Starbucks has traded below 5% cap rates because of their desirable locations and strong corporate guarantees.

Wendy's had the smallest proportion of ground leases of the top five QSR tenants.

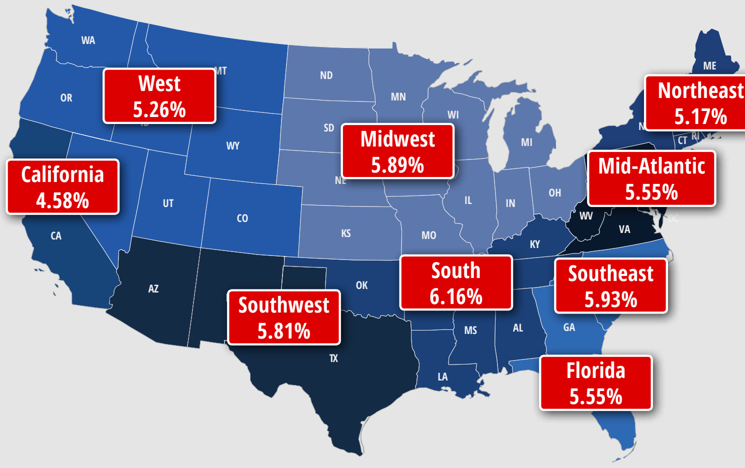
Taco Bell has traded at lower than average cap rates due to its high percentage of properties subject to ground leases.

Arby's had the largest difference between the average cap rate and the average cap rate for properties with at least 10 years remaining.



Cap Rate by Region

This map shows how cap rates can vary by region. California has traded at the lowest cap rates because of the high demand for properties in that state. QSR properties in the northeast have also traded at lower than average cap rates, due to the higher population density in the region and the high percentage of ground leases.



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DISCLOSURES: As part of our market research, we collect sales price, cap rate, and lease years remaining for all publicly advertised and sold STNL properties. a) We are not able to capture 100% of the off-market transactions that occur; however the nature of off-market typically limits their value as true market comps. b) Sources include public records, sales announcements, Calkain sales, and appraiser obtained sales amongst others. c) Our collection process, while thorough, is not all encompassing and there may be biases in the data as it relates to geography, tenancy, or brokers involved in the transaction. d) Public records often lag behind when transactions actually close, months in some cases. Consequently the data supplied here for any given quarter is likely to miss a material amount of transactions that actually closed in it.