National Report

Net-Leased Retail Research

Fall 2017

Marcus & Millichap

Job Growth, Household Formation Powering Retail; Investors Remain Active Amid Stable Rate Environment

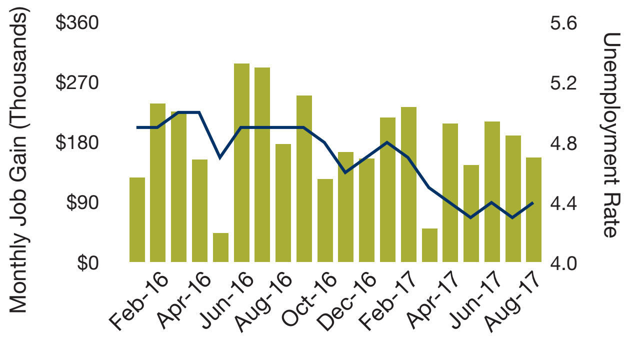
Economic momentum remains in place as tight labor markets contribute to steady growth. Driven by consistent job gains and the lowest unemployment rate since the early 2000s, retail sales remain on an upward trajectory. The steady recovery in the labor market has been dominated by advancement in office-using sectors, which combined for more than 734,000 new jobs over the last year, representing the strongest overall sector in the economy. As a result, household formation expanded meaningfully, creating demand for a broad array of retail products, particularly in the durable goods sector. The momentum has also spilled over into building supplies retailers as the new households remodel existing single-family homes amid a shortage of new construction. Looking forward to the remainder of 2017, extremely low unemployment will begin to feed into greater gains in average hourly earnings, which rose 2.5 percent in August. Increases in spending power will likely be deployed as the savings rate has shrunk over the past few years, reflecting growing confidence among consumers.

- Job growth remains steady, with gains averaging 174,000 positions per month over the past year. As a result, the unemployment rate fell to 4.4 percent, the lowest level since 2001.
- The formation of nearly 1.5 million households this year will drive demand in a number of retail categories, particularly durable goods such as furniture and building materials.
- Core retail sales advanced 3.3 percent year over year in July, highlighting the strength of consumers. Lead growth categories include e-commerce, building materials and garden supplies, and furniture and home furnishings.

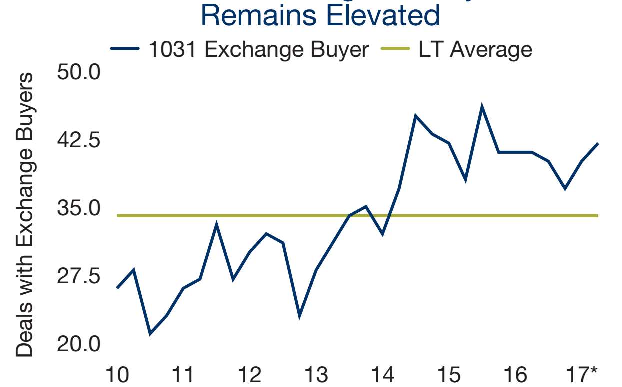
Stabilization of interest rates supporting net-lease market; concern for 1031-exchange revisions remain unanswered. Following the sharp move in interest rates last year, the tight range of long-term interest rates in 2017 has provided a more normalized transaction environment. Spurred by the limited use of leverage in the asset class, buyers have remained focused on properties in quality locations backed by strong nationally accredited tenants. Looking ahead, legislative changes from Capitol Hill remain in flux, although further clarity on regulatory and tax code changes could spark greater urgency among investors to transact before or after the changes are implemented. The most acute issue under discussion is the status of the section 1031 tax-deferred exchange. Driven by investor's desire to shift their portfolios towards less management intensive assets, 1031-exchange volumes make up a considerable portion of the net-lease marketplace. In 2017, exchange-related buyers encompassing more than 40 percent of transaction volumes. As a result, the status of this tax provision moving forward will remain a major driver of deal flow and investment demand.

- Average asking rents have risen 4.3 percent over the past year, reaching $20.21 per square foot nationwide at the end of the second quarter. Average prices per square foot have now exceeded the previous high set in the first quarter of 2008.
- Net-leased development remains the key driver of overall retail construction, accounting for more than 46 million square feet of the 60.4 million square feet delivered over the past year. Single-tenant construction has averaged 45 million square feet over the past three years.

Job Growth Powering Low Unemployment

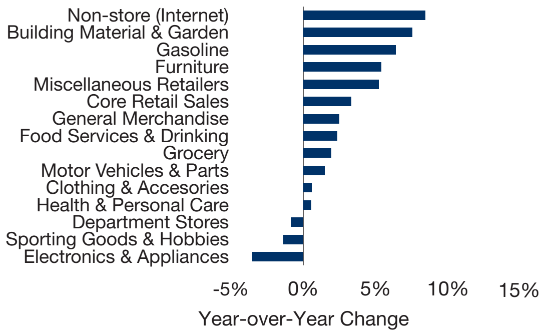


1031-Exchange Activity Remains Elevated

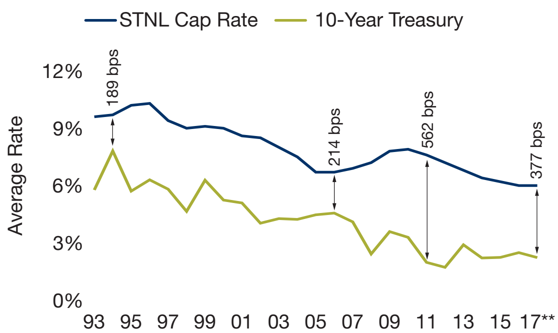


* Through 2Q2017

Retail Sales Growth*

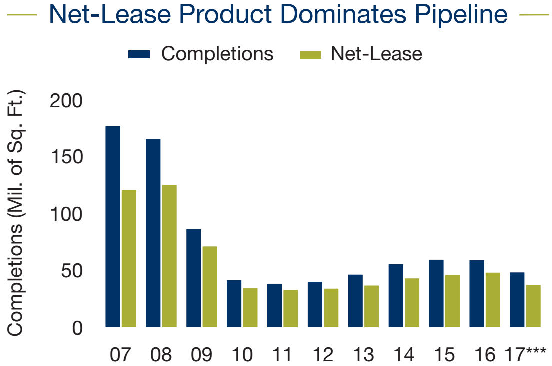


Yield Spread Supports STNL Investment



10-Yr Treasury Trades in Tight Range

Net-Lease Product Dominates Pipeline



* Through August 2017
** Through September 26, 2017
*** Forecast

Uncertainty remains around future of 1031 exchange in potential tax changes; muted effects on pricing and deal flow. Amid rumors and speculation about potential changes to tax and regulatory policy out of Congress, investors and developers alike are contemplating the future of the 1031 exchange. Amid the extensive use of this provision in net-leased deals, the potential elimination of this statute could have a substantial impact on deal flow as investors adjust to the new tax code. While the speculation has been a constant source of discussion among investors, the issue has had little effect on pricing, with infill assets with top-tier tenants pricing from the low-4 percent band.

- The potential for tax code changes, coupled with increasing competition among net-leased concepts, is generating a longer, more intensive due diligence period as investors exercise more caution.
- Initial plans have called for a lowering of the corporate tax rate while simultaneously trimming individual tax rates. The deductions in revenue would be slightly offset by eliminating deductions, although details and concrete plans remain in flux.

Upward pressure remains on interest rates amid policy normalization from the Federal Reserve. The Federal Reserve recently announced the first steps toward normalizing its balance sheet, which expanded to more than $4.4 trillion in the wake of the financial crisis. Initial plans call for allowing $10 billion in Treasurys and agency securities to roll off the balance sheet per month, increasing by $10 billion every quarter to a maximum of $50 billion per month. As a result, upward pressure on interest rates is likely as the market adjusts to less liquidity.

- The spread between the 10-Year Treasury and the average single-tenant cap rate is roughly 380 basis points, resting between the widest point at 560 basis points reached in 2011 and the narrowest point at 215 basis points registered in 2006.
- The Federal Reserve has also signaled additional rate hikes over the course of the next year, with one rate hike slated for 2017 and four increases in 2018.

Developers focused on net-lease properties amid labor market strength and extremely low unemployment. Throughout the current business cycle, builders have been constructing projects favoring single-tenant concepts, particularly in the quick-service restaurant, pharmacy and dollar-store segments. Broadly, net-leased deliveries have accounted for more than 80 percent of retail development since 2009, up from below 70 percent before the recession. Despite the upswing of net-leased deliveries, demand for spaces remains well ahead of supply growth, with net absorption exceeding development by an average of more than 16 million square feet annually since 2010. As a result, vacancy has fallen 250 basis points to 4.7 percent nationwide.

- Retail sales remain constructive for net-leased development, with core retail sales rising 3.7 percent in August on a year-over-year basis. Growth was particularly strong in the furniture and building materials sectors, rising 5.4 percent and 7.5 percent, respectively.
- Following months of discussions with regulators and numerous deal iterations, Walgreens has agreed to purchase 1,932 Rite Aid stores for $4.4 billion. The deal will leave Rite Aid operating roughly 2,600 locations after the deal closes.

Brand	Credit Rating	U.S. Locations
Auto Parts		
Bridgestone/Firestone	A	1,600
O'Reilly Auto Parts	BBB+	4,712
AutoZone	BBB	5,839
Advance Auto Parts	BBB-	5,185
Pep Boys	BB+	804
Dollar Stores		
Dollar General	BBB	13,205
Dollar Tree/Family Dollar	BB+	14,284
General Retail		
Walmart	AA	11,593
Sherwin-Williams	A	4,180
AT&T	BBB+	16,000
Verizon Wireless	BBB+	2,330
Mattress Firm	B+	3,482
Office Depot/Max	B-	1,441
Pharmacies		
CVS	BBB+	9,987
Walgreens	BBB	8,185
Rite Aid	B	4,547
Quick Service Restaurants		
Dairy Queen	AA	4,800
Starbucks	A-	25,085
Chipotle	BBB+	2,250
McDonald's	BBB+	36,899
Yum Brands	BB	43,085
Burger King	B+	20,351
Wendy's	B	6,503
Carl's Jr./Hardee's	B-	3,000
Fast Casual		
Chili's	BBB-	1,652
Darden Restaurants	BBB-	1,541
Red Lobster	BBB-	700
Bloomin' Brands	BB	1,270
Applebee's	B	2,033
Ruby Tuesday	B-	546

Closed Cap Rate Range by Brand*

Cap rates shown above are representative of deals that closed between 1Q2016 and 2Q2017. Actual yields will vary by location, tenant, lease terms and other considerations. Locations and credit ratings sourced from CreditNtell for public companies and lcompany websites for private companies.

* For transactions closed in 2016
Sources: CoStar Group, Inc.; CreditNtell; company sources

Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- **Monetary policy in transition.** Despite the Fed raising its benchmark short-term rate three times in seven months and signaling another rise before the end of the year, long-term rates have remained stable. The yield on the 10-year U.S. Treasury bond remained in the low- to mid-2 percent range throughout the second quarter of 2017. The Federal Reserve wants to normalize monetary policy and, in addition to rate hikes, will likely start paring its balance sheet.
- **Sound economy a balancing act for Fed.** With unemployment hovering in the low-4 percent range, the lowest level since 2007, the Federal Reserve will remain vigilant regarding a possible rapid increase in inflation if wage growth takes off. Additionally, business confidence and job openings are near all-time highs. Businesses finally have the assurance to expand their footprints after years of tepid growth following the Great Recession. The Fed, however, must now balance economic growth and job creation against wage growth and inflationary pressures.
- **Underwriting discipline persists; ample debt capital remains.** Overall, leverage on acquisition loans has continued to reflect disciplined underwriting, with LTVs typically ranging from 60 percent to 70 percent for most retail properties. At the end of 2016, the combination of increasing rates, conservative lender underwriting and fiscal policy uncertainty encouraged some investor caution that slowed deal flow, a trend that has extended into 2017. A potential easing of regulations on financial institutions, though, could liberate additional lending capacity and nominally higher interest rates may also encourage additional lenders to participate.

Recent Marcus & Millichap Transactions

Property Name	City, State	Sales Price	Price per Sq. Ft.	Cap Rate
LA Fitness	Rock Hill, SC	$9,559,375	$251.56	6.40%
CVS	Belton, TX	$7,337,000	$543.04	1.66%
Walgreens	Clinton, CT	$6,272,727	$459.54	5.50%
Tractor Supply Co.	Royse City, TX	$4,338,725	$197.84	6.20%
Outback Steakhouse	Lubbock, TX	$3,782,000	$611.68	5.10%
Bojangles	Lumberton, NC	$3,200,000	$845.00	6.22%
Dollar General	Marco Island, FL	$2,767,272	$369.51	5.49%
Chick-Fil-A	Valrico, FL	$2,275,000	$457.65	4.40%
O'Reilly Auto Parts	Redding, CA	$2,175,000	$362.50	5.24%
Starbucks	Suwanee, GA	$2,144,533	$1,115.78	5.25%
Family Dollar	Elizabeth, NJ	$2,083,333	$245.10	6.00%
Whataburger	Fort Worth, TX	$2,075,000	$579.12	4.46%
Burger King	Castle Rock, CO	$1,866,000	$77.89	5.25%
Sherwin Williams	Chesapeake, VA	$1,663,700	$415.93	5.65%
The Vitamin Shoppe	Mansfield, OH	$1,650,000	$403.42	9.92%
Circle K	Phoenix, AZ	$1,428,500	$475.22	6.00%
KFC	Elizabeth, NJ	$1,400,000	$700.00	5.44%
Applebee's	Fort Worth, TX	$1,250,000	$233.73	9.20%
7-Eleven	Tampa, FL	$1,236,000	$547.63	5.50%
Dollar General	Hebron, IL	$1,225,000	$134.62	7.00%
Pizza Hut	Austin, TX	$1,200,000	$619.20	2.93%

Prepared and edited by

Aaron Martens
Research Analyst | Research Services

For information on national retail trends, contact:

John Chang
First Vice President | Research Services
Tel: (602) 707-9700 | john.chang@marcusmillichap.com

Net-Lease Properties Group

Alan Pontius
Senior Vice President | National Director Specialty Divisions
Tel: (415) 963-3000
al.pontius@marcusmillichap.com

Price: $250