Marcus & Millichap

National Report

Net-Leased Retail Research

Second Half 2018

Strong Tailwinds Continue to Propel Healthy Economy; New Tax Law May Encourage Investors to Refine Strategies

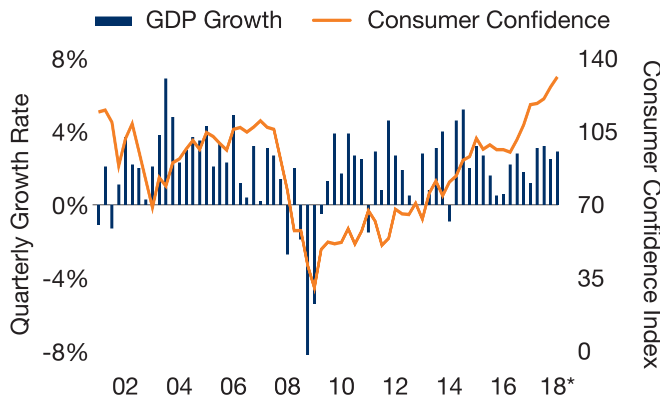
Tax reform powers economic acceleration. The new tax law has invigorated economic growth, boosting consumption and business investment. With optimism running high, many companies have generated new jobs, dropping the national unemployment rate below 4 percent. A tightening job market has supported increased wage growth, expanding personal disposable income more than 2 percentage points above the 10-year average to 5.4 percent. Because of this, core retail sales have benefited, rising by an average of 5.6 percent in May and June. The convergence of these factors has resulted in accelerated economic growth that climbed above 4 percent.

Elevated Treasury rates placing upward pressure on yields. A booming economy brings with it inflationary risk, prompting the Federal Reserve to tighten monetary policy. The single-tenant net-leased retail sector may be substantively impacted by a more disciplined monetary approach as assets are typically responsive to the 10-year Treasury due to their bondlike parallels. This will coalesce with other components such as brand, location and lease terms when determining going-in cap rates. For example, dollar store yields can vastly differ as a number of these assets are in rural locations, providing potential for higher returns. Conversely, yields for convenience stores and quick-service restaurants typically maintain a much smaller range due to their tempered sensitivity to key determinants of cap rates.

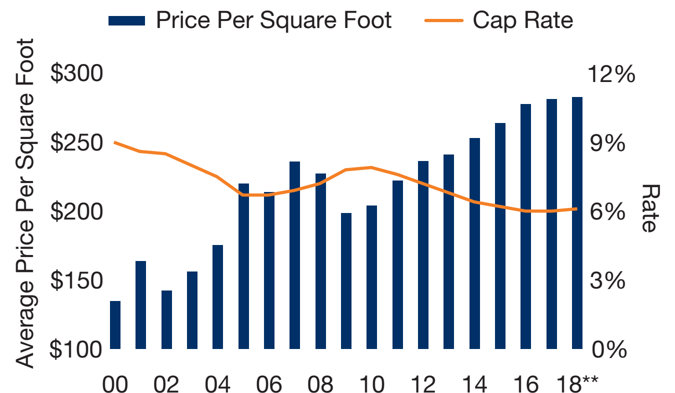
Investment Highlights

- Over the past year, transaction velocity eased modestly as investors awaited details on the new tax law. With much of that uncertainty now relieved, sales activity could accelerate. Furthermore, decreased taxes on pass-through entities could lead to repositioning efforts, bringing more assets online and elevating market liquidity.
- The 1031 exchange was retained in the new tax law, remaining a commonly used practice for single-tenant net-leased investors. Investors favor this tax provision to swap out management-intensive assets for properties that involve a more passive approach while deferring the capital gains tax.
- Under the new tax law, sale-leasebacks have become an increasingly popular tactic. With new restrictions on business interest deductibility, some retailers are selling the real estate in which they operate to investors, then leasing it back to maximize deductions. This process opens the door for reinvestment into existing assets and investment into future plans as more capital would be available.

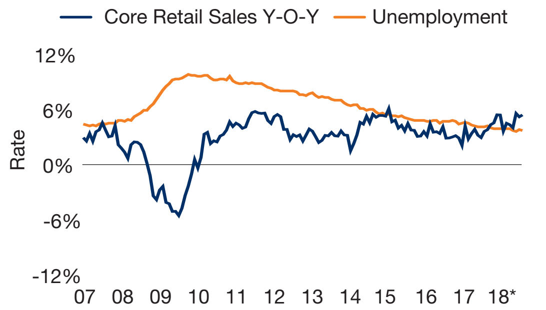
Economic Growth to Accelerate

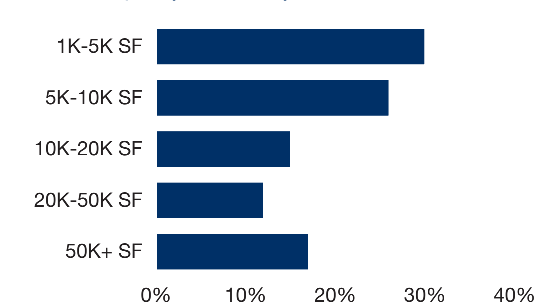


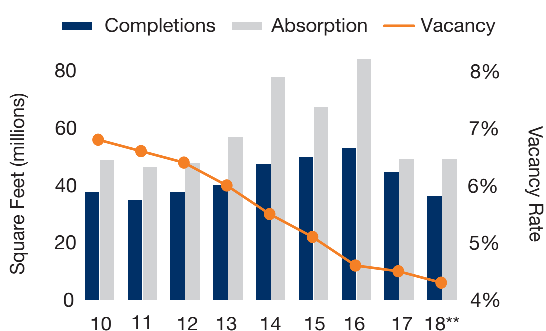
Sales Trends

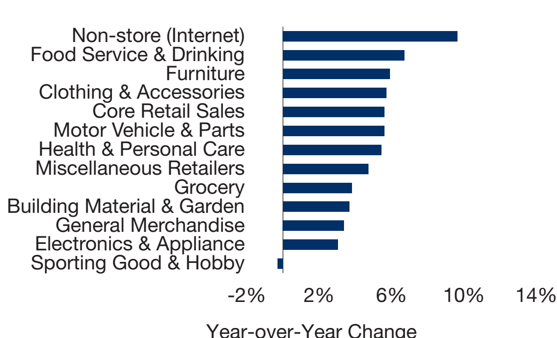


* Forecast
** Through June









* Through July

** Forecast

New Tax Law Provides Spark to Investors; Sale-Leaseback Opportunities Could Increase

New provisions, preservation of old ones may boost investor sentiment. Changes to the tax code, as well as the retention key provisions like tax-deferred exchanges, real estate depreciation and mortgage interest deduction should keep investor sentiment high for single-tenant net-leased retail assets. Additionally, new pieces to the tax code should further boost the appeal of these relatively passive investments. For example, the new 20 percent pass-through deduction enables some active investors using an entity such as an LLC to boost after-tax yields. However, this deduction comes with restrictions based on income and asset base but offers strong potential for those who qualify. Additionally, bonus depreciation is a temporary provision allowing investors to increase their current cash flow by immediately expensing personal property in real estate assets acquired after Sept. 27, 2017.

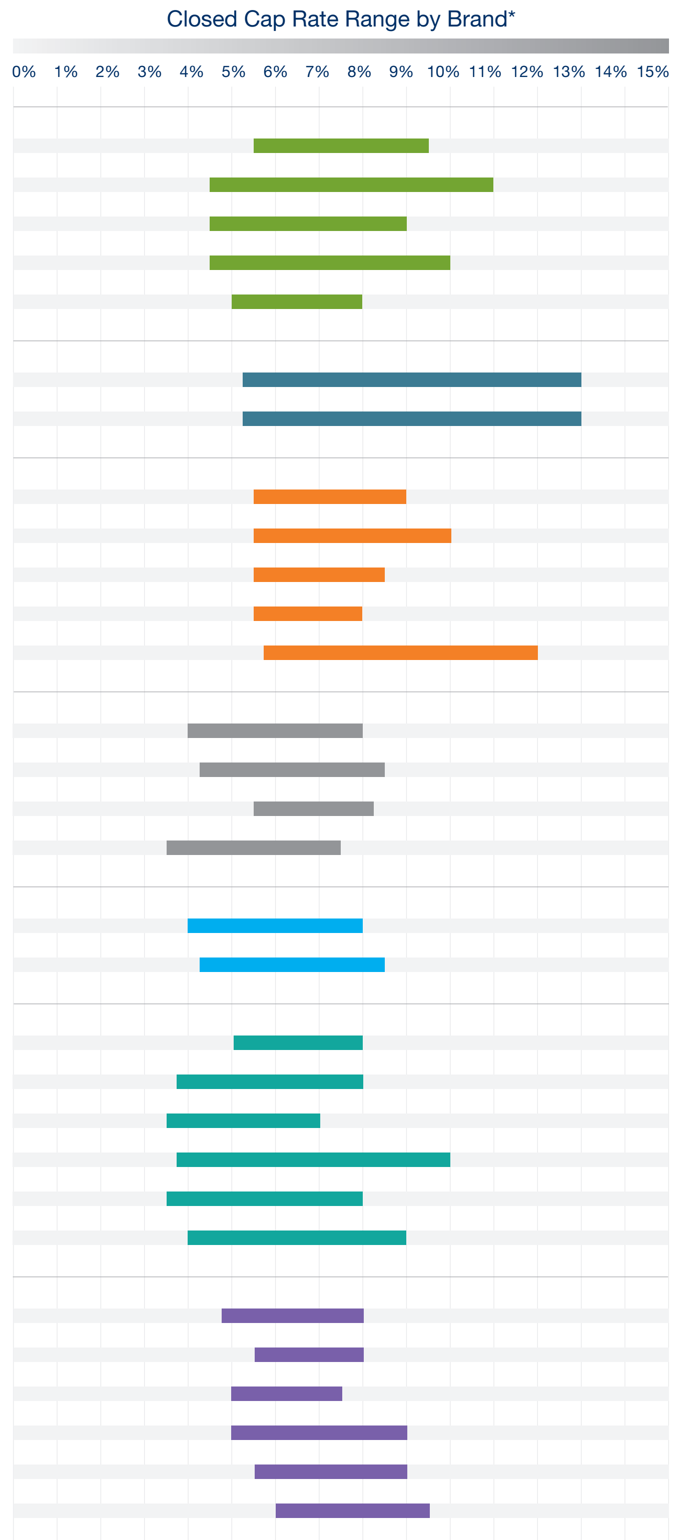
Changes to tax law could inspire owner/users to seek sale-leasebacks. The most influential change to the tax code on the single-tenant net-leased retail sector may be new restrictions on business interest deductions. This provision could encourage companies to utilize sale-leasebacks as they shape their real estate strategies around lease expenses that remain fully deductible. For owner/users, selling the real estate in which they operate to investors and then leasing it back from them could maximize profitability, as well as unlock equity for reinvestment into current operations and funds for potential expansion plans. Also, the previous tax law allowed companies to deduct all of their interest expenses on their taxes, but the new provisions restrict the deductibility of business interest for companies with gross receipts in excess of $25 million. Now, interest totaling just 30 percent of earnings before taxes, depreciation and amortization can be deducted on taxes, further incentivizing companies to pursue sale-leasebacks.

Solid Fundamentals Aided by New Concepts

Rents benefit from thinned construction pipeline. Available space in the single-tenant net-leased sector will contract for the ninth consecutive year, pushing national vacancy down to 4.3 percent in 2018. Even though demand remains strong, construction will continue to taper this year, completing 36 million square feet. The percentage of single-tenant construction is reduced for the second year in a row as developers step back construction. With limited retail property completions, rent gains should be strong this year, advancing 4.2 percent to $21.18 per square foot. This increase well exceeds the previous five-year average of 3.2 percent.

Retailer strategies change to match consumer needs. Convenience continues to emerge as a common theme in the single-tenant net-leased retail sector as several types of retailers have adopted this concept to drive foot traffic and sales. For example, drugstores have improved their product selection by including items historically purchased at convenience stores and grocery stores. This strategy has also helped these retailers improve front-store sales and hold a greater edge over online pharmacies. Additionally, dollar stores have added convenience to their affordable product mix by offering instant-consumption items, such as grab-and-go sandwiches and beverage bars.

Brand	Locations
Auto Parts	
Bridgestone/Firestone	2,200
O'Reilly Auto Parts	5,019
AutoZone	6,003
Advance Auto Parts	5,183
Pep Boys	980
Dollar Stores	
Dollar General	14,534
Dollar Tree/Family Dollar	14,835
General Retail	
Walmart	11,718
Sherwin-Williams	4,620
AT&T	16,000
Verizon Wireless	2,330
Office Depot/Max	1,378
Convenience Stores	
7-Eleven	8,707
Circle K	1,481
QuikTrip	762
Wawa	780
Pharmacies	
CVS	10,091
Walgreens	8,100
Quick-Service Restaurants	
Dairy Queen	6,400
Starbucks	27,339
McDonald's	37,241
Yum Brands	45,084
Burger King	24,707
Wendy's	6,634
Fast Casual	
Chili's	1,674
Darden Restaurants	1,769
Red Lobster	705
Bloomin' Brands	1,489
Applebee's	1,756
Ruby Tuesday	560



Cap rates shown above are representative of transactions that closed in the past year ending in June. Actual yields will vary by locations, tenant, lease terms and other considerations. Locations sourced from CreditNtell for public companies and company websites for private companies.

* For transactions closed in past year ending in June
Sources: CoStar Group, Inc.; CreditNtell; company sources

Capital Markets

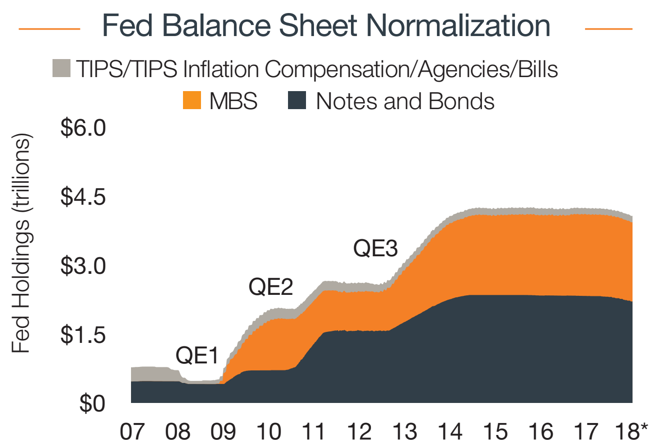
By David Shillington, President, Marcus & Millichap Capital Corporation

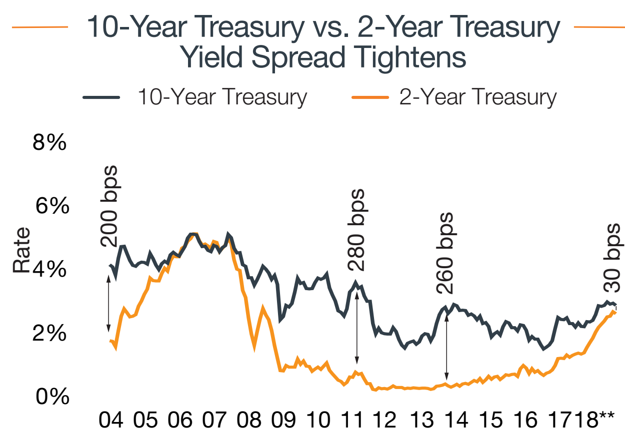
Lenders Pursue Deals as Capital Plentiful; Caution Enforcing Underwriting

Fed watchful as economic surge raises inflationary pressure. Strengthened hiring amid exceptionally low unemployment levels have boosted wage growth, placing upward pressure on inflation. Amid this trend coupled with rising trade protectionism and tariffs, the Federal Reserve appears determined to head off inflation risk by continuing its quarterly increases of the overnight rate. These actions are lifting short-term interest rates while the 10-year Treasury rate remain range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates. Although this event has preceded every recession of the past 50 years, many economists suggest such an inversion this year could be an exception to the rule. Because of distortions caused by regulatory changes and quantitative easing, this inversion could be different. Nonetheless, the Fed's stated path does raise recessionary risk levels because it could weigh on confidence levels and restrain spending by consumers and businesses, thus slowing economic growth.

2018 Capital Markets Outlook

- **10-Year Treasury still "sticky" at 3 percent.** After surging at the beginning of the year, the 10-year Treasury has been range bound near 3.0 percent. To create some headroom for its escalation of short-term rates, the Fed has tried to exert upward pressure on long-term interest rates by unwinding its balance sheet. This quantitative tightening has had little influence, particularly as foreign investors have enjoyed a yield premium relative to their native 10-year rates.
- **Potential rapid interest rate escalation a downside risk.** Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 when the 10-year rose by more than 80 basis points in 60 days, and again at the beginning of 2018 when there was a 60-basis-point surge, market liquidity could tighten if rates jump. Considering this has happened twice in the last two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.





* Through July 20
** As of Aug. 17

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; ChainStoreAge.com; CoStar Group, Inc.; Moody's Analytics; International Council of Shopping Centers; Real Capital Analytics.