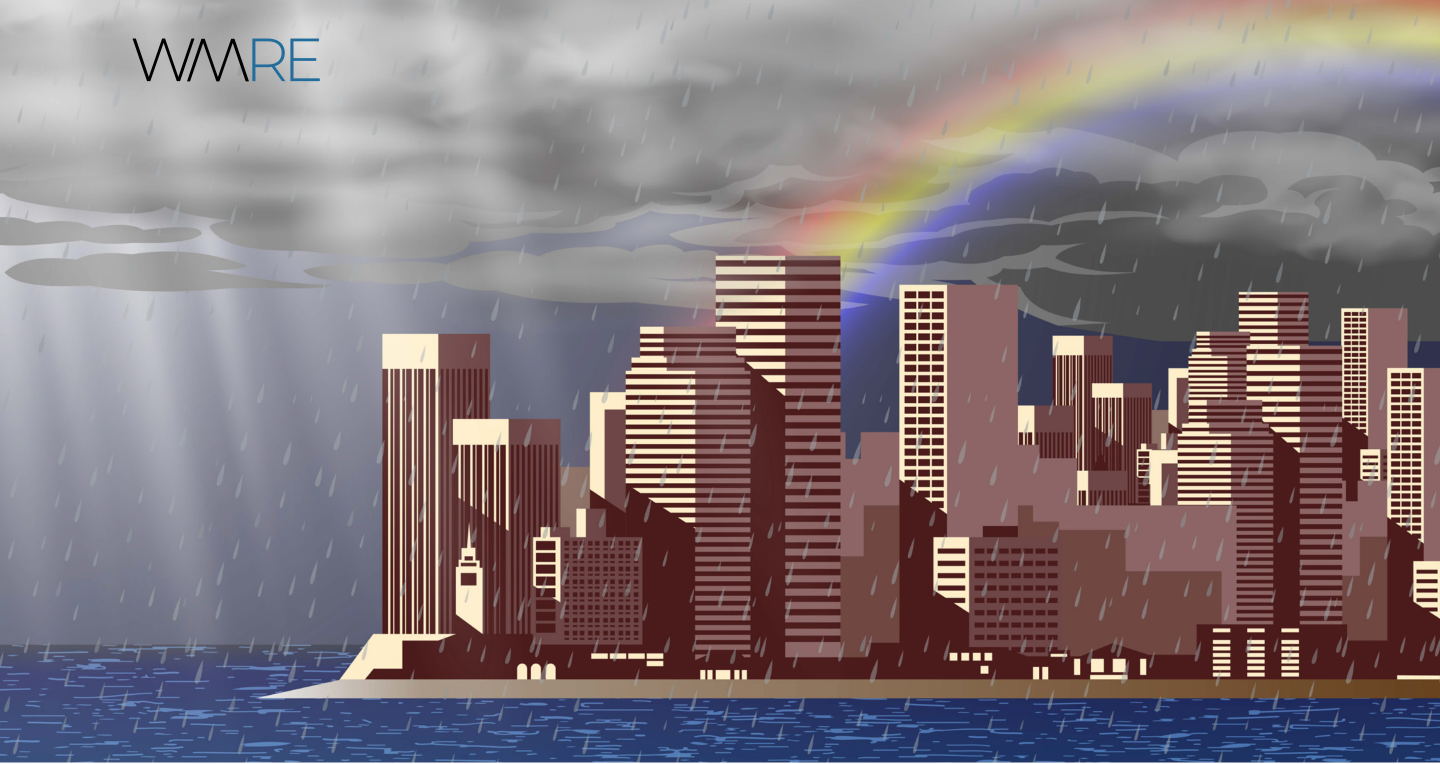

A Flight to Safety

With economic uncertainty on the horizon, investors are looking to the security of net lease assets as a port in the storm.

By **Beth Mattson-Teig**

Investors searching for a safe harbor during economic downturns have traditionally gravitated to the stability of net lease assets and their long leases to credit tenants. That strategy has moved to the forefront once again amid rising interest rates, inflation and expectations of a recession.

According to *WMRE*'s annual net lease research (brought to you by W. P. Carey), investor demand for net lease assets is holding up better than demand for the broader commercial real estate investment market. While investment sales volumes have come down in recent quarters from previous peaks, a majority of respondents in this year's research (58%) see no change in the current level of competition in the net lease sector, while another 23% think there is slightly more competition. Those who think competition has dropped are in the minority, at 19%.

Investment sales activity slowed in the second half of 2022, with fourth quarter transactions that dropped sharply—62% on a year-over-year basis, according to MSCI Real Assets. The decline was largely due to rising rates, uncertainty on property valuations and a disconnect in pricing expectations between buyers and sellers. The choppiness carried over into first quarter of 2023 due to fallout from the crisis in the banking sector and what that might mean for capital markets.

Net lease real estate has a reputation for being a more resilient segment of the commercial real estate investment market, with bond-like characteristics that typically generate steady, predictable returns. Net lease assets tend to outperform during downturns, and likewise underperform during boom times. "That is not to say that net lease is not impacted by market conditions, but it tends to go down less than other sectors," says Randy Blankstein, president of the Boulder Group. "It's great for people who want to be defensive and protect their wealth and have cash flow, and less so for people who want to take big risks and create wealth."

Nearly two-thirds (61%) of respondents think the commercial real estate cycle is currently in a recession phase, with another 16% who believe the sector is at its trough. A minority 5% see the market still at its peak and 5% said the real estate sector is in a recovery/expansion phases. A majority of respondents (89%) also said they are concerned about the impact of a broader economic recession on the net lease market, with 31% who said they were very concerned.

The current economic backdrop is creating both challenges and opportunities for investors. When asked about the biggest challenges in the current net lease investment market, interest rates and a potential recession remain at the top of the list, followed closely by a deterioration in the credit quality of tenants. At the same time, net lease investors also see opportunities ahead, with attention shifting to opportunistic and value-add deals. Some respondents reported that they are keeping an eye out for properties where owners may have defaulted on a loan, as well as the opportunity to

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W. P. Carey (NYSE: WPC), one of today's largest diversified net lease REITs, provides long-term sale-leaseback and build-to-suit capital solutions primarily for companies in the U.S. and Europe.

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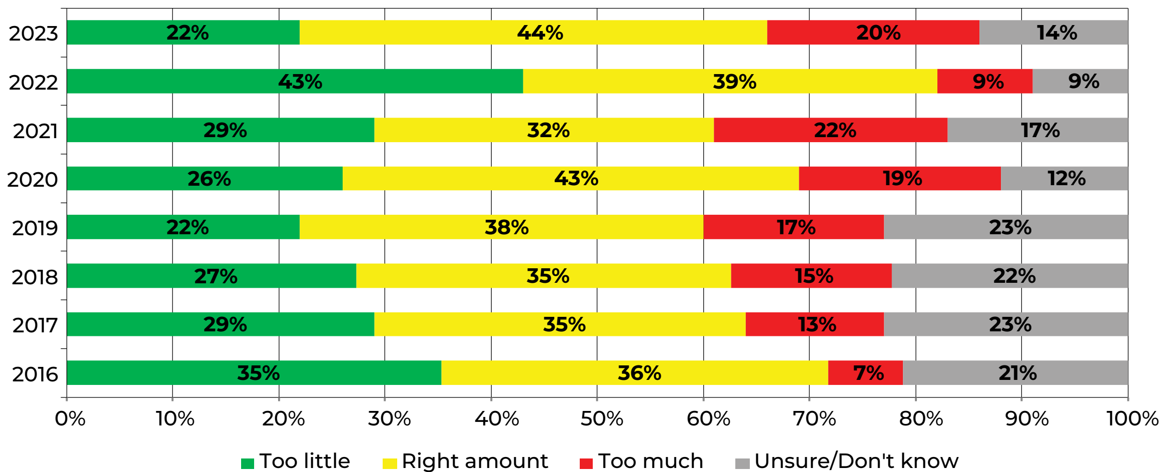


redevelop or reposition vacant assets.

W. P. Carey is one investor that has kept its foot on the gas. Despite rising interest rates, the net lease REIT completed a solid year of acquisitions in 2022 with investments that topped $1.4 billion, two-thirds of which were located in North America. And the company has liquidity and a strong pipeline of deals lined up for the coming year. "It was a good year for us last year, despite the pretty tough background that everyone is well aware of, particularly in the second half when rates began to rise very significantly," says Jason Patterson, a senior vice president on the investment team at W. P. Carey.

Patterson is hopeful that volatility might be in the rear-view mirror with stability returning to the market. "While it is a little bit slow in the first quarter, what we're seeing and hearing from other market participants is that there is a ton of interest in net lease and sale-leasebacks, particularly going into the second quarter and the latter part of the year," he says.

Healthy supply of inventory

Although investors have plenty of entry points into the net lease sector, the preferred investment vehicle remains buying properties directly. About half of respondents (56%) said they are buying properties, followed by investing in public REITs at 42% and private REITs at 38%. Trailing more distantly are private net lease funds at 19% and Delaware Statutory Trusts (DSTs) at 14%.

According to the Boulder Group, there is still a healthy inventory of properties on the market. However, the inventory moved slightly lower in the first quarter compared to the prior quarter. The volume of retail listings declined 8.7% to 3,079 and office listings declined a slight 1.5% to 667, while industrial listings increased 4.6% to 412 listings.

Blankstein attributes the decline to owners that are more reluctant to sell properties in the current market. "Obviously, there is always a flight to quality whenever there's a downturn," he says. That appetite generally benefits properties with investment grade tenants, strong locations in major metros, longer lease terms and newer development deals. So, unless a property checks those boxes, owners are reluctant to list properties in a market that is less robust than it was six months ago and are opting to hold onto assets, he says.

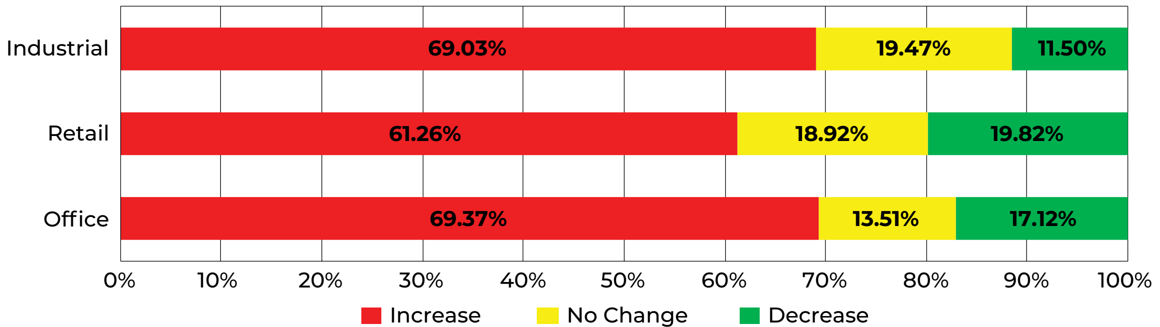
Respondents believe there are still plenty of buying options, although sentiment has shifted from a year ago. A plurality of respondents (44%) believe the current supply is the right amount, while 22% said there is too little, and 20% said there is too much supply on the market. Last year, more than two-fifths of respondents (43%) said there was too little inventory available for investments. The 22% figure saying "too little" equaled the lowest figure in the eight-year history of the research.

"There has been a little bit of a slowdown in new supply, but we're expecting that will change as the year progresses," says Patterson. W. P. Carey focuses primarily on investing in industrial net lease assets, which run across the spectrum from distribution centers to more specialized manufacturing facilities, and it sources a number of its deals from the sale-leaseback market. Although narrowing the gap on pricing is still a challenge, Patterson also sees more acquisition opportunities ahead coming from property owners looking to do sale-leasebacks. Higher rates and tighter lending from banks could fuel more interest in sale-leasebacks as an alternative financing source.

"The good news for us is that during times of uncertainty, particularly on the sale-leaseback side of things, we can see some improved volume as folks that have existing capital structures with debt coming due in the near term seek to refinance or evaluate near-term options for capital, which brings sale-leasebacks back to the foray," says Patterson.

Going Up

Respondents largely expect cap rates on the major net lease property types to rise in the next 12 months.



Access to capital tightens

Survey respondents noted a tightening of capital markets. More than half of respondents (56%) think that debt is less available than it was 12 months ago. That is a big shift compared to 18% who said debt was less available in the 2022 survey, and it also represents the highest level in the history of the research. Roughly one-third (29%) said the availability of debt remains the same, while 10% said it is more widely available.

The main sources of liquidity for smaller net lease transactions have traditionally been local and regional banks, credit unions and, to a lesser degree, CMBS. "Net lease financing is available and lenders' stance towards credit has generally remained consistent, but due to a number of factors, there is less liquidity available in the market today than this time last year," says Marc Sznajderman, senior vice president, head of production, Eastern region, Marcus & Millichap Capital Corp.

Liquidity among banks and credit unions has taken a hit because of withdrawal of customer deposits, which have been flowing out in search of higher-yielding assets such as treasuries. Reduction in bank assets in turn impacts lending ability. Additionally, some of the most active lending sources for net lease transactions had been originating loans for syndication or sale, notes Sznajderman. "As rates have risen, these sources have not been able to sell the mortgages on their books at acceptable prices and free up balance sheet capacity to make new loans. This has further contributed to the reduction in liquidity," he says.

Concerns about tightening liquidity are also evident in shifts in sentiment regarding LTVs and DSCRs. Survey results show that views are split on expectations for LTVs, with 35% who think leverage could increase, 32% remain the same and 33% who predict a decline. Roughly equal levels of respondents believe DSCRs are likely to remain the same (42%) or increase (43%) and far fewer (15%) expect DSCRs to decrease. In the prior year's survey, nearly three-fourths of respondents predicted that LTVs and DSCRs would remain the same in the coming year.

"Higher rates and increased regulatory scrutiny are driving lower LTVs and making achieving DSCR requirements more challenging," says Sznajderman. In addition, certain banks have effectively priced themselves out of the market for the time being by quoting interest rate floors that are non-competitive, he adds. Marcus & Millichap is typically seeing rates for five-year or 10-year net lease transactions in the 5.75% to 6.25% range on deals with leverage between 55% and 65%, but those metrics can fluctuate lower or higher depending on the individual deal. However, Sznajderman also emphasizes that despite market hurdles, there are still active lenders in the market that are willing to finance net lease properties.

Meanwhile, 44% think equity is less widely available than a year ago, which is a dramatic change compared to 12% who said equity was less available in the 2022 survey. The previous high on this sentiment was 21% in the 2021 survey. Views were more evenly split on whether equity availability is unchanged or more available, at 31% and 24% respectively. A year ago, 44% said equity was more widely available—the highest figure in the survey's history.

Cap rates likely to climb

Cap rates within the net lease space have held up better than for commercial real estate more widely, largely because of the fixed cash flow of net lease assets. Investors are typically underwriting cash flows, which have remained relatively steady because of the long-term leases that typically back net lease assets. However, at the end of the day, net lease is challenged by the same issues impacting the broader commercial real estate market—inflation and interest rates. "As financing costs get higher, pricing has to adjust to give investors the same cash-on-cash return. So, clearly pricing has gone up," says Blankstein.

According to research from the Boulder Group, cap rates have trended higher for the past four consecutive quarters. The firm's most recent first quarter research report shows that cap rates ticked slightly higher across the major property categories. Office cap rates increased 5 basis points to average 7.00%; industrial rose 12 basis points to 6.77% and retail increased 10 basis points to 6.05%.

A New Leader

Respondents were asked to rate the outlook for in the next 12 months for each net lease property type.

Property Type	2016	2017	2018	2019	2020	2021	2022	2023
Medical Office/Healthcare	3.9	3.8	3.8	3.8	3.9	3.7	4	3.7
Industrial	3.7	3.8	4	3.8	3.9	3.9	4.1	3.5
Grocery	3.6	3.4	3.3	3.3	3.5	3.8	3.8	3.4
Drugstores	3.6	3.4	3.3	3.2	3.2	3.5	3.5	3.4
Government	3.2	3.2	3.3	3	3.6	3.8	3.2	3.3
Convenience Store/Discount	3.6	3.5	3.4	3.5	3.5	3.5	3.6	3.2
Fitness	3.1	3.1	3.2	3.1	3.3	2.5	3	3.1
Restaurants/Fast Food	3.5	3.3	3.3	3.2	3.4	2.9	3.3	3.1
Misc Retail	3.3	3	3	2.8	3	2.5	3.1	3
Auto	3.3	3.2	3.1	2.9	3.1	3.3	3.4	2.8
Bank/Financial	3.1	3.3	3.4	3.2	3.5	3.3	3.2	2.8
Office	3.1	3.1	3.2	3.1	3.3	2.4	2.8	2.6

When respondents were asked what current cap rates are like in the markets they operate in for the major property types, industrial rated the lowest at a mean rate of 5.6%, followed by retail and office each at 5.8%. A majority expect cap rates to increase in the coming year across all three sectors. Specifically, 70% predict that industrial cap rates will rise with a mean increase of 27.2 basis points; 67% believe office cap rates will rise with a mean increase of 32.3 basis points, and 59% anticipate that retail cap rates will climb by 25.5 basis points.

"We don't anticipate cap rates moving dramatically from here. There is just too much demand," says Camille Renshaw, CEO and co-founder of B+E, a net lease real estate brokerage firm. For example, there is a lot of cash on the sidelines waiting for those added value deals, such as a developer that is holding floating rate debt on an asset that has become unbearably high. Those cap rates may move lower, but there aren't likely to be any extreme bargains based on the amount of capital waiting for those deals, she adds.

In addition, there are a lot of cash buyers in the market that remain active on deals priced below $5 million. Cap rates have moved very little in that segment of the market, rising about 50 basis points, according to Renshaw. "There continues to be such strong demand in that smaller price point from 1031 exchangers and private cash buyers that there isn't a lot of movement in cap rates," says Renshaw. Most of the movement in cap rates is in the area between $5 million and $10 million on properties that require debt. That's where cap rates are rising 100 basis points or more, she says.

Investors favor medical, industrial

For individual investors in particular, there is a flight to quality in the current economic environment. People are looking to buy assets in the top 25 metros, and they are really following the population growth with good demand for assets in areas such as Florida and Texas. People are also looking at those categories that tend to perform better during a recession, such as dollar stores, QSRs, convenience stores, drug stores and medical uses. When asked to rate the outlook for each net lease property type over the next 12 months on a scale from 1 to 5, with 5 being the highest, medical office/healthcare rated the highest with a mean score of 3.7, followed by industrial at 3.5 and grocery and drugstores each at 3.4.

Among the notable results, the outlook for industrial dropped from 4.1 in the 2022 survey and is now at its lowest level in the past eight years of the survey. It is also just the second time in eight years that industrial did not finish atop the property sector rankings. Medical offices have consistently ranked first or second in the survey every year, but it's only the second time the sector finished first outright.

Several other property types scored within a tight band of between 3.0 and 3.4. Office trailed with favorability that declined to 2.6, which is the lowest mean of all categories included in the survey and also the second lowest score for that property type in the past eight years, ahead of only 2021, when it finished with a score of 2.4.

Sentiment on the two property types that are in greatest demand—medical office/healthcare at 54% and industrial at

A Skew in Demand

Demand is heavily concentrated on the medical office and industrial sectors, according to respondents.

Property Type	2016	2017	2018	2019	2020	2021	2022	2023
Medical Office/Healthcare	40%	37%	41%	44%	39%	42%	38%	54%
Industrial	24%	36%	41%	42%	51%	55%	54%	45%
Drugstores	40%	36%	26%	17%	16%	19%	20%	19%
Grocery	23%	16%	15%	14%	18%	25%	23%	19%
Restaurants/Fast Food	34%	29%	31%	31%	28%	18%	24%	18%
Convenience Store/Discount	17%	20%	16%	16%	18%	18%	19%	14%
Bank/Financial	14%	17%	16%	13%	10%	14%	11%	13%
Government	10%	9%	9%	12%	13%	14%	9%	13%
Office	14%	13%	14%	16%	14%	3%	6%	13%
Misc Retail	13%	16%	14%	11%	8%	9%	9%	12%
Fitness	6%	4%	8%	8%	9%	4%	6%	8%
Auto	6%	4%	16%	4%	5%	5%	7%	4%
Other (please specify)	4%	3%	4%	6%	5%	4%	6%	4%

45%—tracks with the more favorable outlook for those two sectors. That marks a flip from last year when industrial was at 54% and medical office sat at 38%. But aside from 2016, the sectors have generally sat first or second in each year's rankings.

Although respondents were allowed to select up to three categories, sentiment on demand for other categories was more evenly distributed, starting with drugstores and grocery at 19%. The score for drugstores is less than half of what it was in 2016, when it tied for first with 40% of respondents saying it had the most favorable outlook.

QSRs are traditionally a very active category, and the sector has continued to see new inventory with expansion coming from both corporate and franchisee locations. The outlook for that segment came in at 18% this year, down from 24% a year ago.

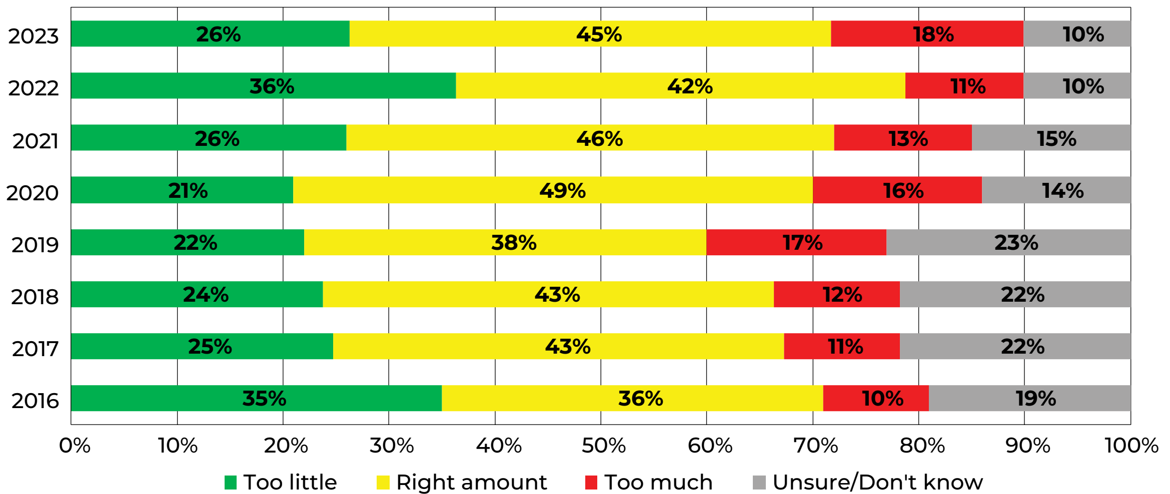
"At B+E, we've been selling a ton of car washes," adds Renshaw. One of the drivers for demand is the bonus depreciation for those types of assets, which makes it attractive to investors that may be looking to offset gains made elsewhere, such as the sale of a business. In addition, there is a shortage of properties priced below $5 million with investment grade credit tenants and less than five years of term remaining on the lease. That is the space where the inventory disappears quickly. "We have some buyers that love five-year deals because they feel that's a place where they can have slightly higher cap rates and get the same quality transaction," she says.

Development remains in check

Nearly half of respondents (45%) believe there is a healthy balance of development activity—a figure consistent with past surveys. In addition, 26% think there is "too little" development—a decline from last year when 36% said there was too little development occurring. There are not many concerns about overbuilding, however, with just 18% saying there is too much development, although that is an uptick from 11% in the 2022 survey.

One reason behind the view that there is not "too much" development is that vacancies remain tight in both industrial and retail. Retail in particular, which represents a large portion of the single-tenant net lease market, has seen very little new development in recent years. According to JLL, net absorption of retail space during 2022 was the highest it has been since 2017. And while demand is higher, deliveries have remained low. The 25.4 million sq. ft. of retail space delivered last year was one-third of net retail absorption, which helped push down vacancy levels to 4.2% in the fourth quarter.

Retail developers have been battling a number of challenges related to costs and getting the economics of deals to work, as well as competition for sites and zoning hurdles. However, there is still steady expansion coming from restaurant and retail brands, particularly in booming growth markets, such as the Carolinas, Florida and Texas, notes Steve Hardy, a principal at Gaspee Real Estate Partners, a private real estate investment firm based in East Greenwich, R.I. that develops



single-tenant net lease retail for brands such as O'Reilly's Auto Parts, Lowe's, CVS and Starbucks, among others.

Gaspee has maintained a steady pipeline of projects, although its development strategy has shifted along with market conditions. The firm is undertaking fewer ground-up projects and more stabilization or repurposing of second generation space. For example, the firm might take a vacant 10,000-sq.-ft. restaurant and split it up to accommodate two smaller users. "We look at some of those things that allow us to get a little bit more value than doing ground-up," says Hardy. On deals with non-investment grade tenants, the firm is also structuring more deals with ground leases to limit its construction risk to site work only.

Expectations for tightening credit could also make development projects more challenging in the coming year. "We have seen some banks say they're not going higher than 50% leverage, and the problem is if you get an appraisal that doesn't come in correctly, you're cooked," says Hardy. For example, if a bank is offering 50% LTV and the appraisal on a deal comes in at $2.5 million instead of $3.0 million, that significantly limits the lending capacity, and those funds need to come from somewhere else. Maybe the firm only has equity for six or seven active development projects instead of eight. "So, there is a trickle effect," says Hardy. "Even though the change might be small, a 5% or 10% change here and there can add up very quickly."

Focus on ESG ticks higher

Survey results show a slight upward trend related to the importance of ESG. In all, 44% said ESG is at least somewhat of a factor in current investment decisions, with 15% who said it was a significant factor. That does reflect an increase compared to 39% who said ESG was at least somewhat of a factor in the 2021 survey and 40% in the 2022 survey. In addition, one-third of current survey respondents said ESG is not a factor in decisions, while 13% said it is not a factor in decisions now but will be in the future.

Respondents have mixed views on how ESG is impacting investment decisions. Nearly one-third said that ESG has been a factor in assessing which assets they've bought or sold (30%) or capital providers (31%) they've worked with. Fewer cite ESG as a factor in assessing brokers they've worked with 13%, and only 20% said it is a factor inside of their own company.

ESG is clearly gaining a bigger focus among larger institutions, including public REITs. According to Nareit, the top 100 REITs all report on ESG. Roughly two-thirds publicly disclose their carbon and sustainability goals and 83 of the top 100 also own green or LEED-certified buildings or structures. Although W. P. Carey looks at investments holistically, ESG is getting more attention. Attributes such as LEED certification and energy efficiency are viewed very favorably, and the REIT also has issued a green bond in recent years. ESG is also an area where W. P. Carey is working with its existing tenants that have their own ESG platforms, notes Patterson. "So, ESG has become a much bigger conversation across the board," he adds. ■

Survey methodology: *The WMRE research report on the net lease sector was completed via online surveys distributed to readers of WMRE in April. The survey yielded 118 responses. Survey respondents included those active in CRE and the financial services industries. Among CRE participants, respondents represent a cross-section of different professionals, including leasing and investment sales brokers, private real estate investors, public REITs and developers, among others. Two-thirds of respondents identified themselves as owners, partners or C-suite executives.*