Chugging Along

Despite continued macroeconomic headwinds, new capital continues to position the net lease market for another strong year.

By **Beth Mattson-Teig**

A common theme sweeping the net lease marketplace is the abundant capital targeting the space that runs across the spectrum from mom-and-pop investors to major institutions. Net lease transaction volume hit a new record last year with $79.3 billion in sales—an increase of 39 percent over 2019 levels, according to JLL. Despite looming challenges stemming from rising interest rates, inflation and geopolitical issues, the net lease sector could be headed for another big year.

Investors have plenty of capital at their fingertips and big appetites to continue acquiring net lease assets. According to the annual *WMRE* Net Lease Investment Survey, 84 percent of respondents said equity is the same or more widely available than 12 months ago, while 78 percent said that debt is the same or more widely available. Those results suggest that liquidity is stronger than it was a year ago, when 71 and 62 percent respectively in the 2021 survey said that availability of equity and debt were the same if not better.

"What we're seeing is at least a decade-long, and perhaps decades long, shift in flow of equity specifically into the net lease segment," says BJ Feller, a managing director and Partner at the Stan Johnson Company. Part of that demand is coming from the wave of baby boomers and retirees. People are selling out of actively-managed real estate and rolling proceeds into more passively managed net lease real estate, whether that is through wholly owned properties or shares in Delaware Statutory Trusts (DSTs). "We have this very long trend where more and more capital is flowing into net lease, because it is really the perfect haven to be tax-advantaged, but also have a consistent yield where people can retire on," he says. Rather than being impacted by disruption related to the pandemic, that trend reinforced itself in 2021, and investors continue to view it as a safe haven for capital, he adds.

"There is no shortage of new entrants into the net lease market," says Ken Heimlich, chief investment officer at Spirit Realty Capital Inc. However, while there is a lot of capital targeting net lease investment opportunities, what most people don't realize is just how big the net lease market is today and how much it has grown, he says.

There are a number of different property types where doing sale-leasebacks is common, whereas that might not have been the case five years ago. For example, Spirit Realty acquired three Mister Car Wash properties in El Paso, Texas, during the fourth quarter of 2021. "That new supply has helped to mitigate all the capital that is coming into the net lease markets," he says. In 2021, Spirit Realty completed about $1.2 billion in acquisitions and expects to acquire between $1.3 billion and $1.5 billion in net lease assets this year.

Respondents have mixed views on how increased competition in the net lease sector is impacting their investment decisions. One-third said that it has had no impact, while 28 percent have started investing at lower cap rates, 27 percent are now investing in new property types and 26 percent are invest-

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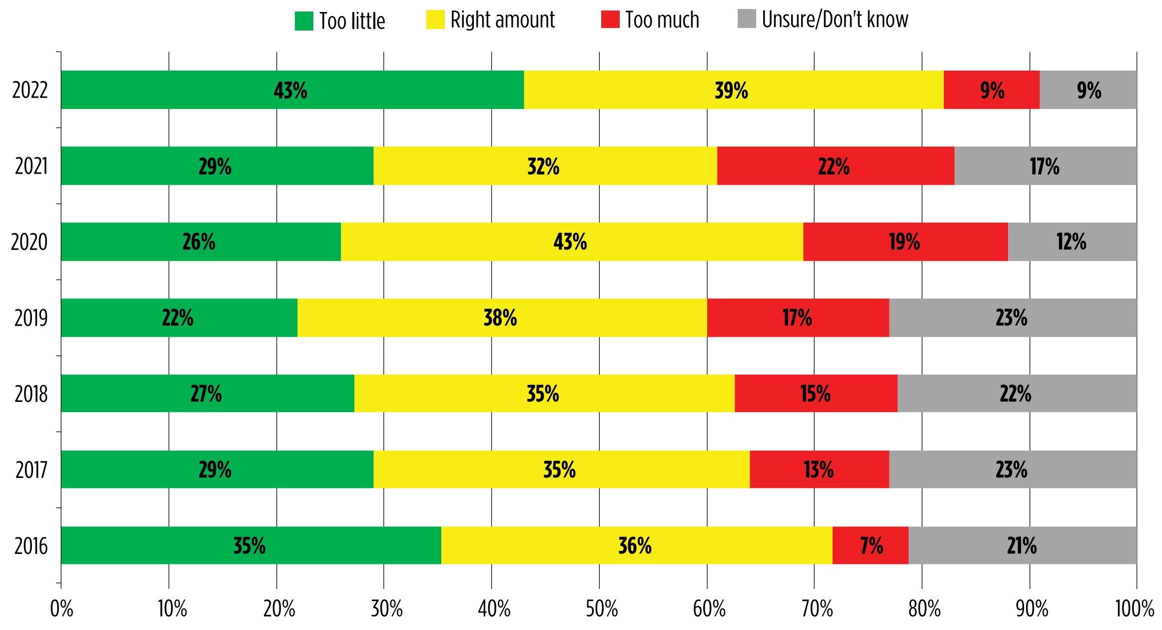


ing in new regions/countries. "Are people looking at other product types because of the pricing pressure in the net lease space? I would say that net lease is more the recipient of that where multifamily and industrial yields have compressed so much that people may look at net lease and/or secondary market net lease product to get yields that they can't get in the core markets," says Mark E. West, a senior managing director in the Dallas office of JLL Capital Markets, Americas and co-leader of the firm's national Corporate Finance & Net Lease group.

Demand outweighs supply

Investors are feeling the pinch from a crowded marketplace. Those who believe there is "too little" available supply of net lease properties for investment jumped from 29 percent in 2021 to 43 percent in the current survey—the second highest level in the seven-year history of the survey. In addition 39 percent think there is the "right amount." Only 9 percent said there was "too much" supply.

Another factor contributing to the supply-constrained market is owners that are reluctant to sell. "There are a lot of transactions happening and a lot of people wanting to make moves, but a lot of sellers are holding back a little bit, because if they sell, they have to do a 1031 exchange and purchase something. So, when you sell in a seller's market, you're also oftentimes buying in a seller's market," says Chad Kurz, an executive vice president at Matthews Real Estate Investment Services.

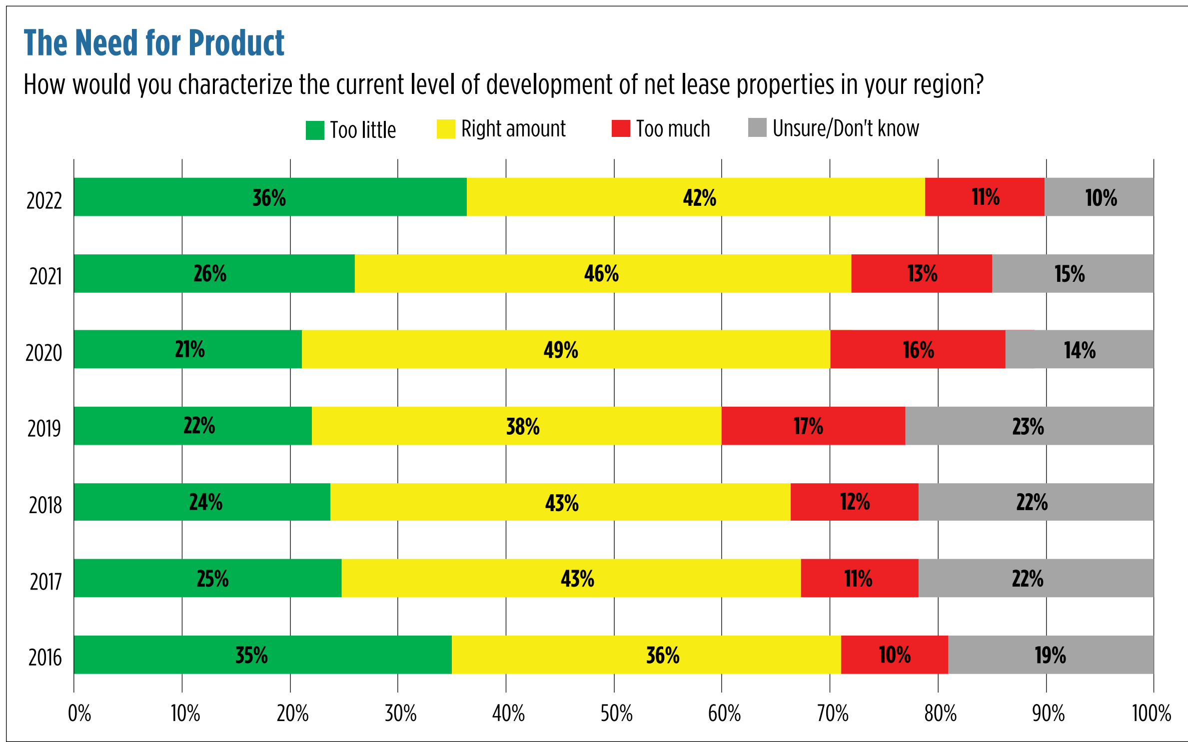
However, the 2021 transaction volume suggests there is ample supply of for-sale assets in the market. "There is a lot of demand for net lease investments out there, but I don't think we're experiencing any significant shortage," says Jason Patterson, vice president, Investments at W. P. Carey Inc. The REIT invested a record $1.7 billion last year and the firm has a strong pipeline lined up to meet its guidance to invest between $1.5 billion and $2 billion this year in North America and Europe. Demand in the market also is being met with a trend in the market from companies looking to monetize their real estate through sale-leasebacks, he says. "We feel pretty good about the supply of deals that are out there and our ability to meet our guidance," he adds.

Survey respondents do not appear concerned about overdevelopment of net lease properties. Most respondents (42 percent) said the current level of net lease properties in development in their respective region is the "right amount". However, those who believe there is "too little" jumped from 26 percent in the 2021 survey to 36 percent—representing the highest level in the seven-year history of the survey. A minority 11 percent said there is too much, and 10 percent were unsure.

Bracing for higher interest rates

Investors are keeping a close eye on rising capital costs. In March, the Federal Reserve raised the federal funds borrowing rate by 25 basis points, marking its first rate hike since 2018. The Federal Open Market Committee (FOMC) also has signaled that the Fed will likely raise rates up to six more times this year. Meanwhile, the 10-year Treasury has increased about 60 basis points since the start of the year to hover at about 2.2 percent as of March 17th.

A majority of respondents (80 percent) predict that interest



rates will increase over the next 12 months compared to 59 percent who held that view in the 2021 survey. "We're expecting that rates will increase, as most people are, in the coming 12 months. That will put a floor on how low pricing can get for industrial assets as the cost of funds on the debt financing side will continue to increase," says Patterson.

However, a majority of survey respondents are optimistic on continued access to favorable financing terms. More than half of respondents expect two key aspects of financing for net lease properties—loan-to-value ratios (LTVs) and debt service coverage ratios (DSCRs)—to remain the same. Fifty four percent of respondents predict that LTVs will remain the same, while 29 percent anticipate an increase and 18 percent think LTVs are more likely to decrease. Specific to DSCRs, 57 percent of respondents believe they will stay the same, while 31 percent said they could increase and 12 percent decrease.

Getting an accurate read on expectations for financing terms is challenging in the net lease sector, because there are so many different property types within the net lease market. Lenders may be more aggressive and accept tighter DSCRs on stronger credit tenants or more favored property types. Lenders are probably going to be willing to accept tighter coverages on assets such as industrial or strong credit retail, which would allow borrowers to maintain the same level of proceeds, notes Farhan Kabani, a partner at Four Pillars Capital Markets. For property types that are viewed as inferior, there likely won't be that same allowance for DSCR to be adjusted lower, which will create some leverage constraints, he says.

There is plenty of capital available, including significant capital raised by debt funds. The difficult component is how it impacts credit spreads based on what spread lenders are going to lend at, says Kabani. "There is a financing solution to each problem, it just might not be the exact solution that a client wants in terms of the all-in rate," he adds.

Time to recalibrate cap rates?

Competition has been putting downward pressure on cap rates, but it remains to be seen how cap rates are likely to be impacted by the rising interest rate environment. More than half of investors (57 percent) expect the risk premium (i.e., the spread between the risk-free 10-year Treasury and cap rates) to increase over the next 12 months, which reflects a significant increase over the 42 percent who held that view in the 2021 survey. One-third of investors think the risk premium will remain the same and 11 percent predict a decline.

"If we have a rising rate environment, eventually that is going to have an impact on cap rates," says West. Pricing will have to shift in order for investors to generate the desired yield. In addition, the high inflation, rising interest rates and geopolitical issues stemming from Russia's invasion of Ukraine have created a lot of uncertainty in the market and rate volatility. So far, it is still a bit too early to tell, but it does appear that spreads are likely to widen because the cost of debt is rising, he says.

Among the major property types, respondents are reporting the lowest mean cap rate for net lease industrial at 4.8 percent, followed by retail at 5.3 percent and office at 5.6 percent. A majority of respondents expect net lease cap rates to move higher in all three property sectors in the coming year.

Leading the Pack

Respondents identified industrial far and away as the net lease property type experiencing the greatest demand.

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

Cap rates have compressed across the board for most retail net lease assets, and sellers are getting 10 to 15 percent higher prices now than they were a year ago, notes Kurz. Logically, if interest rates rise and inflation remains high, cap rates should follow. The other side of the equation is that cap rates aren't driven purely by interest rates. Supply and demand is a big variable that will have an impact on cap rates. For example, while the cost of borrowing has gone up 80 basis points in recent weeks, in some cases, cap rates have gone down another 50 basis points–largely due to supply and demand, he says. "It feels like we might be in the seventh inning, but it all comes down to supply and demand, and there is such strong demand from investors to buy passive net lease deals," he adds.

"There is a lot of resistance built into the market in respect to upward movement in cap rates for a few reasons," agrees Feller. In addition to the supply-constrained market, a second factor is a structural trend of more low-leverage or all-cash investors transacting in the marketplace. "The good news about a marketplace where the prevailing leverage is much lower than it was in the Great Recession in 2008 and 2009 is that people aren't necessarily solving for leveraged yields," he says. Demand from cash or low-leverage buyers could insulate some cap rates from upward movement in interest rates.

Strong appetite for industrial

The net lease property sectors that saw the biggest increase in sales in 2021 were industrial and retail. Industrial sales increased 75 percent over 2019 activity with $37.3 billion in transactions. Net lease retail volume totaled $18.3 billion in 2021, a 65 percent increase over 2019, according to JLL.

Investor sentiment is tracking with sales activity. More than half of respondents (54 percent) said industrial was the sector in greatest demand from investors, followed by medical office/healthcare at 38 percent and restaurants/fast food at 24 percent. Those property types least in favor were office and fitness, each at 6 percent, and auto at 7 percent. When looking at the history of survey results, demand for industrial has seen the biggest improvement, jumping from 24 percent in 2016 to its current level. In comparison, drugstores have dropped from a high of 40 percent in 2016 to 20 percent.

Coming out of COVID, investors have a strong appetite for "essential" properties, such as grocery stores, convenience stores, quick-service restaurants and auto. What is out-of-favor is anything that is non-essential, such as entertainment venues, movie theaters and gyms. Those businesses are coming back, but they are less desirable to investors, notes West.

Following a strategic decision in 2019 to increase its exposure to industrial, Spirit Realty has been an active buyer in both industrial and retail. Although a majority of its portfolio, roughly 70 percent, is retail, acquisitions the company has made over the past 12+ months have been fairly evenly split between industrial and retail. "Not all retail is equal, but we're still happy with certain parts of retail," says Heimlich. For example, gyms and fitness centers is a sector that struggled during the pandemic. "We still like fitness, it just has to be the right operator," he says.

Looking Ahead

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

Property	2016	2017	2018	2019	2020	2021	2022
Industrial	3.7	3.8	4.0	3.8	3.9	3.9	4.1
Medical Office/Healthcare	3.9	3.8	3.8	3.8	3.9	3.7	4.0
Grocery	3.6	3.4	3.3	3.3	3.5	3.8	3.8
Convenience Store/Discount	3.6	3.5	3.4	3.5	3.5	3.5	3.6
Drugstores	3.6	3.4	3.3	3.2	3.2	3.5	3.5
Auto	3.3	3.2	3.1	2.9	3.1	3.3	3.4
Restaurants/Fast Food	3.5	3.3	3.3	3.2	3.4	2.9	3.3
Bank/Financial	3.1	3.3	3.4	3.2	3.5	3.3	3.2
Government	3.2	3.2	3.3	3.0	3.6	3.8	3.2
Misc Retail	3.3	3.0	3.0	2.8	3.0	2.5	3.1
Fitness	3.1	3.1	3.2	3.1	3.3	2.5	3.0
Office	3.1	3.1	3.2	3.1	3.3	2.4	2.8

Property outlooks remain positive

It's no surprise that industrial topped the list when respondents were asked to rate the 12-month outlook on property sectors. Based on a rating scale of 1 to 5 with 5 being "excellent" and 1 being "poor" industrial rated a 4.1, followed by medical office/healthcare at 4.0 and grocery at 3.8. Those sectors that rated the lowest were office at 2.8, fitness at 3.0 and bank/financial and government each at 3.2.

"Based on structural trends, people believe the future is exceedingly bright for industrial. Industrial throughout the pandemic saw incredible inflows of equity capital into that asset class, and that continues today, which is pushing yields on an unleveraged basis to all-time lows, sometimes into the 3 percent cap rate range, which is really unheard of," says Feller.

It also is notable that respondents are more bullish on the outlook for net lease property sectors almost across the board. Views on the 12-month outlook remained the same or moved higher in all but two sectors as compared to the 2021 survey. The two sectors that declined were government leased assets, which dropped from 3.8 to 3.2 and bank/financials, which dipped slightly from 3.3 to 3.2.

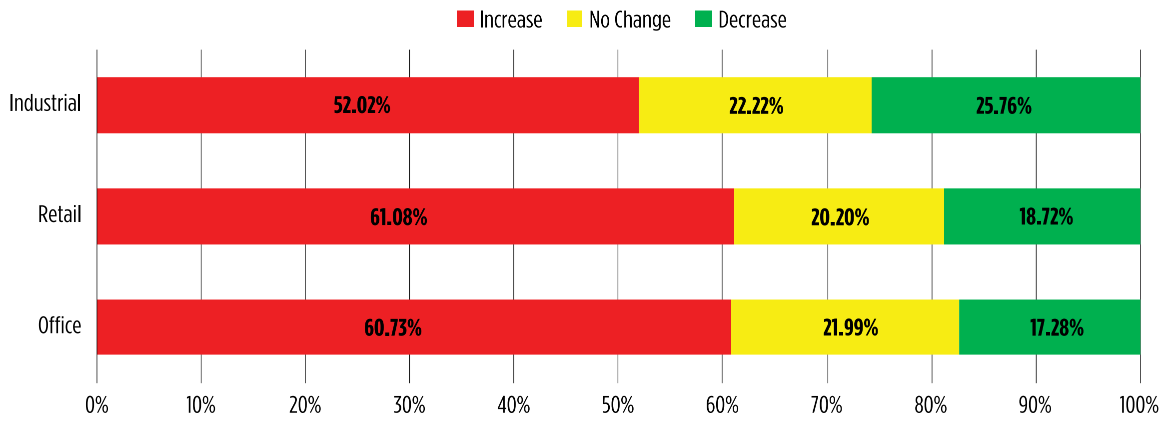
Buyer demand for government-leased assets is dependent on the use and branch of government. Essential government uses such as a VA hospital is going to be more in demand than a generic government office or a post office in a small town, notes West. In addition, there is still good demand for bank branches that have a good credit tenant, such as JPMorgan, Chase and Bank of America. "Buyers want really good locations and they're going to drill down to the deposit base at that location," he says. "If those factors are strong, then the asset will trade very strong."

Steady focus on ESG

Respondents have a consistent view of how ESG is impacting investment decisions, but survey results show plenty of room for improvement. Four out of 10 investors report that ESG is a factor in investment decisions at least some of the time, while 18 percent said it is not a factor in current decisions but will be in the future. Twenty percent of respondents said that ESG is not a factor in investment decisions. Those who said ESG is a significant factor also climbed higher from 6 percent in the 2021 survey to 12 percent.

"ESG is very important, and we take it very seriously. We have put in an enormous amount of bandwidth and energy into ESG in the last couple of years," says Heimlich. A majority of the REIT's top 20 tenants have made their own public commitments to ESG. One of the challenges on the environmental side for net lease landlords is that owners tend to have very limited control over a tenant's energy consumption. Some of the ways that Spirit Realty is working to improve on the "E" of ESG is to take steps to capture better data on its properties and introduce "green" lease language.

Respondents have mixed views on how ESG is impacting investment decisions. Those who said ESG is a factor in assessing assets bought or sold climbed from 28 percent in the 2021 survey to 32 percent. Additionally, ESG as a factor in assessing which brokerage firm to work with climbed sharply from 18 to 28 percent. Similar to the last survey, one-fourth of investors said ESG is a factor inside of their own company.



ESG declined as a consideration when assessing capital providers to 15 percent.

ESG is an important part of the underwriting process at W. P. Carey, notes Patterson. "We look at deals on a holistic basis, not just the lease terms, but also what the tenant does," he says. For example, the REIT acquired a 1.1 million-square-foot Class A logistics facility last year that was leased to Jaguar Land Rover Limited. The facility has earned a BREEAM

"Very Good" environmental rating and also operates at the highest level of energy efficiency with an EPC "A" energy rating. "We view that as a very big positive component of the deal," he says.

Investors are wary of inflation

Inflation that has been running above 7.5 percent during first quarter has pushed the topic to the forefront for investors. "Everyone is keeping an eye on inflation, because with inflation replacement costs go up and rents go up," says West. In addition, the Fed is expected to raise interest rates to contain inflation, which could slow, or even stall economic growth if rates rise too quickly. A majority of survey respondents are concerned about the impact of inflation on the net lease real estate market with 57 percent who said they were somewhat concerned and another 35 percent who are very concerned. Those who are not concerned are in the minority at 8 percent.

Commercial real estate is often viewed as a hedge against inflation, and one of the benefits to net leases is built-in rent escalators. For example, W. P. Carey's portfolio is very well positioned with respect to inflation in that 60 percent of the leases in its portfolio have rent escalations that are tied directly to inflation indicators, such as the CPI.

The remaining 40 percent is tied to fixed-rate rent escalators. Historically, those fixed rate escalators have been set at around 2 percent but have bumped a little bit higher on new deals to match what's happening in the market, notes Patterson. "Inflation has always been a concern for the sector, but at the moment it makes for a great opportunity for corporates to pursue sale-leasebacks to lock-in rent streams for the long-term, which will increase the volume of inventory on the market," he says.

Although there are some cases where a net lease property might be structured with a flat lease, those cases are rare. In addition to the built-in rent increases that help provide a hedge against inflation, net leases place responsibility for property maintenance and repairs on the tenant.

To some extent, that shift of expenses to the tenant insulates owners and investors from inflation-related increases in property operating expenses. "At the end of the day, what we're looking for is predictable income streams out for the next 15 to 20 years, and we're going to shoot for a 2 percent escalator on every lease that we do," says Heimlich. According to its fourth quarter 2021 release, it's forward looking same-store sales were at 2.4 percent.

It remains to be seen how the conflict between Russia and Ukraine impacts inflation, particularly oil and gas costs, and global supply chains, which could create ripple effects on economic growth and interest rates in the U.S. "People are watching that very, very closely, which is why we have seen the volatility and widening of spreads on debt," says Feller. ■

Survey methodology: *The WMRE research report on the net lease sector was completed via online surveys distributed to readers of WMRE in March 2022. The survey yielded 232 qualified responses with the vast majority at the executive level of vice president or higher. Respondents included a broad cross-section of industry participants of owners, developers, brokers and lenders. Private investors represented the largest group at 45 percent. Survey respondents are active nationally, with the biggest percentages operating in the South/Southeast/Southwest at 46 percent, East at 43 percent, West/ Mountain/Pacific at 37 percent and Midwest/East-West North Central at 33 percent. International investors also represented 10 percent of survey respondents.*