March 2017

Investor Appetite Strong for Net-Lease Assets

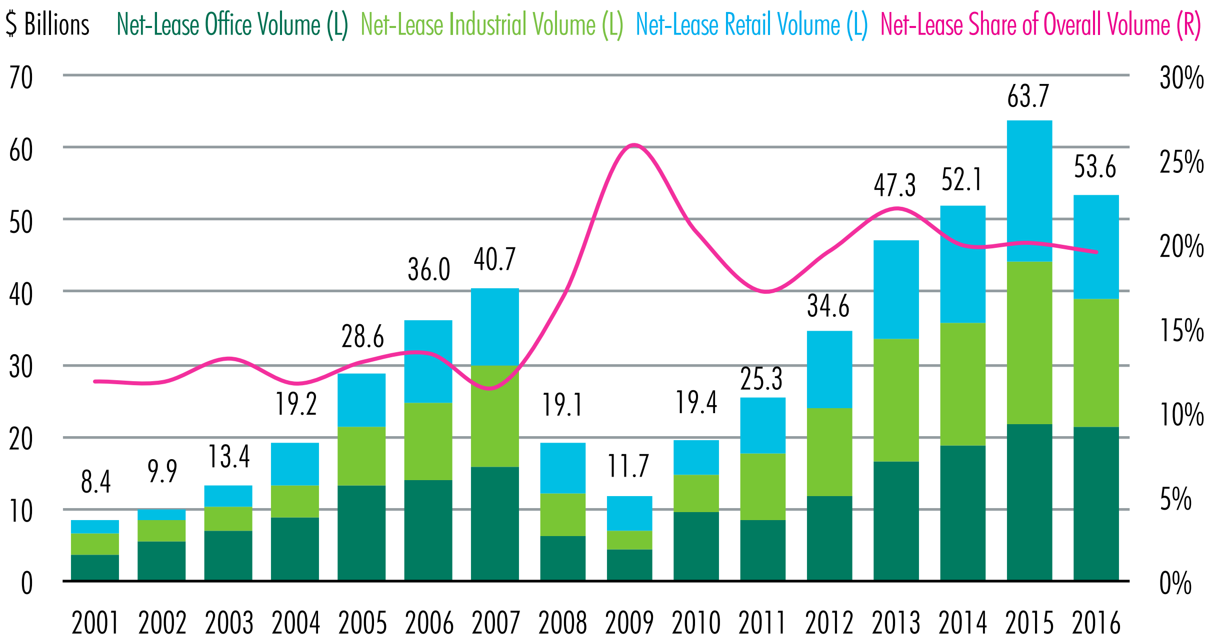
Summary

- Investor demand for U.S. net-lease product remains strong, with 2016 transaction volume the second-highest annual amount in the past 15 years. Net-lease transactions are also increasing as a share of total annual investment.
- Despite rising 10-year Treasury rates and marginal softening in net-lease cap rates, spreads remain in line with long-term averages, ranging between 300 and 400 basis points (bps). With further increases in long-term rates expected, spreads are likely to be under pressure. Furthermore, investors are likely to become more selective on asset type, lease terms and credit quality.
- Lender appetite, rising interest rates and questions regarding proposed tax reforms present headwinds for the net-lease segment. However, the overall outlook is cautiously optimistic, particularly given the considerable equity chasing yield-driven real estate in the U.S.
- Net-lease retail is the strongest performing net-lease asset type. Drugstores and casual-dining properties represent about half of total transaction volume, fueled by favorable consumer trends and opportunities for sale-leasebacks.

Net-Lease Market Overview

Second highest net-lease volume since 2001

Figure 1: U.S. Net-Lease Sales Volume

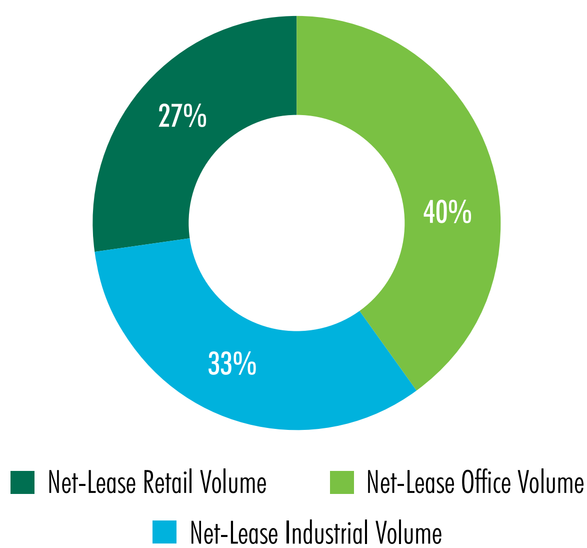


Source: Real Capital Analytics, Q1 2017.

U.S. net-lease transaction volume, comprising office, industrial and retail properties, totaled $53.6 billion in 2016. While down from 2015's record high of $63.7 billion, this was the second-highest annual volume in the past 15 years and 20% above the prior five-year annual average of $44.6 billion.

The net-lease segment accounts for a rising share of total real estate investment, and the preference for this relatively low-risk option is apparent in the shift in net-lease transactions as a share of total investment before and after the Great Recession. As a share of total annual office, retail and industrial volume, net-lease transactions increased from an average of 12.4% between 2001 and 2007 to 20.2% between 2008 and 2016.

Figure 2: 2016 Net-Lease Volume Breakdown by Property Type



Source: Real Capital Analytics, Q1 2017.

Search for elusive yield combined with risk aversion drives investor appetite

The search for yield is the main motivator for investing in U.S. commercial real estate.[1] When combined with increased risk aversion, this provides the key investment impetus for net-lease investments. Net-lease deals provide long-term, passive, relatively stable and periodic cash flows, and deliver a significant yield spread when compared with other asset classes.

While private buyers remain the dominant buyer group, accounting for a stable 40% market share in the past four years, the net-lease segment is becoming more appealing to institutional and cross-border buyers.

In the past three years, acquisition volume among institutional buyers—typically a more conservative and risk-averse group—nearly doubled, rising to 26% of the total volume in 2016 from 15% in 2013. The increase in cross-border capital is more dramatic: Acquisition volume in 2016 surpassed 2013 levels by more than 200% (although moderating from higher volume in 2015) and represented 12% of total volume vs. 4% in 2013.

Figure 3: Yield Comparison Table

Investment Vehicle	Yield	10-Yr Treasury Multiple
German 10-Year Treasury	0.42%	0.2x
Japanese 10-Year Treasury	0.08%	0.0x
U.S. 10-Year Treasury	2.50%	-
Investment-Grade Bonds	3.30%	1.3x
BBB CMBS	6.80%	2.7x
Class A Core Real Estate (unlevered)	4.60%	1.9x
Single-Tenant Cap Rates		
Industrial	6.6%	2.7x
Office	6.2%	2.5x
Retail	7.0%	2.8x

Source: Bloomberg, Commercial Mortgage Alert, Real Capital Analytics, Q1 2017.

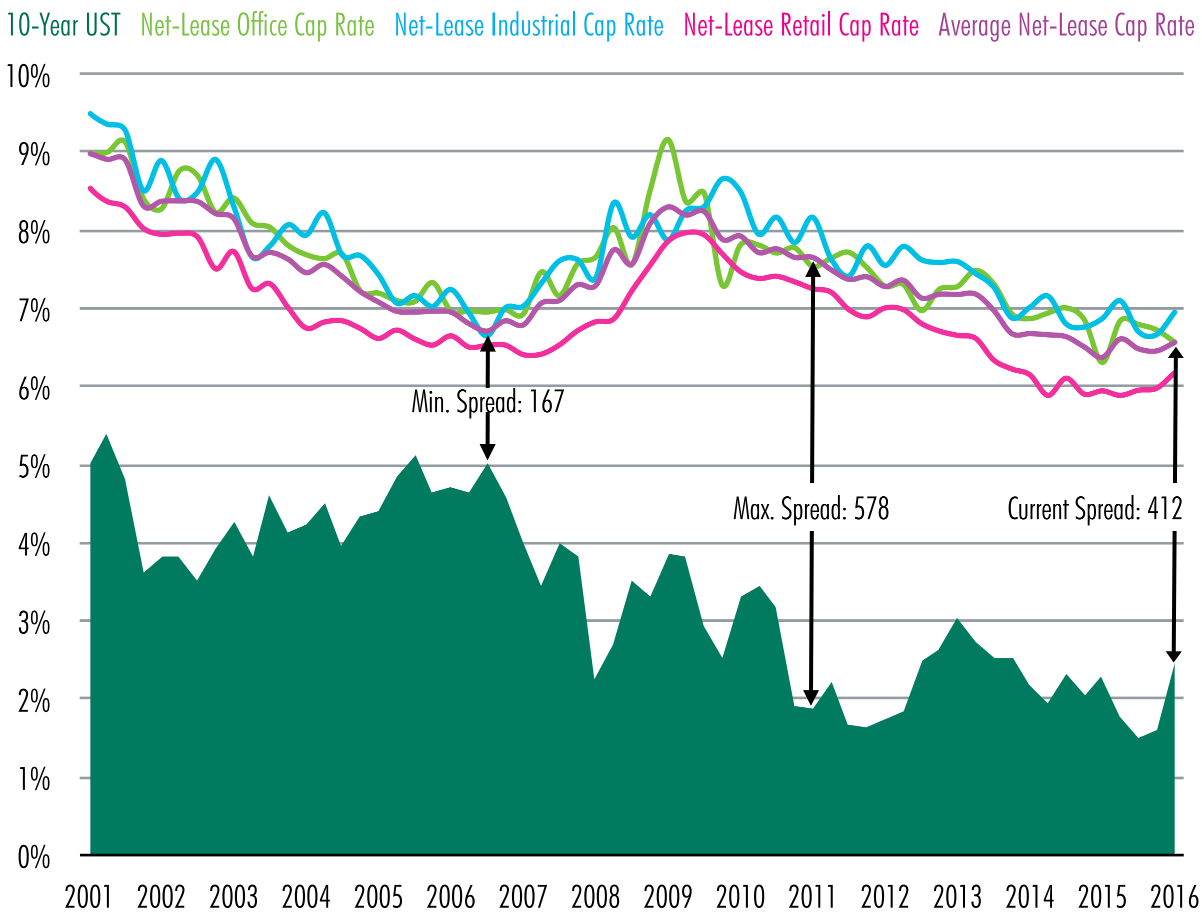
1 CBRE 2017 Americas Investor Intentions Survey.

Spreads remain high despite pricing pressures

Despite the almost 70-bps increase in the 10-year Treasury following the U.S. presidential election, spreads between net-lease transaction cap rates and 10-year Treasury rates remain healthy at approximately 400 bps. The pre-recession average spread was 332 bps between 2001 and 2007. This echoes the findings from a recent CBRE post-election pricing analysis (covering all commercial real estate), which indicated a 3% decrease in value for approximately 30% of the transactions analyzed.[2] However, for those transactions that did reprice, it is difficult to disentangle the impact of the change in the cost of capital from that of fundamental cyclical concerns.

By year-end 2016, there was marginal softening in net-lease cap rates (8 bps higher than mid-2016), in line with the rest of the market. Increases in office, industrial and retail cap rates ranged from 1 to 18 bps over the same period, according to CBRE's Cap Rate Survey for the Second Half of 2016. Current spreads range from 300 to 400 bps, in line with the long-term average, and likely will be under further pressure.

Figure 4: Cap Rate Spreads



Source: Real Capital Analytics, Q1 2017.

2 CBRE U.S. Market Flash, Post-election interest rate rise modestly impacts commercial real estate pricing, January 2017.

Net-Lease Retail Spotlight

Increasing demand and supply imbalance in the most active net-lease investment sector

Retail is an active component of the net-lease market. Although retail accounts for the smallest share of total net-lease dollar volume (27% in 2016), it drives the bulk of all trading activity in terms of total properties. More than 9,100 net-lease retail properties were sold in 2016, compared with just over 6,800 net-lease industrial properties and approximately 3,700 net-lease office properties.

Drugstores were the most active net-lease retail sector by both volume and number of properties in Q4 2016. This was fueled primarily by the expected divestment of more than 1,000 Walgreens stores following the Walgreens/Rite-Aid merger. While a significant number of Walgreens asset sales will close (subject to lease-back), competing drugstore brand Fred's has taken advantage of the space coming online by agreeing to purchase nearly 900 Rite-Aid stores.

Given strength in key retail drivers, investment demand for net-lease retail is expected to remain healthy, but modest supply constraints are expected in 2017. Construction activity slowed in 2016, and net-lease retail deliveries were down by 11%. New product is concentrated among food retailers, fast-food and casual-dining restaurants.

This supply should be easily absorbed as more than half of the top-30 retailers planning to open stores in the next two years are fast-food and casual-dining restaurants.[3] Additionally, several major grocery chains are aggressively expanding and remain attractive to investors. While cap rates for most store types softened somewhat by year-end 2016, restaurants, fast-food and grocery stores registered continued cap-rate compression.

Figure 5: Key Retail Demand Drivers

Overall Retail

Total Retail/Food Service Sales
Increased by 4.1% year-over-year in Q4 2016

Consumer Sentiment
Up 5% year-over-year as of February 2017

Drugstore

Health & Personal Care
Of all brick-and-mortar retail sectors, health & personal care retailers had the strongest year-over-year growth in retail sales.

Prescriptions
Nearly half the population takes at least one prescription drug. As baby boomers continue to age, drugstores will remain important.

Source: CDC, Census Bureau, University of MI, Q1 2017.

Figure 6: Key Retail Supply Metrics

Net-Lease Retail Inventory
3.9 billion sq. ft. as of year-end 2016

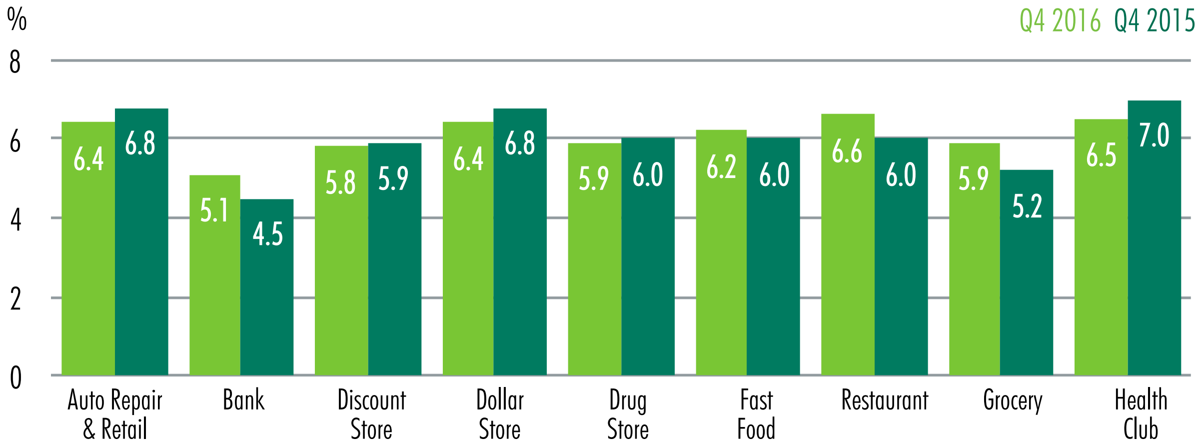
Deliveries
29.2 million sq. ft. delivered in 2016

Construction
27% of construction starts from food retailers, fast-food and casual-dining restaurants

Source: CBRE Research, Q4 2016.

3 RBC Capital Markets, Q3 2016.

Figure 7: Net-Lease Retail Cap Rates by Store Type



Source: CBRE Research, Q1 2017.

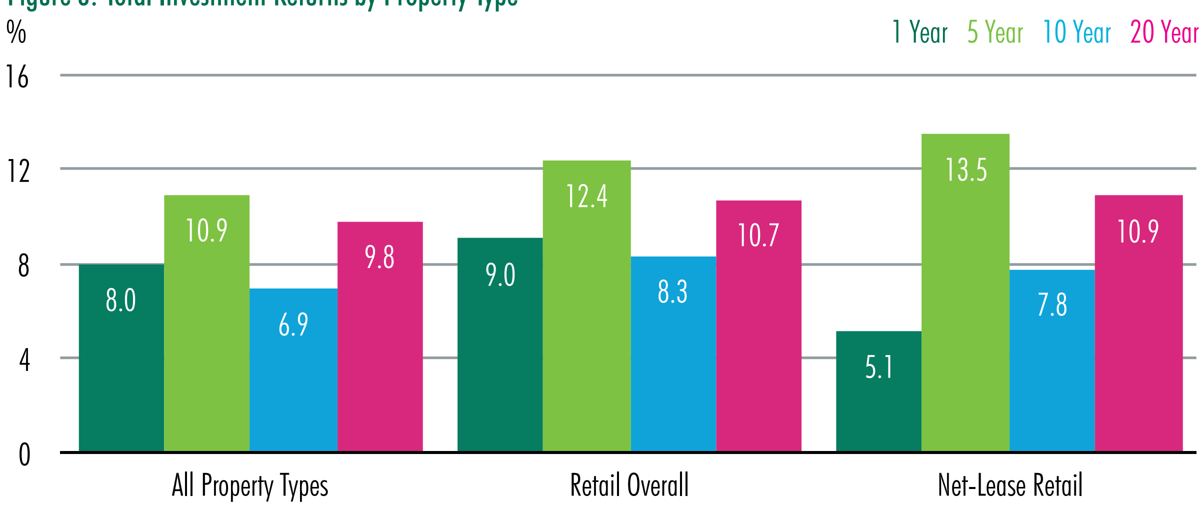
Net-Lease Retail Strongest Performing Asset Type

Investment performance by the net-lease retail segment has remained robust in the past several economic cycles, with net-lease returns strongest over the long term. Relative to the five major property types, net-lease retail had the highest total return for the past five-year and 20-year periods, and was second only to overall retail for the 10-year return period.[4]

Private investors—the traditional net-lease investor group—accounted for nearly 60% of total net-lease retail volume in 2016, and increased their acquisitions dramatically in the past decade. Within this group, developers/owners were by far the most active.

Retail has not experienced the pronounced influx of capital from institutional and cross-border investors as has the overall net-lease segment. This is partly because net-lease retail is perceived as somewhat riskier than office and industrial, but also because retail deals tend to be priced much lower.

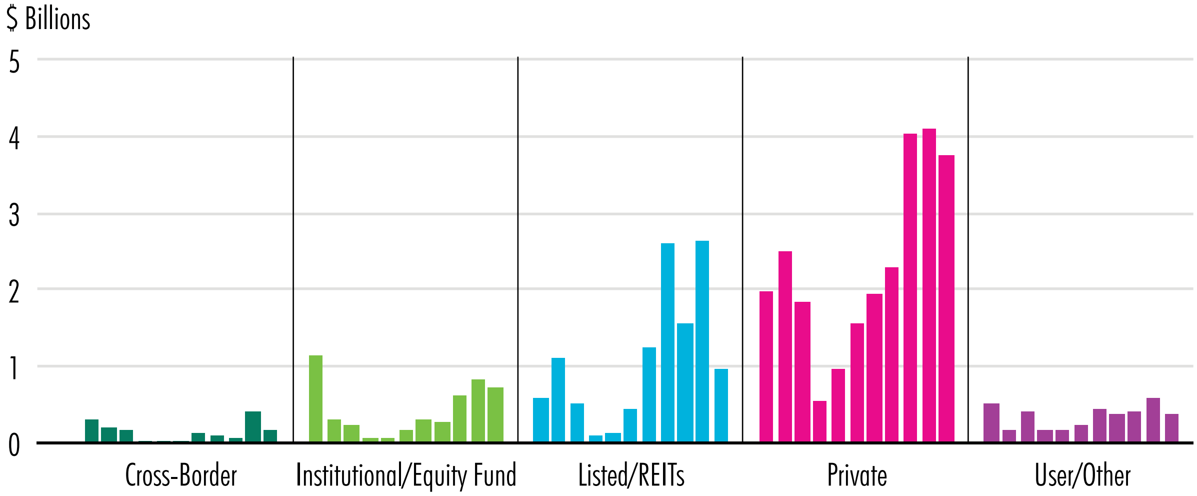
Figure 8: Total Investment Returns by Property Type



Source: NCREIF, Q4 2016.

4 NCREIF, Q4 2016.

Figure 9: Net-Lease Retail Acquisitions by Investor Group, 2006-2016



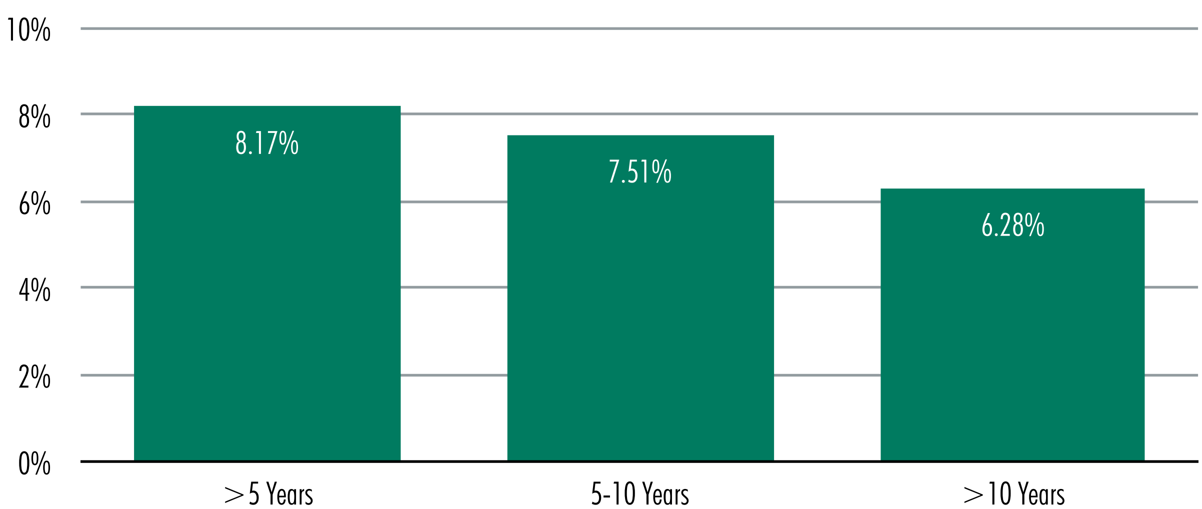
Source: Real Capital Analytics, Q1 2017.

Analysis of CBRE-brokered net-lease retail investment

CBRE is a top brokerage of net-lease properties, closing about 16% of the U.S. net-lease retail transaction volume in 2016[5] and a higher share when including deals below the $2.5 million threshold set by Real Capital Analytics (a significant number in the net-lease retail segment).

The analysis presented below is based on a sample of $3 billion in CBRE-brokered investment sales of net-lease retail properties and portfolios in 2016. The average cap rate for the CBRE sample was 6.63% and ranged between 5% and 10%, reflecting continued investor appetite for deals with a range of price points.

Figure 10: Average Net-Lease Retail Cap Rate by Time Remaining on Lease



Source: CBRE Research, CBRE Net Lease Property Group, Q1 2017.

5 Real Capital Analytics, 2016.

Figure 11: Sample Statistics, CBRE-Brokered Net-Lease Retail Deals in 2016

Store Type	Avg. Cap Rate	Avg. Size (Sq. Ft.)	Avg. Close Price ($Mil)	Avg. Price PSF	Total Sales Vol ($Mil)	Total Assets Sold
Auto	6.48	7,682	2.0	260	79.9	40
Bank	6.53	7,923	1.7	211	185.9	111
Big-Box	6.91	87,734	13.5	154	757.5	56
Casual Dining	6.08	6,425	3.9	604	605.0	156
Discount Store	7.35	12,592	2.3	183	76.2	33
Drugstore	7.25	13,387	4.8	359	807.7	168
Fast Food	6.15	4,334	2.1	482	119.1	57
Convenience Store	6.19	4,151	2.5	605	90.4	36
Grocery	7.06	50,332	8.5	168	59.3	7
Healthcare	6.44	12,882	5.1	397	30.7	6
General Retail	7.18	19,069	4.9	257	156.6	33
Average/Total	6.63	14,964	6.3	335	2,968.3	703

Source: CBRE Research, CBRE Net Lease Property Group, Q1 2017.

The remaining length of lease term at the date of purchase impacted cap rates significantly. With longer leases representing less risk, the average cap rate for properties with more than 10 remaining years (the majority in the CBRE sample) was 189 bps lower than the average for properties with less than five years. On average, fast-food deals had the longest leases (15.3 years), while big-box had the shortest (9.9 years).

By store type, drugstores were the most frequently traded, followed closely by casual dining, with sale-leasebacks a strong driver of activity in both segments. In terms of dollar volume, drugstores remained on top, though big-box properties surpassed casual dining. Together, these top-three store segments accounted for nearly three-quarters of total volume. The average cap rate for casual-dining deals was the lowest (6.08%), while drugstores had the second-highest (7.25%). However, a large proportion of the CBRE drugstore sample includes Rite Aid transactions, which traded at higher cap rates than the overall drugstore segment.

The CBRE sample indicates that the net-lease retail segment remained fairly stable during the market volatility and rising interest rates in late 2016, with minimal movement in both transaction volume and cap rates throughout the year. There did appear to be a gradual increase in the time taken to close deals, possibly as a result of increased due-diligence requirements.

Outlook for 2017

Significant wall of equity capital chasing U.S. real estate

Investor interest in the net-lease segment is expected to remain strong in 2017, as capital availability—particularly from institutions—remains high. Institutional investors are under-allocated to real estate by about 130 bps in the Americas,[6] and Preqin estimates that total available capital for close-ended funds in North America is at an all-time high ($144 billion as of Feb. 2017).

While many institutional buyers are likely to remain focused on net-lease office product, particularly in core markets, other buyer groups will seek better yields in alternative markets and property types.

Headwinds from debt market and tax reform

Among some of the challenges facing the net-lease commercial real estate sector in 2017, two material ones are:

- **Debt market conditions.** Lending volumes face headwinds both in the CMBS and bank markets, as risk-retention rules affect not just appetite for construction lending but also higher-risk deals. Rising interest rates also present increasing pricing pressure—market observers, including CBRE Econometric Advisors, expect the 10-year Treasury to approach 3.0% by year-end 2017. Investors are likely to become increasingly selective on asset type, lease terms and credit quality in order to best absorb changing debt metrics.
- **Potential tax reform.** Uncertainty surrounding proposed tax reforms raises key questions for the net-lease segment, particularly retail. Shifts in investor appetite could occur due to changes in tax rules for 1031 exchanges, income classification of net-lease income and limits on mortgage interest deductibility that could materially alter lease vs buy mechanics. Additionally, the proposed Border Adjustment Tax on imports could have a dramatic impact on retailer profitability, especially for apparel retailers, and the real estate demand from these tenants.

On balance, given the weight of capital currently in the market and favorable macroeconomic and consumer trends, the net-lease segment is expected to remain a strong investment option in the near term, albeit with some pricing pressure.

6 Cornell Hodes Weil, 2016.

Figure 12: Top-10 Retail Net-Lease Transactions in 2016

Date	Tenant	Address	City	State	Sq. Ft.	Price ($Mil)	$/Sq. Ft.
Q3 2016	Bijan	420 N Rodeo Dr	Beverly Hills	CA	5,095	122	23,945
Q4 2016	Saks 5th Avenue	220 Post St	San Francisco	CA	38,400	73	1,901
Q4 2016	Stop & Shop	41 Alvord Ln	Stamford	CT	69,733	45	651
Q2 2016	UA Kaufman Astoria Cinemas	35-30 38th St	Long Island City	NY	84,000	45	536
Q1 2016	BJs	287 Washington St	Attleboro	MA	115,660	43	372
Q3 2016	Marianos Vernon Hills	1720 N Milwaukee Ave	Vernon Hills	IL	70,895	36	513
Q4 2016	Mariano's Bronzeville	3857 S Martin Luther King Dr	Chicago	IL	60,653	34	454
Q3 2016	Home Depot	1213 VFW Pkw	West Roxbury	MA	103,162	34	330
Q4 2016	AMC Loews Village 7	66-72 Third Ave	New York	NY	54,328	32	595
Q3 2016	BJs	200 Crown Colony Dr	Quincy	MA	85,650	31	358

Note: Excludes portfolios and transactions for redevelopment.
Source: CBRE Research, Real Capital Analytics, Q4 2016.

This is the first in a series of CBRE reports on the net-lease market.

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