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REAL ESTATE INVESTMENT BANKING

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**Brower**  
MILLER + COLE

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REFI FINANCING

## Debt markets start off strong ahead of major refinancing pipeline

The commercial real estate debt markets are starting the year off strong ahead of another heavy year of maturities. Indeed, there is almost \$120bn of CMBS loans slated for maturity, and more non-CMBS loans, and the hope is the bulk will be refinanced. A concern, however, is loans with fairly high balances and questionable performance, said Bryan Shaffer, a principal with Los Angeles-based George Smith Partners.

Even with the proliferation of mezzanine lenders, it will be difficult for borrowers who fit that profile to refinance loans. "The question is if there will be another group of lenders—portfolio, fund lenders or debt funds who can refinance these loans. No one can absolutely say that there won't be hiccups in the market, but there is clearly some uncertainty," Shaffer said.

Another concern is the CMBS market, which has seen unpredictable swings in spreads that are making it difficult for lenders to figure out where loans can be sold, Shaffer said. The CMBS landscape has been affected by the drop in oil prices and its effect on junk bonds, he added.

"The major CMBS lenders can't tell you where pricing will be next year and there is so much chaos in the market that it's hard to know where the next deal is going to be priced," Shaffer said. "The last five deals of 2015 were priced wide.

All-in pricing that would have been about 4.5% for fully leveraged properties is now closer to 5%. There's been a 50-basis point increase in CMBS lending," he added.

"For the most part, I have not seen borrowers or owners making financing decisions that are specifically tied to an expectation or fear of rate increases. But we do have a number of situations where there are defeasance penalties on loans that mature in 2016-2017 where we are frequently doing analyses for clients showing the breakeven rates to help them decide whether it makes sense from them to pay the penalty in order to refinance now," said Scott Singer, president of New York-based The Singer & Bassuk Organization. "Many owners seem to be basing their decisions on the expectation that there won't be a dramatic rise in borrowing rates over the next 12-24 months."

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"THE MAJOR CMBS LENDERS CAN'T TELL YOU WHERE PRICING WILL BE NEXT YEAR AND THERE IS SO MUCH CHAOS IN THE MARKET THAT IT'S HARD TO KNOW WHERE THE NEXT DEAL IS GOING TO BE PRICED"  
BRYAN SHAFFER

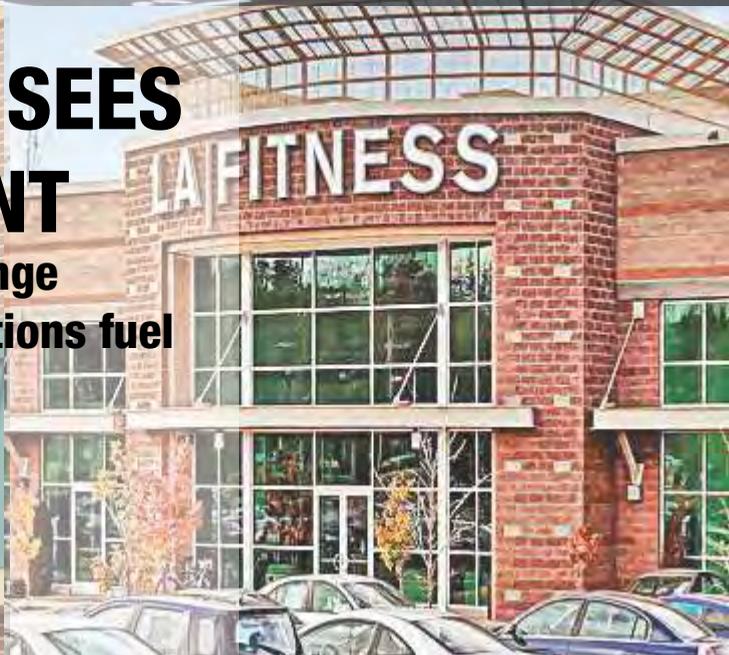
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JANUARY 2016

## NET LEASE SECTOR SEES STRONG INVESTMENT

Continued investment from exchange buyers, foreign capital and institutions fuel the net lease market.



**U.S. Property Trust Looks For Centers  
North Florida And Phoenix See New Investment  
Sky Zone Seeks Retail Environments  
Capital Markets Review**

## Net Lease: Stronger, With Changes In Store

The single-tenant net lease retail sector has seen strong demand from investors, while supply issues ease.

Randall Shearin



CBRE's Net Lease Properties Group recently sold this Rite-Aid in suburban Philadelphia for \$4.9 million.

While one of the most stable asset classes of investment properties over the past 10 years, single-tenant net lease retail (STNL) has seen a number of changes over the past 12 months. Supply is less constrained, likely because many buyers have realized what fits their investment criteria and narrowed their definition of acceptable assets. Demand, say experts, remains strong from 1031 buyers, all-cash investors, foreign investors, and opportunity-driven investors, but has been tempered by fewer transactions from larger investors. As a change in the interest rate was announced from the Fed, the market also sees some changes on the horizon.

For our annual look at the single-tenant net lease market, *Shopping Center Business* interviewed more than 25 executives active in the field, from investors to brokers to those who specialize in arranging financing for this niche property type.

### CURRENT ENVIRONMENT

As 2015 drew to a close, the Federal Reserve Bank announced the first interest rate hike in a number of years, an announcement that had many investors pressing to close deals before any such action would affect lending terms. Many lenders have already priced in a rise in rates, assuming the market could not stay low forever, say some sources. That action hasn't slowed activity in the net lease transactions market at all. In a sector where many properties trade under \$5 million, a number of buyers choose to pay cash and place debt on the properties after closing. While the initial bump of 25 basis points in the rate will likely not have much of an impact, further increases down the road may cause wider changes in the investment market.

"There is enough positive leverage out there already and plenty of capital seeking good quality real estate that one-quarter of a point won't make much difference in the market," says Bob Peterson, vice

president of investments with Passco Companies.

While small increases are often bearable, over time they will reflect a higher cost to borrow funds.

"Increases in interest rates are always interesting, because they disrupt the market," says Joe Cosenza, vice chairman of Inland Real Estate Acquisitions. "Those who are the top bidders on properties do their due diligence and find out that no lender will give them the loan they thought they were going to get, so they will not acquire the property."

As the rate changes, activity in the market has been strong, with many firms reporting their transaction volume was up in 2015 over 2014 levels. In the third quarter of 2015, transaction volume in the industry was up approximately 8.3 percent over third quarter of 2014, according to CBRE.

"This is the longest recovery period the country has sustained since World War II," says Bernie Haddigan, senior managing director of investment properties with

# NET LEASE



Strong credit retailers, like Walmart, are always attractive to net lease investors. This Walmart was recently sold by Marcus & Millichap.

CBRE Capital Markets. “Most recoveries are typically three to four years; we are going on six years in this recovery. We are seeing a slowdown in buyer activity and fewer NDAs signed in other asset classes, but in the net lease world – specifically with assets under \$5 million – the market

is very active.”

Many brokers SCB spoke with reported that they felt cap rates have stabilized and are no longer seeing sustained downward pressure.

“The cap rate compression has slowed a bit, but from time to time, we are still

seeing some records broken,” says Jeffrey Thomas of The Thomas Company, a net lease brokerage based in Seattle. Like others, The Thomas Company has seen its volume rise over the last 12 months.

“We have clearly tested the bottom of the cap rates; a lot of people brought properties to market that pushed the envelope,” says Peter Block, executive vice president with Colliers International in Chicago. “I’ve seen a mix of incredible deals and a number of sellers come back with the asset re-priced. It would seem that we’ve hit bottom on where cap rates can go. Unique assets are still pushing that limit.”

“The market is fairly stable,” adds Jereme Snyder, executive vice president of the retail services group for Colliers International in Orange County, California. “Demand is very strong in the industry right now. Many are in the market looking for clean net lease deals. Credit is king; anything that you can find that has good credit and a long-term triple net lease is trading at an aggressive cap rate.”

## Inland Real Estate Acquisitions



**Joseph Cosenza**  
President

**Q:** What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?

**A:** Out of the 200 to 300 emails I receive daily, easily about 60-70% are net leased deals representing a much stronger demand from investors for purchasing these properties in 2015 as opposed to 2014. After all, the economy is getting slightly better and that’s also a reflection of why there would be more purchases in 2015 than there were in 2014 of net leased deals.

**Q:** As the threat of an interest rate spike looms, was there any increase in demand for assets?

**A:** Interest rate increases always cause a fluctuation in the marketplace, whether it is because everyone thinks “let’s hurry up and buy to avoid the increase”, even though most of it is already built into the marketplace, OR it could very well be toward the end of the year lenders generally have filled their quota, and so buyers are trying to hurry and be the last one at the lender’s doorstep just prior to closing the door. However, I believe the largest threat causing increase in demand for purchasing net leased deals is NOT the increase in the interest rate, but the threat of the present administration’s desire to eliminate the like-kind exchange rules. According to Chicago Title and Trust, just about 50% of the closings in 2015 were 1031 related deals. Most of those deals would not have occurred had it not been for the laws that Congress enacted in 1921.

**Q:** With supply limited, have you seen investors seek “off the radar” or other non-traditional net leased assets? (definition of “traditional” = top-credit, well-known brand properties)

**A:** You are seeing 2 changes over the last year regarding what investors are seeking. You are finding that they are seeking properties that are more population challenged as opposed to the properties in high density areas. The second thing you’re seeing is that the top credits are still the most desirable, but the acceptance of shorter term leases have become very, very popular with investors, even without a large differentiation in cap rates.

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# NET LEASE



Stream Capital Partners recently sold this Walgreens in Readington Township, New Jersey, for \$9.7 million.

Snyder's team at Colliers International expected to close 100 net lease deals by the end of 2015, about double the volume the group did in 2014.

Jonathan Wolfe and Jordan Shtulman, managing principals with Chicago-based Stream Capital Partners, feel the market is shifting. With the recent movement in interest rates, buyers are becoming more

focused on the real estate.

"Location has become more important than it was six or nine months ago," says Shtulman. "Today, they are concerned with the location just as much as they are credit."

"A year ago, the market was so strong that investors weren't as concerned about location," adds Wolfe. "Now, we are hear-

ing from buyers that they are focused on location and demographics."

"Spreads between non-credit deals and credit deals are pretty thin," adds Shawn Bakke, senior vice president with Colliers International in Los Angeles. "We are seeing non-credit deals trade at 6 percent cap rates and credit deals, outside California, probably 75 to 100 basis points lower than that."

Deals in California tend to trade 75 to 100 basis points lower than comparable properties in other states, says Bakke.

Paula Danker, senior vice president with San Diego-based Commercial Facilities, Inc., agrees. "Quality net leased investments in California are being offered at 4 percent cap rates — sometimes lower — and sites outside the state are being offered at 5 percent cap rates in markets that have historically sold at 6 percent cap rates and above," she says.

Along with Stream Capital Partners, which noticed the market for single-tenant net lease retail properties shifting this summer, other companies have seen velocity in the market shift a bit as well.

## United Trust Fund

**Q:** As the threat of an interest rate spike looms, was there any increase in demand for assets?

**A:** It is very possible given the global interest rate environment that when the Fed finally raises that yields may go down i.e. the rate hike is priced in and then some. But even a modest increase will not stop the 1031 machine.

**Q:** With supply limited, have you seen investors seek "off the radar" or other non-traditional net leased assets? (definition of "traditional" = top-credit, well-known brand properties)

**A:** There has never been in the history of sale-leasebacks or net leased investments a less "traditional" selection of quality investments. Because the majority of creditworthy companies have already executed on their strategies to monetize their real estate what remains is in the eye of the beholder. With the demand side so strong for so long some investors have no choice but to go to a lower level of companies, a less desirable location, etc. We are seeing an emperor with no clothes...but the clothes are selling thanks to Fed policy and the 1031 tax code.

**Q:** With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?

**A:** 2015 was strong for sellers primarily of existing net leased transactions. Sale leasebacks are United Trust Fund's only business and we are the oldest firm doing sale leasebacks. We have closed \$382,000,000 YTD in 2015 and we expect to exceed that number next year.



**Paul M. Domb**  
Asset Management

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# NET LEASE

“The average number of offers per property is slowing down,” says CBRE’s Haddigan. “But you only need one buyer to close a deal. Whereas you may have had 100 NDAs and 20 offers one year ago, today you might have 40 NDAs and three offers. In good times and bad, net lease is less volatile than other property types.”

“The net lease space is much more liquid than other leased investments, like shopping centers or office buildings,” says Bill Rose, vice president and national director of Marcus & Millichap’s Net Leased Properties Group. “Because they are in single tenant buildings, you can acquire a portfolio of 50 of them and you may spin off one or two. That makes the investor feel that it is more liquid than other assets.”

“Investors are a little more cautious right now,” says Shtulman. “There was just so much activity at the end of last year. With the upcoming election and with interest rates going up, there is an attitude of caution.”

Still, despite the rise of interest rates and caution, many brokers say it is import-

ant to maintain realistic expectations on well-located properties with strong credit.

“If you expect to buy a new 20-year McDonald’s ground lease at a 5 percent cap rate, you’re dreaming,” says Doug Aronson, a director in Calkain Companies’ South Florida office. “It’s more like a 4 percent cap, and in some parts of the country, even lower.”

## ACTIVE BUYERS AND SELLERS

The net lease market is very active. At a relatively low price point, it is arguably the most active sector of commercial real estate by number of transactions. Marcus & Millichap’s Rose says there are roughly 10,000 net lease trades that occur every year. Within that, our sources identified several tranches of investor groups actively acquiring in the market:

- 1031 exchange buyers;
- REIT, institutional and fund investors;
- All-cash investors; and
- Opportunistic investors, who buy short-term leases at higher cap rates, renegotiate lease terms and quickly sell the properties to more mainstream investors.

The most active buyer group, and the one that will pay the lowest cap rate, remains the private investor who is seeking a replacement property in a 1031 like-kind exchange.

“REITs and fund buyers have proven themselves to be a very consistent source of acquisitions,” says Rose. “Even so, the private client who is exchanging out of one property and into another remains the most active investor in the single-tenant net lease retail space.”

“We see second- and third-generation ownership of apartments exit those assets in favor of net lease,” says Ian Schroeder, senior vice president of CBRE’s Net Lease Properties Group in Newport Beach, California. Schroeder has one client who has been selling apartments in the Bronx at a 3 percent cap rate and trading into net lease assets. “They are exiting the apartment market and going into \$10 million to \$15 million net lease assets. The apartment money is helping to drive the net lease market, and those buyers are willing to pay. If a deal would normally be at a 6 cap, they are happy to

## Spirit Realty Capital

AJ Peil Director, Investments

**Q: What demand are you seeing from net lease investors?**

**Is it stronger or weaker than 2014?**

**A:** Spirit is seeing high demand for net lease assets as the sector continues to provide investors higher yields compared to traditional asset classes. The demand is consistent with 2014 as the interest rate environment remained low and capital was deployed in pursuit of attractive returns.

**Q: As the threat of an interest rate spike looms, was there any increase in demand for assets?**

**A:** No. The threat of an interest rate increase has been present since late 2014 with multiple head fakes and until recently no action. Market participants in the net lease sector have continued to acquire and dispose of assets in a measured fashion and demand has remained steady.

**Q: With supply limited, have you seen investors seek “off the radar” or other non-traditional net leased assets? (definition of “traditional” = top-credit, well-known brand properties)**

**A:** Yes. Non-traditional assets have become more prevalent recently, not as a reaction to limited supply but rather as a continued effort to invest in higher yielding assets.

**Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?**

**A:** During 2016 the net lease sector should continue to provide attractive results and as result we expect demand will remain high. However, the fervor should dampen slightly as we expect market participants to be cautious of the upcoming monetary tightening scheduled to occur throughout 2016. Overall, we expect that the sector will remain attractive and fluid throughout 2016.

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pay a 5.5 percent cap rate to lock it up. Their return is already up. We don't see the apartment market slowing down; as long as it remains robust we expect the A quality net lease assets to maintain low cap rates."

Apartment sellers and other exchangers are fueling the market — they know real estate from their years in multifamily, yet are eager to get into less management intensive properties that still produce comparable incomes. In buying net lease, private buyers may also be willing to pay more because of their local market knowledge, says Rose. While funds buy on proven metrics like credit and lease term, a private investor may know a market so well that he or she knows if the tenant goes out, the location within the market is so desirable that another tenant — which he or she may also know — would step up immediately.

"They may love a property because it is in their hometown, and they may know that real estate really well," says Rose. "They are happy to pay a 5 percent cap rate for an asset like that."

For many exchange buyers, finding that replacement can be elusive, and they are often willing to up the offer if the replacement window timeframe is closing.

"We are seeing a lot of 1031 exchange buyers that want to find the right product but can't find it," says Andrew Bogardus, senior managing director, Net Lease Investment Services with Cushman & Wakefield in San Francisco. "When the product comes available, sellers are getting multiple offers for brand new 15- and 20-year leases that they like."

While private investors have made the market tougher for institutional buyers, Chris Sands, founder and managing director of Sands Investment Group, says those entities have navigated the market well by maintaining a blended average rate of return for their investors.

"They have made sure they check all the boxes from an institutional buying pool criteria and that their investors would be happy with the properties," says Sands. "At the end of the day, many have created a blended average cap rate that gives them a yield that works."

"There's a fragile balance that people are trying to strike right now to get an acceptable return," says Sean O'Shea, man-

aging director with the O'Shea Net Lease Advisory of BRC Advisors. "You are going to pay a premium for the best of the best."

All-cash buyers continue to fuel the market to add to their portfolios. Many are seeking stable returns to "park" cash that other investments cannot offer at this point in time. Many of these investors hold out for properties with good locations, stronger credit and longer lease terms. Others will sacrifice one of those elements if the other two are in place.

"Some of these buyers are willing to buy a franchise concept, or something that is not corporate credit but has a strong background, like 50-plus units. They will take that in lieu of a corporate credit lease," says Sands.

"The lower yield being offered by corporate-backed sites is causing buyers to consider and purchase large franchisee sites in good locations, which offer higher yields," says Danker of Commercial Facilities Inc.

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Bull Realty recently sold this Hooters location in Columbia, South Carolina. The listing quickly brought 12 strong offers for the property.

Investors that were not doing so previously are now acquiring assets with less than 10 years remaining on the lease, as long as the other fundamentals of the real estate make sense.

“Investors are becoming more comfortable with less term left on the leases,” says Parker Carroll, managing director

with Coldwell Banker Commercial in Austin, Texas. “We’ve done a number of transactions over the past 12 months that have not been your typical absolute, 15-year net lease properties. We have seen some ground leases transact and some older properties that are in their option periods that have been very attractive be-

cause rents can be lower compared to the market rate.”

International buyers also mostly fall into the all-cash buyer category, and many of SCB’s sources reported that they have remained a steady force in the net lease market. Haddigan, for one, has seen buyers from Asia, Israel and Europe.

“The same mentality buying super luxury residences in Los Angeles and New York – parking money – is coming into the net lease market as well,” Haddigan says. “Even in the \$2 million to \$10 million range, we are seeing foreign money invest in the United States that is principal direct. In past cycles, we had seen that come in through advisors. Now, we are seeing this from wealthy individuals or wealthy families buying one-off deals, or multiple properties. It is a factor that is fueling the market.”

Ralph Cram, president of Northbrook, Illinois-based Envoy Net Lease Partners, also sees foreign capital active in the net lease market, with many outbidding the 1031 exchange buyers. He noted a recent transaction where a foreign buyer’s offer

## Angelo, Gordon & Co.

**Q: What demand are you seeing from investors interested in your funds? Is it stronger or weaker than 2014?**

**A:** Angelo Gordon closed its latest fund of \$1B+ of equity in mid-2014, which we are currently investing. Therefore, our group has not been actively fundraising in 2015. That being said we have seen strong demand from investors for special account products that meet different return thresholds than our main fund, as well as interest in European investment opportunities and a high grade product. The demand for yield is still very strong among investors.

**Q: As the threat of an interest rate spike looms, have you faced more or less competition towards the end of 2015?**

**A:** The potential for an interest rate spike as well as the gapping spreads in the CMBS market have created significant uncertainty about the direction of cap rates in the future. While competition remains steep, with many players in the market, the rate uncertainty has left many players unsure of how to accurately price transactions.

**Q: With supply limited, have you sought “off the radar” or other non-traditional net leased assets? (definition of “traditional” = top-credit, well-known brand properties)**

**A:** Angelo Gordon focuses primarily on “off the radar” assets. We seek investments in the below investment grade space across all asset classes but primarily in the office and industrial space. These transactions allow us to provide the yield and return that our investors are looking for. We underwrite mission critical assets on long term leases for companies we believe to have a strong credit story with potential for an upgrade in the future.

**Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?**

**A:** Volume and velocity will depend on the interest rate environment but there will continue to be strong deal flow to unlock real estate value through sale leaseback investments. This is our core focus so we expect our volume to continue to be strong.



**Gordon J. Whiting**  
Managing Director and  
Portfolio Manager

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General merchandise tenants like Tractor Supply Co. are in demand from investors. This unit in the Southeast was recently sold at a 6 percent cap rate by Andrew Bogardus at Cushman & Wakefield.

was 25 to 35 basis points lower than that of a 1031 buyer.

There are many opportunistic funds and acquirers in the single-tenant net lease retail market now. This group of buyers is looking for shorter term lease deals; properties that might have five to eight years left on a lease that do not have

a slew of renewal option periods thereafter. With these assets, there is often a negotiable point on the lease structure that allows for an extended term. If the retailer extends, value is instantly added to the asset. Once that is done, this type of owner generally turns around and sells the property. Some hold the properties

as investment, accreting the value to the yield.

Patriot Equity Partners is an opportunistic investor based in Newport Beach, California, that acquires institutional-quality assets with upside. The company sells when the opportunity is right, and buys when the opportunity is right. The company bought and sold about \$150 million worth of real estate in 2015.

“We are buying assets that have some opportunity for improvement, whether that be a shorter term lease or a credit that is not as strong today as it will be in the future, or some feature that will add value to our portfolio,” says Principal Brian Garrigan.

Institutional and fund buyers are actively seeking properties. Generally, because of commitments to investors, they are seeking properties with higher cap rates than those acceptable to a private or 1031 investor, who is in search of a safe property that generates steady yields.

One of the largest institutional investors, Inland Real Estate Acquisitions, likes to acquire properties with known

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tenants, leases that have around 20 years or more remaining; rental rates that are at or below market, and a cap rate between 6 percent and 7 percent. Inland Real Estate Acquisitions has acquired \$1.5 billion in assets since January 2015, approximately \$400 million of that are net lease properties, according to Cosenza.

Passco Companies is in the process of acquiring single-tenant net lease assets. The Irvine, California-based company has a number of criteria that it seeks in net lease acquisitions. Chief among those are location, submarket, traffic counts, functionality of the property, tenant credit and remaining in lease term. The company also researches a path for exiting each property. Passco plans to hold properties for seven to 10 years. Passco has several funds it offers investors, including a fund it offers to 1031 exchange investors. Among the types of investors Passco is seeing in its funds are individual investors, family offices and foreign investors.

“Most of our investors want the opportunity to own institutional quality

real estate and not have to deal with the headaches of asset management,” says Peterson. He says that Passco is planning to acquire \$500 million worth of commercial real estate in 2016.

Miami-based United Trust Fund has also been an active buyer in the market. The company buys all property types, primarily acquiring sale-leasebacks from corporations, including retailers.

With the difficulty to identify assets on a regular basis, some investors are changing the types of properties they invest in — completely. Coldwell Banker Commercial’s Carroll has seen some investors that traditionally have acquired net lease properties switch over to acquiring multi-tenant projects.

“They can get the yields they had previously been able to accomplish with single-tenant assets,” he says.

Calkain Companies has also been working with developers of small multi-tenant strip centers of 7,000 to 10,000 square feet with three or four national tenants.

“Investors like these because they can usually achieve higher cap rates and

hedge their bets,” says Aronson. “If one of the tenants doesn’t survive, they still have income from the other tenants.”

Regardless of who is buying, investment sales professionals who represent sellers say that they still see some concerns with the ability to deliver inventory to buyers.

“Everything we bring to market, we end up transacting,” says Rose.

“The product that will trade most quickly will offer the investor a combination of the longest possible lease term, combined with rent increases and an absolute net lease and investment grade credit,” says Patrick Luther, managing director with Faris Lee Investments.

## BUYING, SELLING AND FINANCING

While many say that the market for investing in single-tenant net lease properties is getting slightly less intense, the market is still tilted towards sellers. Today, there are a few big players active in the sales markets now. Some funds are selling because they are taking advantage of cap rate arbitrage with properties they

## Envoy Net Lease Partners



**Ralph Cram**  
President

**Q: What demand are you seeing from net lease investors? Is it stronger or weaker than 2014?**

**A:** We’re seeing demand somewhat stronger with continued rotation towards private buyers, especially foreign capital. Foreign buyers are setting the sale prices for triple net properties on the West Coast. Envoy recently listed a non-credit preschool deal in Southern California that had five buyers seeking to purchase the property a week after it hit the market. The two top buyers, both foreign capital sources, bid about 25 - 35 bps higher than the remaining field. In the Northeast, currently, the stock of new net lease properties is limited, so any new triple net lease properties are bid up significantly — with similar conditions existing in South Florida.

**Q: With supply limited, have you seen investors seek “off the radar” or other non-traditional net leased assets (definition of “traditional” = top-credit, well-known brand properties)?**

**A:** At the moment, we’re seeing more and more buyers looking at two- and three-tenant outparcel centers. Though the tenant’s lease terms for these centers aren’t as long, cap rates are higher and more credit tenants are going into them. Also, due to rising land costs, tenants (such as Starbucks and Chipotle) increasingly rely on multi-tenant outparcel developments to meet their store opening goals.

**Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?**

**A:** As we see it, the sale/leaseback market is likely to strengthen next year as tenants reach the borrowing limits on their credit facilities and need new sources of financing to meet their corporate goals. Also, paradoxically, as interest rates rise sale/leaseback financing will become more cost competitive and alternative funding sources become more expensive. Envoy also sees pent up demand for sites for QSR/fast casual restaurants, as restaurant chains have aggressive growth plans for both corporate and franchisee units. Likewise, we see the current “medical in retail locations” trend rapidly expanding nationwide.

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acquired during or shortly after the downturn. Apartment sellers are exchanging into net lease because they want less management intensive properties that still provide income.

“It is good to be a seller today,” says Garrigan, whose Patriot Equity Partners is both a buyer and a seller. “It is a sellers’ market. There is so much demand that if you have something you are unsure about for the long haul it is really tough not to sell it.”

To find its acquisitions, Patriot utilizes the brokerage community and works directly with retailers, as well as finding off-market properties.

“You can’t just focus on one method if you are trying to source deals,” says Garrigan. “You really have to expand your horizons and find a multi-pronged approach to finding opportunities.”

Sell-side brokers have plenty of success stories from 2015. For them, the thrill of the deal is being able to connect buyer to seller, and meet the expectations of both parties. Still, some are astounded at the cap rates that buyers are willing to

pay. Jereme Snyder’s team at Colliers International recently sold a Chick-fil-A for a 3.9 percent cap rate that had 11 years remaining on the lease.

“I don’t remember any asset like that trading that aggressively with 11 years on the lease,” says Snyder.

Atlanta-based Bull Realty listed a Hooters Restaurant in summer 2015 in Columbia, South Carolina. The property quickly generated 12 offers because it had an aggressive cap rate. Every offer was vetted and the best buyer was presented to the seller.

“That event has happened time and again on a number of properties we’ve listed this fall,” says Nancy Miller, senior vice president, National Net Lease Investment Group for Bull Realty. Miller says she is seeing many all cash offers where the buyer may have a lender lined up to provide financing after closing.

“Credit, lease term and location are the deal factors,” says Mark West, senior managing director of HFF in Dallas. “If you have all of those, it is going trade. If you have compelling arguments for two

of the three, the deal is still going to be good. If a property is an outlier — it doesn’t have much credit, there is not much term — it is going to be difficult to trade. When you have shorter leases, lesser credit and weaker locations, it is not a question of it being mispriced, it is a question of that property being less liquid.”

“The majority of net lease buyers are going to think about credit and lease term first,” says Jeffrey Thomas. “Then, they will look at other aspects particularly important to them, including location, net operating income growth, or other attributes.”

Among the three criteria, the biggest issue that many buyers

have a problem with changing is geography. Buyers like to know the market, or at least know of it.

“Some buyers want a major metro area or they want to stay out of small towns,” says Bull Realty’s Miller. “Often, those major metro markets are going to be a lot more expensive, notching cap rates down 25 to 50 basis points.”

Bull Realty represents one buyer that has a property under contract in a smaller market with a brand new, 15-year net lease with a known retailer. The buyer is comfortable with the location because of the long length of the lease and credit of the tenant.

“Buyers have to move quickly when they see an opportunity that fits their criteria,” says Michael Bull, CEO of Bull Realty. “They need to provide as quick and clean a contract as they can.”

International buyers, meanwhile, prefer to stick to major metro markets and like to have credit and lease term present as well.

“We generally see foreign capital show up when there is a Class A asset in a gateway market,” says Thomas.

For many investment sales brokers, educating buyers is a part of the acquisition process. While many investors may be familiar with real estate, they are used to the fundamentals of operating real estate, which can be different than thinking of a property as an asset in an investment portfolio.

“Some 1031 buyers are buying these properties like they are buying a car,” says Christian Marabella, president of Marabella Commercial Finance in Carlsbad, California. “It is not a car; it is real estate. You need to look at all facets of the deal, from the environmental aspects to the lease to the common area maintenance agreements, before pulling the trigger on a deal. It may not haunt you now, but after you close, something could come back to you.”

Education has lessened over the years, as investors have become more familiar with the asset class.

“Twenty-eight years ago, when I started The Silver Group, institutional experts didn’t have single-tenant properties on their radar and had little interest in hearing the pitch,” says Barry Silver, principal of The Silver Group, based in the San



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# NET LEASE



Quick-service restaurants are among the hottest net lease investments, with McDonald's leading the pack. This McDonald's in Canton, Ohio, was recently sold by CBRE.

Francisco Bay Area. "Individual investors required education on the features and benefits of single-tenant ownership. Today, some of the largest landlords of single-tenant properties are institutions. The attraction of little or no management associated with these properties is so appealing that the learning curve is much shorter."

While supply has been a concern for single-tenant net lease properties, many in the industry say that has been alleviated by new inventory coming to market. Supply, say many brokers, is all a matter of what you consider it to be. Buyers have narrowed the scope of the properties they consider acceptable, meaning that the supply within their bandwidth may be limited, but not the overall supply of STNL properties.

"When I talk to buyers and they say, 'there's a lack of supply,' I try to clarify that by asking, 'Do you mean there's a lack of inventory in the market or there is a lack of inventory of what you are interested in buying?'" says Sands. "Most of the time, they agree with me. Most of the time sellers are placing properties on the market and pricing them as aggressively as they can. There's a difference in buyers feeling like there is inventory, or inventory matching their criteria. They are generally speaking about what matches their strike zone."

In addition to new development [see page 68] supply is also being created by owners of portfolios of net lease properties that are culling their assets and

placing non-conforming properties on the market.

"We are seeing a lot more inventory coming to market," says Haddigan. "If owners are in a position where they do not want to hold a property five years from now, they are likely to sell it now."

"Owners of multiple assets are always managing their portfolios," says HFF's West. "They may have too much concentration of one credit tenant in a portfolio or too much concentration in one geography, or maybe they have too many drugstores. They are always looking to work through assets that aren't core to their business investment philosophy as that changes over time."

As well, those who bought properties during the downturn are now reaping the rewards by selling them at higher prices.

"Buyers of REO product from 2009 to 2012 are now unloading that inventory," says Luther. "Interestingly, some have done zero on the asset level in terms of lease-up, improvement of operations, NOI growth, etc., and are simply taking appreciation on a price per square foot level."

With the attraction of low cap rates comes the danger of sellers rushing to the market. That could create a glut of properties on the market in 2016.

"A few years ago, everyone had cash to put out and there wasn't enough product," says Shtulman. "Now, there is still a lot of cash, but that cash is a little more cautious and there is a lot of product. When that happens, there is a bit of a

supply-demand imbalance."

Many buyers are acquiring deals in all-cash transactions, then pulling out cash by placing financing on the properties after closing. Of those, many have loans pre-arranged so they can jump on opportunities as long as the property fits certain criteria the lender has agreed to.

"That goes back to supply and demand," says Marabella. "People roll into net lease deals to defer taxes and get into a landlord-friendly property. There isn't the amount of supply that there once was. Now, we have more buyers and fewer stores. It has created a sellers' market. They dictate the terms, like short due diligence. Buyers have to understand there is risk with short due diligence periods. If we run into issues, we are putting money at risk with the seller. A lot are closing all cash to get the deal done, then pulling cash out after the deal with financing."

"There are many cash buyers out there, most of whom are coming off 1031 exchanges," says Calkain's Aronson. "But those that are using debt are often getting 60 percent to 75 percent loan-to-value, depending on the asset, the strength of its lease, the strength of the borrower and, of course, its location. The biggest challenge for those using debt is that they cannot compete against the cash buyer who promises to close quickly. And by quickly, I mean as fast as two to three weeks from escrow."

Banks' appetites for net lease retail assets today is much like that of investors: certain attributes must tick the boxes in order to pique their interests.

"Life insurance companies, CMBS lenders and banks all love the [net lease] product, but they underwrite it according to the perceived risks," says Gary Mozer, principal and managing director with Los Angeles-based George Smith Partners. "Real estate, market and sponsor are really the three legs of the stool for the lender."

Banks have always been concerned with credit, but that hasn't been the only factor they've looked at. Many of SCB's sources reported they are happy to see lenders taking a strong look at the underwriting of STNL properties because they feel it will prevent a situation where there is over-borrowing and under-cautious lending.

# NET LEASE

“Credit is important, but it is only a partial determination of a cap rate,” says Envoy’s Cram. “There is maybe a 10 percent differential in cap rate now [between a credit or non-credit tenant] whereas it used to be a 20 to 25 percent differential in cap rate. A franchised QSR restaurant versus a corporate QSR restaurant with the same brand will maybe have a 50- to 75-basis point difference in cap rate.”

On lesser credit properties, or those with an inferior location, Marabella says many lenders look at what is known as the “hangout.” That refers to when the value of a shortened term of the lease equates to the value of the loan at a given point. For example, if a property has a 15-year lease and a loan on a 10-year term with rent of \$100,000, the lender wants to see the loan balance in the 10th year equate to the value of last five years of the lease (\$500,000). If a lease term is shorter, a lender will look at the value of the vacated property. For properties that are franchised, they will consider the sales-to-rent ratio. Sponsorship is also important on franchise deals, he says, with many lend-

ers wanting only multi-unit operators with a 10- or 20-unit minimum.

Regardless of the three legs of the stool – credit, location and lease term – deals are getting done by the various buyer pools, many of which are more concerned than ever about what they are buying.

“If you know your real estate, if you have a feel for the marketplace in general and you have a good feel for the area that the property is in, underwriting it for acquisition is relatively easy,” says Inland’s Cosenza.

## NEW DEVELOPMENT

In the mid-2000s, new development provided a majority of the supply of net lease properties. Newly constructed properties continue to fuel the market, but not to the degree they once did. Merchant developers like Embree Group, GBT and others, are actively developing properties that are sold into the market or held until the market is right for the property to sell.

“We are finally seeing more development in retail, but it is really more dollar stores and quick service restaurants,” says Haddigan.

Andrew Bogardus of Cushman & Wakefield works with a lot of merchant developers that are preferred developers for tenants.

“They seem to have a strong pipeline for 2016,” he says. “If my group has a good pipeline, then that means that the other developers likely have a good pipeline also. Hopefully, that means we will see some new product. The great news about new product is that the leases are fresh.”

Developers seek new operators or tenants that are expanding, such as healthcare and restaurant tenants. They want to be their preferred development partner

so they can add scale versus just doing one-off projects. Other popular expanding tenants include auto parts retailers, dollar stores and hardware/supply stores like Tractor Supply Co.

“As a merchant builder, we continue to see significant retailer and healthcare provider expansion,” says Josiah Byrnes, vice president of Embree Capital Markets Group. “We bring those properties to market immediately.”

Many merchant developers follow retailers to new markets. Embree Group recently developed a Buffalo Wild Wings ground lease in the Phoenix MSA on a power center outparcel, which the company then sold.

“Given the strong location, in-favor asset class, tenant creditworthiness and perceived lower risk profile of a ground lease, we were able to pre-sell the asset many months in advance of commencement and still lock in a very favorable spread,” says Byrnes.

Investment brokers, as well, have seen new developments come to market as retailers expand into new areas.

“New net leased properties come across our desks every day,” says Danker at Commercial Facilities Inc., in San Diego. “Dollar General is continuing to expand on a nationwide basis, Mattress Firm is also expanding; drug stores and fast food sites are popping up. We are also learning more about food concepts that are either new to California or do not exist in California, like Raising Cane’s and Zoe’s Kitchen. In addition, many fast food companies are expanding their franchisee-run locations, so instead of seeing a prevalence of new corporate sites opening up, we are seeing a lot of new franchised locations.”

Marabella believes the industry runs in trends. As with players like Blockbuster Video in the 1990s, the industry is seeing different tenants now that follow the changing lifestyle and technological habits of society.

“QSRs are hot right now because you can’t sell hamburgers on the Internet,” he says. “Those industries where the Internet can’t take away from brick-and-mortar sales will be the industries that stay.”

“We see more services, food and retail that can’t be sold over the Internet as the categories that are developing new locations,” agrees Ralph Cram of Envoy.

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Quick-service restaurants (QSRs) are among the hottest net lease tenants. Pictured is a recent Chick-fil-A sold by Colliers International in Lake Park, Florida, at 3.9 percent cap rate.

Bogardus is seeing a lot of auto parts stores, like Advanced Auto and retailers like Tractor Supply Co. and bank branch locations. Bogardus has two deals that were sold pre-construction, approximately 12 months from delivery.

“These deals are good for the developer because they have passed on the interest rate risk to the buyer,” he says.

Similarly, Calkain Companies has been working with PDQ, a national chicken restaurant concept from the founders of Outback Steakhouse. The company has been growing primarily in Florida, Texas and North Carolina.

Northbrook, Illinois-based The Boulder Group is also seeing strong demand for lower cap rate assets. “The product types we are selling the most of are restaurants and drug stores,” says Randy Blankstein, president of The Boulder Group. “There is some hesitation in the drug store space; a lot of investors are waiting to see how the Rite-Aid acquisition by Walgreens plays out.”

One of the largest single-tenant net lease retail transactions in the country during 2015 was done by Faris Lee. Luther says his team sold a Lifetime Fitness facility in Las Vegas for \$51 million, representing a high 5 percent cap rate. The property was sold by Gramercy Property Trust, which purchased it a few months before for \$45.5 million as part of a 10-property corporate sale-leaseback transaction from Lifetime Fitness.

Even with an interest rate hike causing some concern for the industry, net lease is on target to remain on investors’ radar screens. The steady income and stability of assets keep the properties top of mind.

“The beauty of net lease is that it acts and feels like a bond, but in the eyes of the IRS, it is real estate,” says Marabella.

As well, the net lease industry continues to grow; it is now widely considered its own sector within commercial real estate. The sector has spawned a number of new conferences over the past 10 years, including two sponsored by *Shopping Center Business*, and brokers and investors who are focused on the asset class continue to be amazed by the amount of data available.

“The space has gotten a lot more efficient over the last 10 years with the increased use of technology, as well as the popularity of net lease,” says Garrigan of Patriot Equity Partners.

“In the past five years, this asset class has reached a whole new level of awareness and participation,” says Colliers International’s Block. **SCB**

## GBT Realty Corporation

**Q: What demand are you seeing from net lease investors?**

Is it stronger or weaker than 2014?

**A:** Stronger.

**Q: As the threat of an interest rate spike looms, have you faced more or less competition towards the end of 2015?**

**A:** Higher interest rates, more competition, increasing construction costs, and flat rents make for a challenging development market. GBT is well positioned and cautiously optimistic about 2016.

**Q: With supply limited, have you sought “off the radar” or other non-traditional net leased assets? (Definition of “traditional” = top-credit, well-known brand properties)**

**A:** GBT remains very active with the traditional tenants but we have mixed in “off the radar” tenants in our strip centers.

**Q: With 2015 as a strong year for the net lease sector, what do you predict for 2016 in terms of volume and velocity?**

**A:** There is still strong demand for net lease product and small increases in interest rates will have little impact in 2016.

**Q: Has demand for net leased properties changed your business, operations, etc.? How?**

**A:** Over the last 5 years GBT has grown its development operation to meet the demand for new net lease assets.



**George Tomlin**  
President & CEO