RetailResearch
NET-LEASED OUTLOOK
Marcus & Millichap
Third Quarter 2015

Retailers Cope with Challenges; Investors Unfazed

Single-tenant retailers' expansion plans continue as new households form amid an improving economic outlook despite the industry uncertainty surrounding minimum-wage legislation. Upticks in household formation and retail sales have encouraged retailers to open new locations and use e-commerce strategies to engage their customers more often. The continued rise of Internet shopping has also pushed more traditional retailers such as Wal-Mart to offer quicker shipping times and in-store fulfillment, which shoppers have cheered. Retail sales will continue to climb through next year. Plummeting oil prices have provided consumers more spending power, although the current trend is to shore up savings rather than increase consumption. Yet, recent retail sales reports suggest this behavior is reversing; retail sales at restaurants and bars accelerated well above the national average. However, some retailers have expressed caution about expanding quickly as many states and municipalities have already taken steps to raise the minimum wage, leading several employers to follow suit. How this might impact their bottom line is still unknown. Viewed holistically, retailer demand will remain well ahead of expected supply increases this year as net absorption nearly doubles planned completions. As a result, asking rents are expected to climb in the low single digits.

Historically low interest rates and rising property values have encouraged investors to expand their holdings in a search for yield. Due to the ease of capital migration, net-leased assets remain highly attractive with institutional and private buyers seeking to deploy money outside their home markets. Extremely low Treasury yields have led to robust competition among potential bidders wishing to rebalance or exchange their assets, and many closed sales consisted of high portions of cash. Assets with a large majority of the lease remaining and corporate credit tenancy will often exchange ownership in excess of the asking price, depending on traffic counts and location. Foreign capital also remains active, particularly due to recent volatility in overseas currency and equity markets, with investors keen on the safety and security of U.S. based assets. An expected interest rate increase from the Federal Reserve will encourage elevated trading activity throughout the remainder of 2015.

Net-Leased Retail Market Overview

Year-Over-Year Average Cap Rates down 50 Basis Points

Auto-Part Retailers: Boosted by secular demand from older vehicles on the road, investors pushed average cap rates 50 basis points lower to 6.8 percent on average, with most deals pricing between the high-5 to high-7 percent range.

Year-Over-Year Average Cap Rates down 50 Basis Points

Casual-Dining Establishments: As retail sales have surged in the restaurant and bar sector, buyers bid up the price of casual-dining establishments. Over the past 12 months, cap rates contracted 50 basis points to 6.3 percent while ranging from the low-4 to low-9 percent area.

Year-Over-Year Average Cap Rates down 30 Basis Points

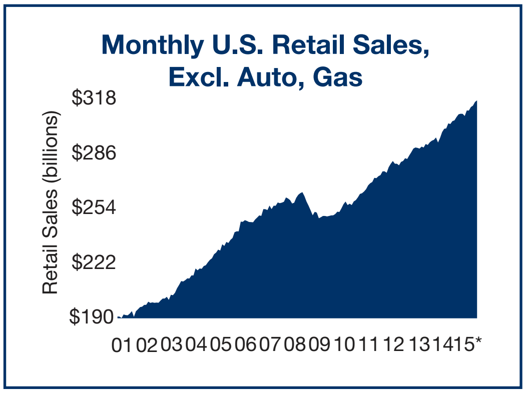
Dollar Stores: Average cap rates for dollar stores will range between the low-6s to high-7s, with the average deal in the low-7 percent range. Over the past year, first-year yields slipped 30 basis points, matching the previous yearly contraction.

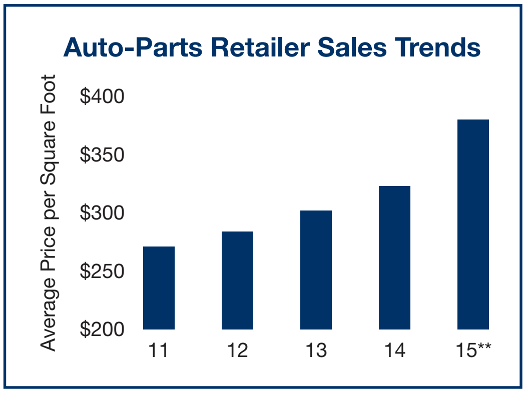
Year-Over-Year Average Cap Rates down 30 Basis Points

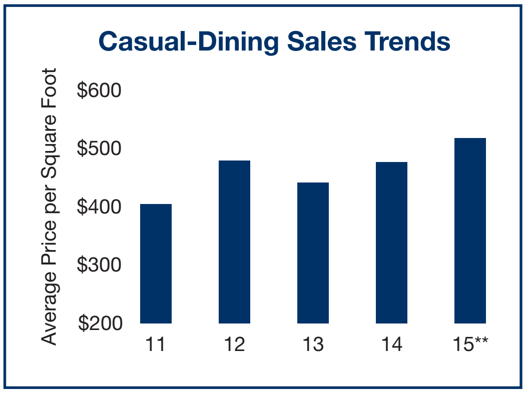
Drugstores: Investors have continued to be constructive on drugstores, trimming cap rates 30 basis points to range between the low-4 to high-6 percent range. New leases will exchange ownership near the bottom of this range.

Year-Over-Year Average Cap Rates down 30 Basis Points

Quick-Service Restaurants: Quick-service restaurants were in high demand during the last 12 months, falling 30 basis points to average first-year yields of 5.8 percent. Corporate-owned locations can trade more than 150 basis points below franchisee chains.







*Through August
** Through 2Q
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Economy

- Since the fourth quarter of 2009, employers have created more than 12.1 million jobs, dropping unemployment 460 basis points to 5.3 percent. The pace of expansion has remained robust over the last year as well, with more than 2.9 million positions added. High-paying professional and business services sector jobs accounted for the bulk of hiring, creating 670,000 workers.
- In combination with the strengthening labor market, applications for unemployment are hovering just above multidecade lows last posted in November of 1973. The unemployment rate stands at 5.3 percent, the lowest level since the first quarter of 2008.
- During the past 12 months, retail sales excluding motor vehicles and parts dealers rose 2.1 percent as improvement in the labor market has begun to spill over into consumer spending habits. Food-service and drinking places recorded year-over-year growth of 8.5 percent, supporting a multitude of retail operations.
- **Outlook:** As the labor market continues to strengthen, millennials will form new households, supporting local retailers. Additionally, the upcoming holiday season will provide a boost to retailers in more traditional areas such as shopping centers. Overall, retail vacancy will fall 40 basis points this year to 6.1 percent.

Auto-Part Retailers

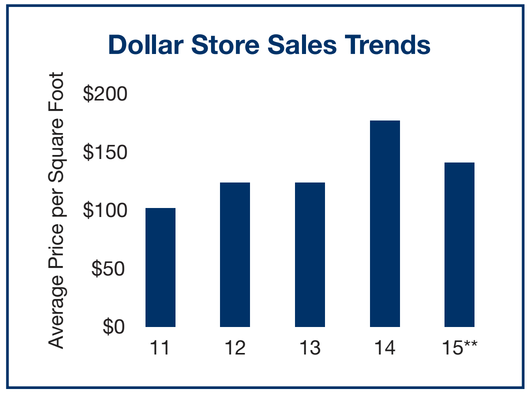
- While new car sales and lease activity remain at elevated levels, the average age of a vehicle on the road in the United States is still at a record 11.5 years, supporting thriving operations for secondary auto-parts suppliers.
- Deal flow rose more than 30 percent this year as secular demand in the industry has led to thriving demand. Investors paid an average of $380 per square foot, ranging from $115 to $700, depending on lease structure and location. Corporate credits such as AutoZone and Advanced Auto Parts dominate trading activity.
- Along with an increase in prices per square foot, buyers also accepted lower first-year yields as cap rates dipped 50 basis points to average mid-6 percent nationally. Implied yields will range from the mid-4 to 8 percent range.
- **Outlook:** Ease of capital migration and robust industry trends provide investors an incredible opportunity to ride the repair cycle of older automobiles.

Casual-Dining Establishments

- Casual-dining participants are undergoing a dramatic dichotomy, with growing upstarts such as Buffalo Wild Wings expanding as Olive Garden and Applebee's are closing underperforming locations.
- Transaction velocity picked up 12 percent during the last year ending in June, with average prices per square foot up 8 percent to average just above $500. Overall, prices can range between $350 and $750 per square foot.
- First-year yields can vary widely based on tenant and location, with cap rates ranging between the high-4 to 9 percent range. Urban locations near shopping centers command a premium to the average.
- **Outlook:** Divergences between top performers and laggards will push investors to examine the long-term dynamics currently underway in the casual-dining space, with leaders occupying the bulk of investor demand.

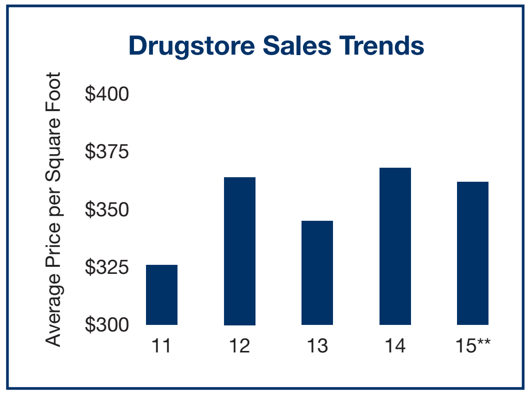
Dollar Stores

- Following the Dollar Tree and Family Dollar merger, the combined firm announced its intention to sell 330 stores to assuage antitrust fears.
- Trading activity slipped 6 percent over the past 12 months as investors digested consolidation risk in the sector. The average price on closed deals reached $140 per square foot, down modestly from the prior year when several deals priced above $180 per square foot.
- First-year yields slipped 30 basis points to the low-7 percent range on average, while most deals traded in a range between the high-6 and mid-8 percent. Family Dollar priced at a premium to the market, while Dollar General made up the bulk of closed transactions.
- **Outlook:** Investors have proceeded with caution in the wake of the closed megamerger, opting to pursue other options in the single-tenant space. However, following the resolution on store closings, trading activity has re-accelerated, presenting a bright outlook for future developments.



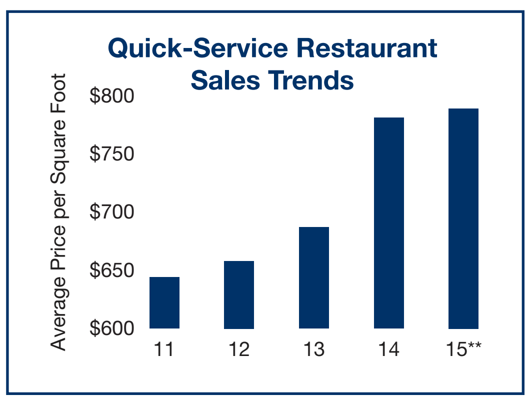
Drugstores

- Drugstores remained the sector stalwart over the past year, valued for their bullish secular trends and robust credit backing. Walgreens and CVS accounted for the vast majority of trading, while Rite Aid is beginning to register an acceleration in buyer interest as their credit rating outlook improved.
- Transaction prices were consistent with the prior year, ranging between $350 and $800 per square foot, depending on leasing terms and location. Walgreens garnered an average price of nearly $400 per square foot, outpacing CVS at $375 per square foot.
- A newly built drugstore with a 30-year lease can exchange ownership below 5 percent, with cap rates falling to the mid-4s on these properties in good locations. The average trade prices in the low-6 percent range, with shorter leases and less desirable locations reaching the high-6s.
- **Outlook:** The ease of capital migration and low-risk nature of drugstore leases will continue to foster investor interest, particularly as market participants rebalance their portfolios.



Quick-Service Restaurants

- As national calls for a higher minimum wage rise, many states have moved ahead with establishing legislation supporting the idea. Many retailers are following suit, which may pressure margins going forward.
- Deal flow rose significantly over the past year, with the number of transactions vaulting 19 percent as the average transaction price topped $2 million. During this period, the average price per square foot swelled 3 percent to $780 per square foot, as result of a competitive bidding environment.
- Fast-casual chains led first-year yields in the sector to 5.8 percent on average, down 30 basis points year over year. Overall, cap rates can range from the low-4s to the mid-6s, largely based on traffic counts and location.
- **Outlook:** Secular growth stories such as Starbucks and Chipotle will trade above the market averages in addition to McDonald's, KFC and Burger King. Despite the challenges in the space, these assets remain in high demand.



*** Through 2Q*
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- Several macroeconomic headwinds, including the strong dollar and lower energy prices, have recently dropped the yield on the 10-year U.S. Treasury to the low-2 percent range. Despite weakness abroad, U.S. economic data remains robust as existing home sales hit levels not seen since 2006 and retail sales growth indicates a willingness by consumers to spend in areas beyond the essentials. Additionally, jobless claims are just above a 41-year low and more than 200,000 positions have been created in 14 of the last 16 months, providing further evidence of broad strength in the labor market.
- The Federal Open Market Committee has committed to a policy of "lower for longer" as it assuages fears surrounding a possible interest rate increase this fall. The initial policy rate change is expected to be just 25 basis points, the first hike since 2006, with measures remaining accommodative for several years.
- Life insurance firms are underwriting with terms of up to 25 years for retail loans. Their 10-year pricing ranges between 4 and 4.25 percent with average LTVs from 60 to 65 percent. Meanwhile, CMBS lenders are offering 10-year terms at rates between 4.4 and 4.65 percent, with LTVs at 75 percent. Commercial banks are also active in the sector, generally offering shorter-term loans from 3.75 to 4.75 percent for 70 percent leverage. Floating bridge loans for stabilized assets will require LTVs of 70 percent and price with a spread between 250 and 425 basis points over LIBOR, while value-add transactions will be underwritten at 80 percent LTV (60-65 percent of cost) with a 300- to 475-basis-point spread.

Recent Sales Highlights

Property Name	City, State	Sales Price	Price per Sq. Ft.	Cap Rate
Home Depot	Port Saint Lucie, FL	$16,400,000	$108	4.1%
Wal-Mart Market	Ashland, VA	$11,564,000	$281	5.2%
Walgreens	Midfield, AL	$7,063,943	$523	5.3%
CVS Pharmacy	Passaic, NJ	$6,071,650	$600	5.3%
Capital One	Toms River, NJ	$5,216,494	$1,304	4.5%
Longhorn Steakhouse	Lakeland, FL	$3,210,000	$516	5.6%
Panera Bread	Midland, MI	$3,100,000	$876	5.3%
Taco Bell	Salt Lake City, UT	$3,028,571	$1,537	5.3%
Taco Bell	Bristol, TN	$2,200,000	$843	5.4%
IHOP	Westerville, OH	$2,100,000	$285	5.5%
Carl's Jr	Tigard, OR	$2,010,000	$737	3.6%
Advance Auto Parts	Burleson, TX	$1,946,161	$283	6.2%
Starbucks	Laramie, WY	$1,880,000	$979	5.6%
Starbucks	Idaho Falls, ID	$1,825,000	$951	6.0%
Starbucks	Lynn, MA	$1,625,000	$739	5.4%
McDonald's	Fort Worth, TX	$1,609,000	$358	4.0%
Burger King	Colorado Springs, CO	$1,600,000	$435	6.5%
Chipotle	Dickson City, PA	$1,520,000	$689	5.5%
Burger King	Hammond, LA	$1,250,000	$417	6.0%
Salad and Go	Mesa, AZ	$1,224,000	$1,749	7.0%
Hardee's	Independence, MO	$1,219,512	$441	6.2%
Kentucky Fried Chicken	Shakopee, MN	$1,125,000	$318	6.0%
7-Eleven	Joppa, MD	$1,000,000	$417	5.2%

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