Marcus & Millichap

National Report

Net-Leased Retail Research

Third Quarter 2016

Steady Labor Market Underpins Net-Leased Growth in Discretionary Retailers

Builders focus on net-leased floor plates as job growth continues unabated. The United States economy continues to be the engine for global growth, even as macroeconomic events such as Brexit continue to make headlines. Employment growth has now reached 24 straight quarters of positive traction, pushing unemployment below 5 percent for the first time in the current cycle. In addition, retail vacancy is at the lowest level since 2005 as a slowdown in construction has prompted retailers to pick up dark spaces across the country. Builders have focused primarily on net-leased floor plates over the course of the current cycle, while drifting into mixed-use projects to fulfill multi-tenant requirements. Though supply has grown, net-leased vacancy has fallen to just above 5 percent. Consumer spending has remained robust and thus tenant demand has expanded. The largest gains are in discretionary categories such as bars and restaurants, supporting a positive outlook for additional tightening in the net-leased sector, particularly as lower unemployment translates into a pickup in labor pricing. Any rise in wages will translate directly into higher consumption, boosting net-leased demand and rental rates.

Former apartment owners executing 1031 exchanges dominate net-leased environment in search for yield. As interest rates have remained incredibly depressed, the search for positive yielding assets has soared, particularly in real estate. In addition, aging baby boomers are taking advantage of record-low cap rates in the apartment sector to transition capital to the net-leased sector, where required management and maintenance are much lower. The combination of these two factors has created scarcity in the single-tenant sector, even as construction vaulted above 40 million square feet in 2015. This environment has fueled dramatic increases in average selling prices and cap rate compression as multiple bidders compete for the same assets. A steady pace of expansion among multiple retailers in the net-leased space will continue to provide investors with opportunities to deploy funds, especially if international pressures ease over the coming months.

2016 Net-Leased Retail Market Overview

Y-O-Y Average Cap Rates
down 10 Basis Points

Auto-Part Retailers:

Considerable tailwinds from an aging fleet of vehicles on the road will boost demand for replacement auto parts. First-year returns in the space range from the high-5 percent to mid-7 percent band, depending on tenancy and location.

Y-O-Y Average Cap Rates
down 10 Basis Points

Casual-Dining Establishments:

Operator performance and branding will be the primary driver of pricing in the casual-dining category. Top-tier national credits offer cap rates in the mid-5 percent range, as regional and local operators drift into the mid-7 percent region.

Y-O-Y Average Cap Rates
down 50 Basis Points

Dollar Stores:

While store count concerns on the back of merger considerations between Family Dollar and Dollar Tree have trimmed transactions, consistent growth in the Dollar Store category will continue to prompt allocations of capital. Cap rates for these assets typically trade in the mid-6 percent range.

Y-O-Y Average Cap Rates
down 20 Basis Points

Drugstores:

The long lease structure of CVS and Walgreens will power the majority of investor dollars in the space, while Rite Aid locations offer a slightly higher yield. Cap rates begin in the low-5 percent region, drifting into the mid-6 percent range for shorter leases and less-traversed locations.

Y-O-Y Average Cap Rates
down 20 Basis Points

Quick-Service Restaurants:

The range of tenancy and lease structures have generated tremendous investor interest in the QSR space. Brands such as McDonald's and Starbucks trade in the mid-4 percent range, while regional operations can drift into the high-5 percent band.

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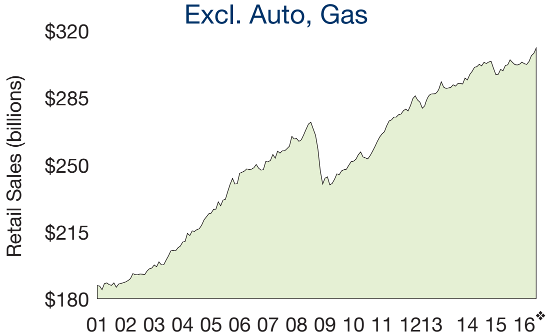
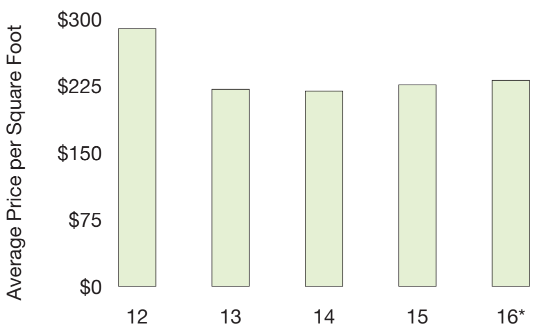
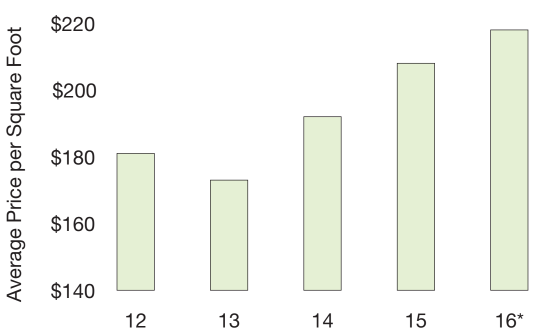
Monthly U.S. Retail Sales, Excl. Auto, Gas



Auto-Parts Retailer Sales Trends



Casual-Dining Sales Trends



❖ Trailing 12-month period through 2Q
* Forecast
Sources: CoStar Group, Inc.; Real Capital Analytics

Economy

- During the first six months of the year, organizations created 1.03 million new positions, bringing hiring over the past four quarters to more than 2.45 million jobs, a 1.7 percent rate of growth. Office-using, education and healthcare firms were most active, responsible for more than half of the payroll additions nationwide.
- Improvement in the labor market has been quite successful in bringing down the number of unemployed workers, with the unemployment rate closing out the second quarter at 4.9 percent. After peaking at 10 percent in 2009, unemployment has been consistently falling, down 40 basis points over the past year alone.
- Over the past 12 months ending in the second quarter, retail sales rose 2.7 percent as consumers continued to outlay cash for a number of goods. Excluding volatile automotive and gas station expenditures, core retail sales expanded 3.1 percent as energy prices remained erratic.

Outlook: Although the rate of global growth is slowing, consumers in the U.S. continue to spend at respectable rates, prompting a positive outlook for the national economy over the coming year.

Auto-Part Retailers

- In July, U.S. auto sales reached 17.9 million units annually, just off a record of 18.5 million reached in November of last year. When combined with an average age of roughly 11.5 years on existing vehicles, auto part sales are well supported
- Deal flow in the auto-parts segment has remained robust over the past year, with the average price per square foot in the low-$200 range, although infill locations can extend above $300 per square foot occasionally.
- The average first-year return can vary tremendously based on brand name and location, yet typically exchanges ownership in the high-5 to mid-6 percent range for existing leases. Advanced Auto Parts and NAPA Auto Parts will make up the bulk of trading activity, with new leases in the mid-5 percent first-year return range.

Outlook: Relatively higher cap rates, coupled with structural demand as older vehicles are replaced, led to greater investor interest in the segment.

Casual-Dining Establishments

- Consumers continue to dole out spending at bars and restaurants, with retail sales in this category advancing 6.4 percent over the past year. Investor appetite has focused mostly on national brands that have extensive credit history.
- Transaction velocity has remained consistent over the past year, with dollar volume reaching nearly $800 million. Prices per square foot will range from the low-$200s to more than $500, depending on tenancy, location and lease structure.
- Cap rates begin in the mid-6 percent band while extending into the mid-7 percent range for smaller credit tenants and regional brands. Top-tier operators push into the high-5 percent range.

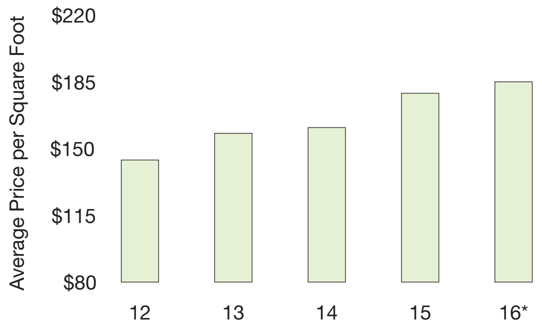
Outlook: Investors will focus on large established chains for the bulk of capital inflow into the sector. Struggling brands will proceed to trim locations, while new concepts make up the bulk of new floor plates in the space.

Dollar Stores

- Dollar store brands expand meaningfully, even as mergers in the sector force store closures in a number of markets. Dollar General announced 1,000 planned openings by the end of 2017.
- Despite concerns about store closings, deal flow in the dollar store segment has continued to rise. The average price per square foot typically closes in the mid- to high-$100 range, with lease and location considerations most paramount to investment decisions.
- The typical cap rate on closed transactions is in the high-6 to low-7 percent range, while new leases will typically extend toward the low-6 percent band. Dollar General stores price at a premium to Dollar Tree and Family Dollar due to merger store closures associated with the latter two brands.

Outlook: The growing success of the dollar store segment is bringing more investors into the market, with dollar volume and transactions continuing to grow. This could foster additional price increases as the market expands in size and volume.

Dollar Store Sales Trends

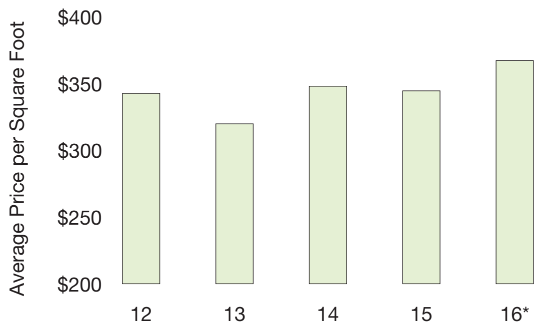


Drugstores

- Drugstores performed well over the past year, with retail spending at health and personal care retailers up 7.5 percent. The $17 billion pending merger between Walgreens and Rite Aid could create the largest operator in the space with over 13,000 stores. Regulatory approval from the Federal Trade Commission is currently pending, however a decision is due by year-end.
- The widening of insurance costs and the aging of the American population has prompted vast amounts of capital investment in the sector. As a result, dollar volume exceeded $2 billion nationwide, with prices per square foot exceeding $400.
- Existing leases typically exchange ownership in the high-5 percent range, while new locations trade with cap rates in the high-4 percent band. Rite Aid trades at cap rates more than 100 basis points above comparable CVS and Walgreens locations, underscoring the significance of branding in the segment.

Outlook: The hands-off management structure and long leases associated with the drugstore segment will propel investor dollars, even as concerns over the Walgreens/Rite Aid merger persist.

Drugstore Sales Trends

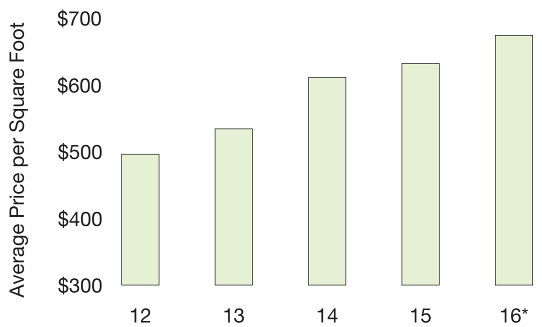


Quick-Service Restaurants

- Rising discretionary income is supporting traffic at quick-service restaurants. The expansion of the sector has multiplied brands and locations, making the segment the largest in the net-leased market.
- Transaction velocity rose considerably over the past year, with prices per square foot falling between $450 and $1,500 per square foot, depending on brand name and location. McDonald's and Starbucks stores will trade at significant premiums to the average storefront.
- The average cap rate was in the high-5 percent band during the last four quarters, with deals ranging from the mid-4s to mid-6 percent. Lease length and tenancy are the most important investor considerations in the segment.

Outlook: The ease of operations and brand recognition will continue to motivate investors to quick-service restaurants.

Quick-Service Restaurant Sales Trends



* Forecast
Sources: CoStar Group, Inc.; Real Capital Analytics

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Capital Markets

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

- Global capital markets have remained stable over the past few weeks, even as Brexit and the continued devaluation of the Chinese yuan have induced bouts of volatility into stock and bond markets. Meanwhile, U.S. economic data has proved resilient, with increases in retail sales and steady hiring supporting a measured pace of growth. Additionally, higher bond prices have lowered prospective yields, boosting the appeal of commercial real estate.
- As the current economic cycle has continued, retail vacancy descended to 5.8 percent by the end of the second quarter. A focus on net-leased construction for pre-leased tenants and mixed-use developments has limited development activity in relation to prior cycles, supporting robust increases in average asking rents. Builders will deliver 46 million square feet of retail space this year, with more than two-thirds of new supply slated as single-tenant structures. This environment will sponsor a fourth straight year of average asking rent growth, with advancement projected to exceed inflation over the same period.
- Capital markets remain highly competitive, with a broad assortment of fixed-rate products available through commercial banks, life-insurance companies and CMBS lenders. Loans are generally offered at terms up to 10 years at maximum leverage of 65 to 75 percent. For 10-year terms, rates will typically reside in the high-3 to mid-4 percent range, depending on leverage and underwriting criteria. Floating bridge loans and financing for repositionings are typically underwritten with LTVs above 80 percent, while pricing at 300 basis points above Libor for recourse deals and extending to 470 basis points above Libor for non-recourse transactions.

Recent Marcus & Millichap Transactions

Property Name	City, State	Sales Price	Price per Sq. Ft.	Cap Rate
Walgreens	Weston, FL	$11,236,053	$718	4.74%
CVS	Vernon, NJ	$9,750,000	$737	5.05%
Natural Grocers	Wheat Ridge, CO	$7,130,435	$475	5.75%
Red Lobster	Knoxville, TN	$4,667,299	$486	6.00%
IHOP	Amarillo, TX	$4,000,000	$1,053	6.25%
On The Border	Fort Worth, TX	$3,517,500	$593	6.47%
Wendy's	Chino, CA	$3,500,000	$968	4.76%
Chick-fil-A	Dallas, TX	$3,400,000	$50	3.75%
Perkins	Blaine, MN	$2,835,000	$65	6.53%
PDQ	Clearwater, FL	$2,796,610	$559	5.90%
McDonald's	Las Vegas, NV	$2,650,000	$487	5.74%
O'Reilly Auto Parts	Bradenton, FL	$2,637,803	$352	5.25%
Boston Market	North Miami, FL	$2,550,000	$955	4.49%
Family Dollar	Glendale, AZ	$2,400,018	$288	5.50%
Red Lobster	Hattiesburg, MS	$2,276,079	$400	6.20%
KFC	Tilton, NH	$2,037,037	$852	5.40%
Dollar General	Stephens City, VA	$1,950,000	$214	6.45%
Applebee's	Sidney, OH	$1,935,541	$372	5.45%
Arby's	Waycross, GA	$1,876,000	$586	6.17%
Five Guys	Wooster, OH	$1,800,000	$468	6.75%
Starbucks	Valdosta, GA	$1,750,000	$1,000	5.10%
TGI Friday's	Morrow, GA	$1,478,888	$296	6.75%
AutoZone	Granbury, TX	$1,283,000	$20	4.25%

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