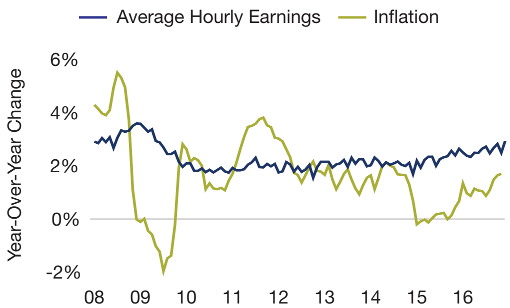
Marcus & Millichap

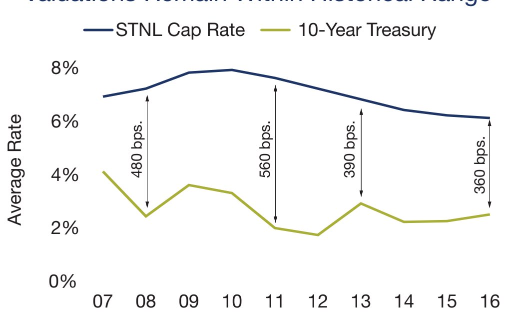
Hourly Earnings vs. Inflation



Exchange Buyer Momentum Elevated Within Single-Tenant Retail

10-Year Treasuries Rise Postelection

Valuations Remain Within Historical Range



Consumers Drive Steady Growth; Exchange-Driven Net-Lease Market Advances

Positive economic momentum carries into 2017. Boosted by the resurgent consumer, the economy bounced back to perform admirably in 2016 following a slow start to the year. This trend will likely carry into 2017 as consistent job creation across a wide array of employment sectors provides momentum for the economy while restraining the unemployment rate. As a result, upward pressure on wage growth and rising consumer confidence will support consumption and drive gains in retail sales. This bodes well for net-leased retail properties, as the steady tailwinds support the wide range of proliferating single-tenant concepts.

Rising interest rates spark investor recalibration. The postelection interest rate surge last year forced many investors to reconsider their strategies, though the low-leverage preferences of net-leased investors tempered the pullback in activity. Still, given the pronounced downward pressure on net-leased asset yields through much of this expansion cycle, a modest elevation of cap rates in response to the rising interest rate climate seems increasingly probable. Notably, the popularity of these assets, particularly among investors exchanging out of more-management-intensive assets, will restrain any upward drift in cap rates. Properties in good locations in major metros backed by strong credit and offering a longer-term lease horizon will be the most resistant to rising yield trends. One variable of particular consideration for net-leased assets will be the future of the section 1031 tax-deferred exchange, with activity likely to increase over the coming year due to uncertainty regarding potential changes to the statute. The scrutiny of this provision by Capitol Hill amid a broader tax reform plan is raising concerns among investors and developers, but little guidance on the future of this tax provision has yet emerged.

Development Supports Net-Leased Expansion; Buyers Tighten Cap Rate Spread Amid Rising Rates

Developers favoring net-leased properties amid tight vacancy and strong demand from a variety of tenants. Throughout the current business cycle, builders have overwhelmingly delivered projects that have skewed toward single-tenant concepts, particularly in the quick-service restaurant, pharmacy and dollar store segments. Broadly, single-tenant buildings have accounted for more than 80 percent of retail construction since 2009, up from below 70 percent before the recession. Despite the upswing in net-leased deliveries, demand for space remains well above supply growth, with net absorption exceeding development by an average of nearly 16 million square feet annually since 2010.

Tightening spread between cap rates and borrowing rates emerges as buyers remain active. While longer-term interest rates have recently stabilized, it is anticipated that the Federal Reserve will continue to raise short-term interest rates throughout the year. Combined with intensifying inflation expectations, borrowing rates are likely to elevate in the year ahead as well. These two factors have led the spread between 10-year Treasury rates and average cap rates to tighten from 560 basis points in 2011 to 360 basis points at the end of 2016.

Brand	Credit Rating	Locations
Auto Parts		
Bridgestone/Firestone	A	1,600
O'Reilly Auto Parts	BBB+	4,712
AutoZone	BBB	5,839
Advance Auto Parts	BBB-	5,185
Pep Boys	BB+	804
Dollar Stores		
Dollar General	BBB	13,205
Dollar Tree / Family Dollar	BB+	14,284
General Retail		
Wal-Mart	AA	11,593
Sherwin-Williams	A	4,180
AT&T	BBB+	16,000
Verizon Wireless	BBB+	2,330
Mattress Firm	B+	3,482
Office Depot/Max	B-	1,441
Pharmacies		
CVS	BBB+	9,987
Walgreens	BBB	8,185
Rite Aid	B	4,547
Quick Service Restaurants		
Dairy Queen	AA	4,800
Starbucks	A-	25,085
Chipotle	BBB+	2,250
McDonald's	BBB+	36,899
Yum Brands	BB	43,085
Burger King	B+	20,351
Wendy's	B	6,503
Carl's Jr./Hardee's	B-	3,000
Fast Casual		
Chili's	BBB-	1,652
Darden Restaurants	BBB-	1,541
Red Lobster	BBB-	700
Bloomin' Brands	BB	1,270
Applebee's	B	2,033
Ruby Tuesday	B-	546

Closed Cap Rate Range by Brand*

Cap rates shown above are representative of deals that closed in 2016. Actual yields will vary by locations, tenant, lease terms and other considerations. Locations sourced from CreditNtell for public companies and company websites for private companies.

* For transactions closed in 2016
Sources: CoStar Group, Inc.; CreditNtell; company sources