Q2 2023 Cap rate report

U.S. Capital Markets Net Lease Group

The Federal Reserve's continued interest rate hikes have begun to show signs of effectiveness, as inflation appears to be stabilizing and stocks across major indices are up, in some cases double digits, YTD.

The net lease market is experiencing a slight shift in cap rates. Having been relatively unchanged for several quarters, we've seen an uptick of 30 bps to 5.95%. This adjustment comes after a period of sustained stability in cap rates, reflecting changing dynamics and illustrative of the typical lag we see in the net lease market compared to 10-Year Treasury. While the increase might raise concerns among investors, it also signifies a market that is finding a new equilibrium.

While the slight rise in cap rates might imply reduced property valuations, it could present an opportune moment for certain investors, especially the all cash buyers upon which the net lease sector often draws. Those seeking stable and predictable income streams value in net lease properties, which most often come with long-term leases and well-established tenants. This market shift could encourage more realistic pricing expectations, fostering healthier transaction activity.

Automotive was the only tracked vertical that observed cap rate compression in Q2, while all other verticals saw an increase in average cap rate, therefore signifying softened pricing in the sector. Like previous quarters, STNL assets have generally out-performed peers due in large part to lower price points, which in a lot of cases render debt markets, plagued by rising interest rates, irrelevant as they can be purchased on a cash basis.

It can also be noted average term remaining on transactions across all tracked verticals was down QoQ, landing at 11.5 years remaining on average in Q2 vs. 12.4 years remaining on average in Q1, with most tracked verticals following this trend.

A closer look at the performance of specific sectors reveals much more complex and nuanced market conditions. Of particular interest were the Convenience Store (C-Store), Pharmacy, and quick service restaurant (QSR) sectors.

Average Cap Rate
5.95%

Average Lease Term Remaining
11.5

Sectors in brief

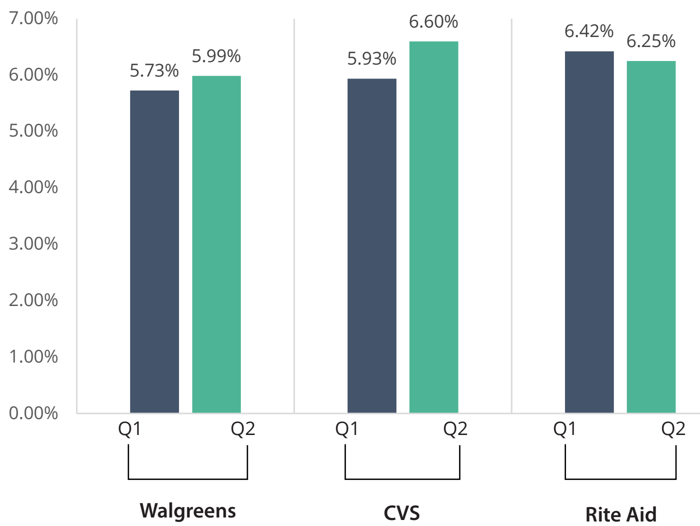
Sectors	Q1 2023 Avg Cap Rate	Q1 2023 Low	Q1 2023 High	Q1 2023 Avg Lease Yrs	Q1 2023 Sample Size	Q2 2023 Avg Cap Rate	Q2 2023 Low	Q2 2023 High	Q2 2023 Avg Lease Yrs	Q2 2023 Sample Size	Change in Avg Cap Rates (bps)	Change in Lease Years (Rem)
Automotive	5.88%	4.25%	8.08%	9.5	43	5.63%	4.50%	6.60%	10.6	31	-24.95	1.1
C-Store	5.09%	3.68%	11.05%	13.5	31	5.88%	3.75%	11.03%	12.6	31	52.35	-0.6
QSR	5.07%	3.25%	8.00%	14.3	116	5.18%	3.25%	8.00%	13.9	140	11.12	-0.4
Dollar Store	6.04%	4.75%	7.60%	11.9	77	6.35%	5.00%	8.68%	10.3	78	30.69	-1.6
Casual Dining	5.48%	3.23%	7.79%	15.5	13	6.24%	4.88%	9.00%	11.0	39	76.28	-4.5
Medical	5.87%	5.00%	6.58%	8.0	18	6.05%	4.50%	8.15%	7.1	26	17.72	-0.9
Other Retail	5.61%	3.80%	8.50%	13.3	40	5.88%	4.00%	9.32%	10.0	53	26.96	-3.3
Pharmacy	5.86%	4.23%	10.00%	14.4	72	6.27%	4.75%	10.00%	15.4	35	41.35	1.0
Bank	5.03%	3.20%	9.06%	11.1	8	6.20%	4.50%	12.63%	7.5	13	116.80	-3.6
Industrial	5.93%	3.40%	7.75%	6.4	15	7.01%	2.83%	10.00%	6.6	29	107.97	0.2
Average	5.65%			12.4		5.95%			11.5			
Sample Size					433					475		

[1] Other retail includes retailers who don't otherwise neatly fit into one of the above categories such as grocery stores, cellular stores, mattress stores, and fitness centers.

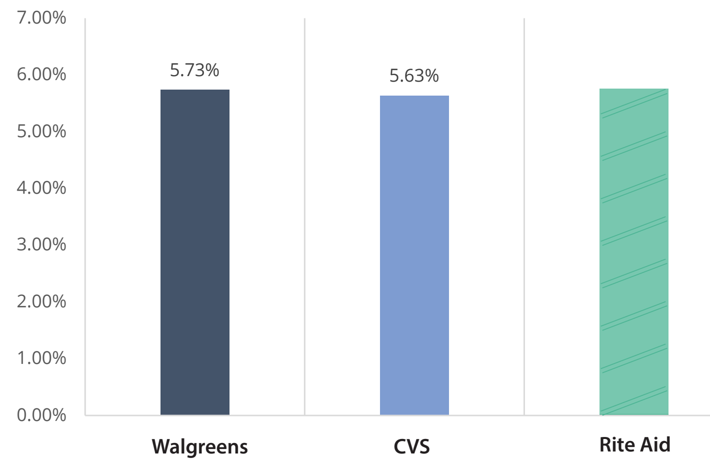
Markets in depth: Pharmacy

The pharmacy sector saw reduced transaction volume QoQ, registering 35 transactions as opposed to 72 in Q1. Cap rates on observed transactions generally trended upward, increasing roughly 41 bps on average, landing at 6.27%, with the low cap rate being 4.75% and as high as 10%. CVS did recently announce a round of layoffs, so it will be interesting to see what bearing, if any, this has on their brand or pharmacies as a whole. We witnessed a drop off in 10+ year term Rite Aid transactions as a result of the Walgreens acquisition, hence a limited data pool exists making the cap rate irrelevant..

Overall Pharmacy Cap Rates



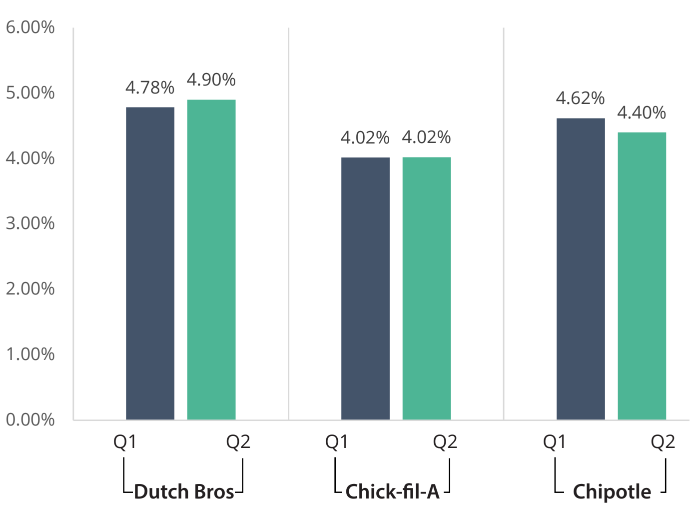
Pharmacy Cap Rates w/ 10+ Years



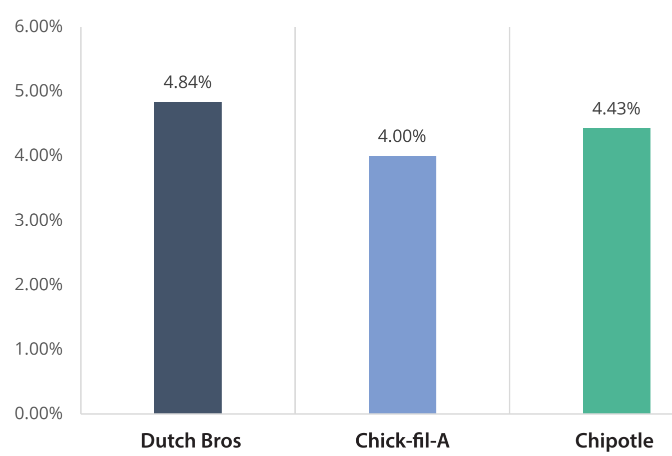
Markets in depth: QSR

As usual, quick service restaurants or QSR's represented the highest concentration of transaction volume out of any of the tracked verticals, registering 140 transactions in Q2, an increase from Q1's total of 116. Cap rates trended only slightly upwards, increasing 11 bps on average from 5.07% to 5.18% and term remaining was relatively unchanged as well, decreasing .4 years on average from 14.3 years to 13.9 years. The sector remains a favorite amongst investors due to the heightened demand for lower cost food in times of economic turbulence.

Overall QSR Cap Rates



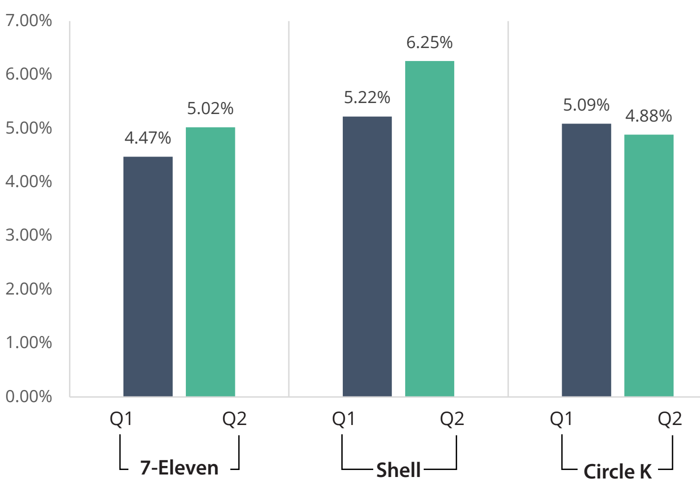
QSR Cap Rates w/ 10+ Years



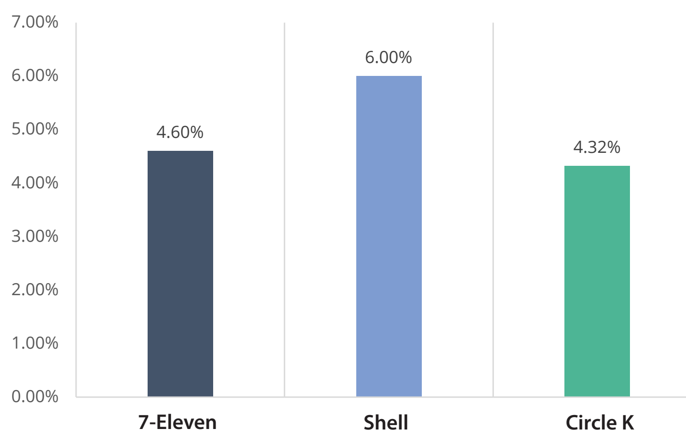
Markets in depth: C-Store

Following the trend of resiliency, Convenience stores or C-stores saw only a modest increase in average cap rate, increasing 52 bps and landing at 5.61% on average. Transaction volume remained stagnant, with there being 28 observed trades in Q2 as opposed to 31 in Q1. The average term remaining on C-Store transactions was 12.9 years, slightly down from the 13.5 years on average observed in Q1.

Overall C-Store Cap Rates



C-Store Cap Rates w/ 10+ Years

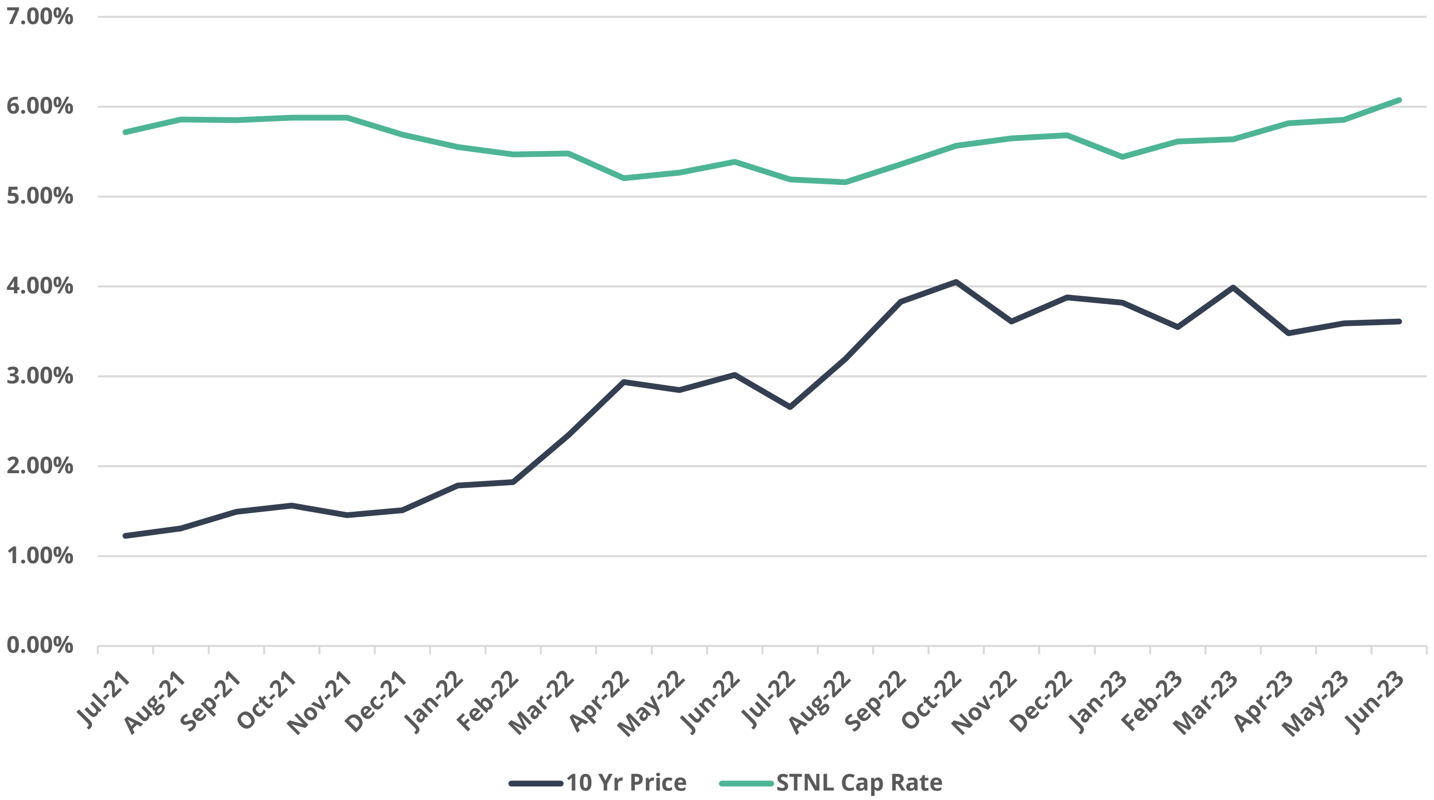


Brand by brand: Average cap rate changes

Tenants	Q1 2023 Avg Cap Rates	Q2 2023 Avg Cap Rates	Change in Avg Cap Rates (bps)
Dollar General	5.95%	6.16%	20.85
Walgreens	5.73%	5.99%	25.95
CVS	5.93%	6.60%	66.38
Starbucks	4.86%	5.02%	15.92
Family Dollar	6.48%	7.13%	64.55
7-Eleven	4.47%	5.02%	54.73
Advance Auto Parts	6.60%	5.79%	-81.06
Dutchbros	4.78%	4.90%	11.65
Taco Bell	4.63%	5.45%	82.42

*All calculations are based upon available comps for each specific quarter. The total number of sale comps for respective tenants in each quarter also varies.

STNL Cap Rates vs. 10-year Treasury Rates



Conclusion

Overall, the net lease market's outlook remains positive, albeit with a more balanced perspective. Investors should remain vigilant in monitoring interest rate trends, tenant stability, and broader economic indicators that can influence cap rates. With financing options extremely limited, and conventional sources of capital increasingly skittish, STNL should continue to be the beneficiary as investors looking to satisfy 1031 requirements can take advantage of lower price points and more concrete demand fundamentals. That is not to say that the sector will remain unaffected from macroeconomic turbulence. It will continue to outperform its peers that are more predicated upon turbulent debt markets and whose future utilization remains in a state of limbo as companies evaluate their return to office strategies. As the market navigates this phase of adjustment, adaptability and a keen understanding of tenant industries will be crucial for investors aiming to capitalize on potential opportunities while effectively managing risks.

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