Q3 2023 Cap rate report

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As capital markets activity across the broader commercial real estate sector has for all intents and purposes come to a halt, mainly stemming from a volatile interest rate environment, the single tenant net lease (STNL) sector has begun to show that despite its general resilience, it is certainly not immune from these structural and cyclical challenges.

With debt markets in a continued state of disarray, and perceived risk in traditional equities presenting a tough risk adjusted reward to investors, bond yields have spiked dramatically, with the 10-Year U.S. Treasury yield approaching 5% as of Q3 2023. This has caused even further suppressed investor appetite for real estate assets, due to the fact that treasuries are generally deemed to be "risk-free" investments, as opposed to real estate where there is no way to remove risk from a deal. That said, STNL cap rates still remain higher on average than treasury yields, so investors have not completely shied away from the sector to the same extent as other sectors such as office. As mentioned in previous reports, the lower price point attributable to STNL deals has assuaged the impact that turbulent debt markets have had on transaction volume, since many STNL assets are purchased on a cash basis. Lastly, although there hasn't been as many 1031 buyers in the market as in previous fourth quarters, those who have opted to pay their capital gains tax and not do a 1031 exchange has decreased buyer pool. On the other hand we have 1031 buyers that will still go low for the right asset that checks all of their boxes.

The average STNL cap rate registered 5.93% in Q3, up 13 bps from 5.8% in Q2, which despite rising treasury yields, still offers a risk adjusted premium for investors. This is compared to the average cap rate of 5.38% in Q3 2022. Across all tracked verticals, banks, industrial and convenience stores were the only sectors of STNL to see cap rate compression, while all other tracked verticals witnessed increases in average cap rates. Another noteworthy trend is the shift in term remaining on executed deals. Many investors have focused on longer terms, with all but four sectors showing an increase in average term remaining. Seven out of the 10 tracked verticals recorded average term remaining of over 10 years. Across all verticals, the average term remaining increased 19 bps to 11.15 from 10.96. Despite the price point of STNL deals, the sector is not immune from broader economic turbulence, with the number of tracked transactions showing a rather dramatic drop off, landing at 503 in Q3 2023 vs. 656 in Q2 2022.

Average Cap Rate
5.93%

Average Lease Term Remaining
11.15

Sectors in brief

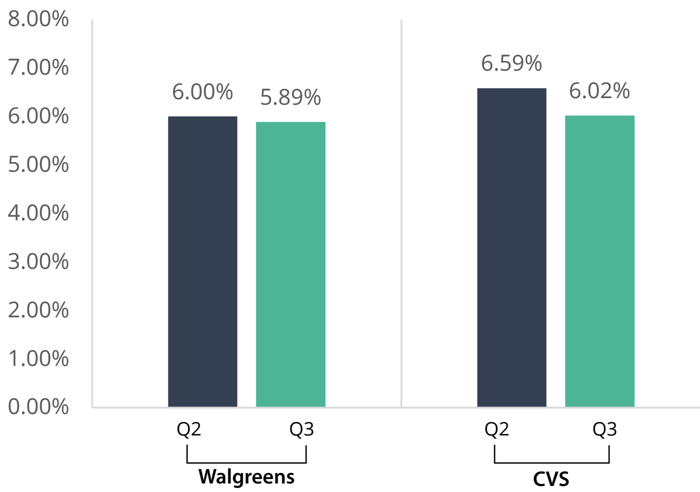
Sectors	Q2 2023 Avg Cap Rate	Q2 2023 Low	Q2 2023 High	Q2 2023 Avg Lease Yrs	Q2 2023 Sample Size	Q3 2023 Avg Cap Rate	Q3 2023 Low	Q3 2023 High	Q3 2023 Avg Lease Yrs	Q3 2023 Sample Size	Change in Avg Cap Rates (bps)	Change in Lease Years (Rem)
Automotive	5.68%	4.25%	7.17%	10.29	46	6.10%	4.50%	13.79%	11.07	32	42.69	0.78
Bank	5.68%	4.25%	12.63%	8.46	16	5.76%	4.24%	9.14%	8.28	14	8.00	-0.17
Casual Dining	6.11%	3.23%	9.00%	12.03	46	6.29%	4.52%	13.03%	11.99	56	17.78	-0.03
C-Store	5.37%	3.75%	10.00%	13.00	40	5.20%	4.00%	8.62%	13.77	32	-17.55	0.77
Dollar Store	6.24%	4.75%	8.68%	11.02	113	6.53%	4.61%	10.27%	11.12	73	29.23	0.10
Industrial	6.84%	3.40%	10.00%	6.65	35	6.44%	3.63%	9.62%	10.83	14	-40.23	4.18
Medical	6.07%	4.50%	8.15%	7.33	35	6.48%	5.10%	8.22%	9.75	33	40.54	2.43
Other Retail	5.82%	4.00%	9.32%	10.83	72	5.89%	3.35%	9.02%	9.13	44	6.72	-1.70
Pharmacy	6.24%	4.75%	10.00%	16.30	62	6.34%	5.00%	12.95%	11.44	34	9.87	-4.86
QSR	5.18%	3.25%	8.00%	13.72	191	5.46%	3.00%	9.91%	14.10	171	27.76	0.39
Average	5.80%			10.96		5.93%			11.15			
Sample Size					656					503		

[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.

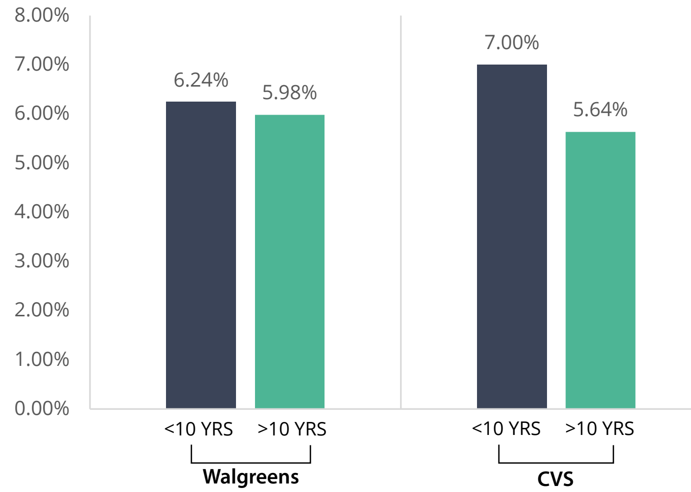
Markets in depth: Pharmacy

The pharmacy sector saw limited transaction volume going into Q3. Cap rates on observed deals trended upward towards 6.34% with a low cap rate of 5.0% (4.75% in Q2) and high of 12.95% (10.00% in Q2). CVS and Walgreens continue to face a challenging business environment with both having announced rounds of layoffs and pharmacist protests. It will be interesting to see what outcome, if any, this has on each brand as well as pharmacies as a whole.

Overall Pharmacy Cap Rates



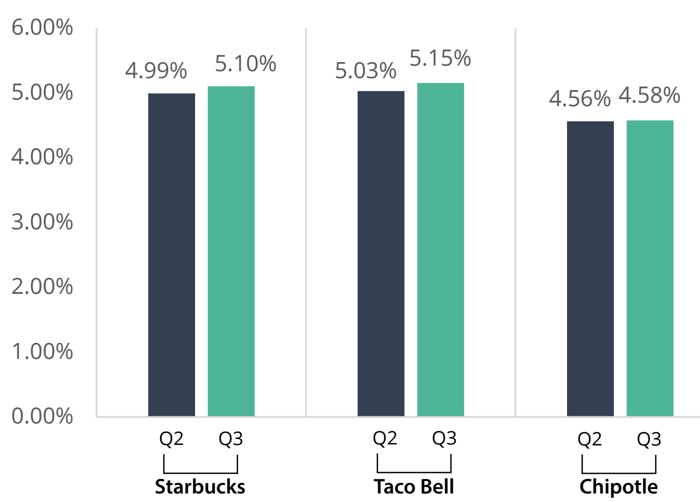
Pharmacy Cap Rates by Term Remaining



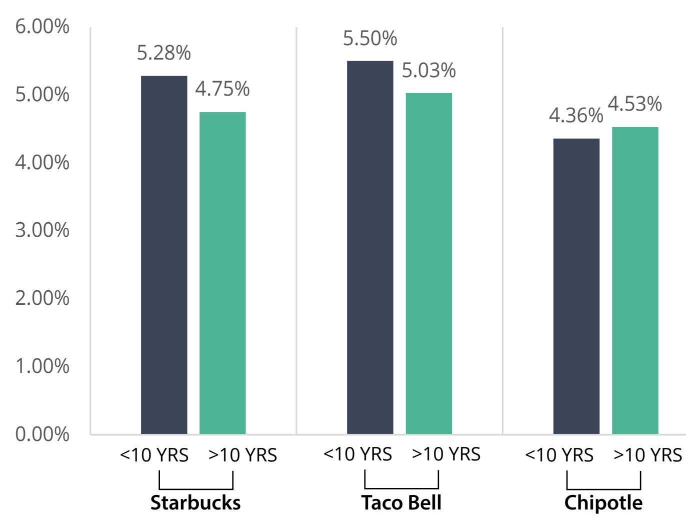
Markets in depth: QSR

It's no surprise that quick service restaurants or QSRs represented the highest concentration of transactions out of all the tracked verticals, though volume dropped roughly 10%. Unsurprisingly, like most sectors, cap rates trended upwards, increasing about 28 bps on average to 5.46% while average term remaining grew slightly, signifying increased new construction transactions. The sector remains a favorite amongst investors due to economic turbulence and the ability to simply backfill space to tenants that can lightly modify the space.

Overall QSR Cap Rates



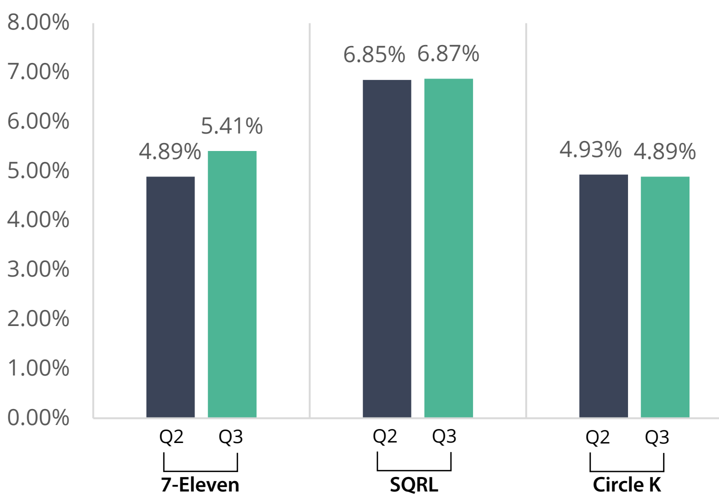
QSR Cap Rates by Term Remaining



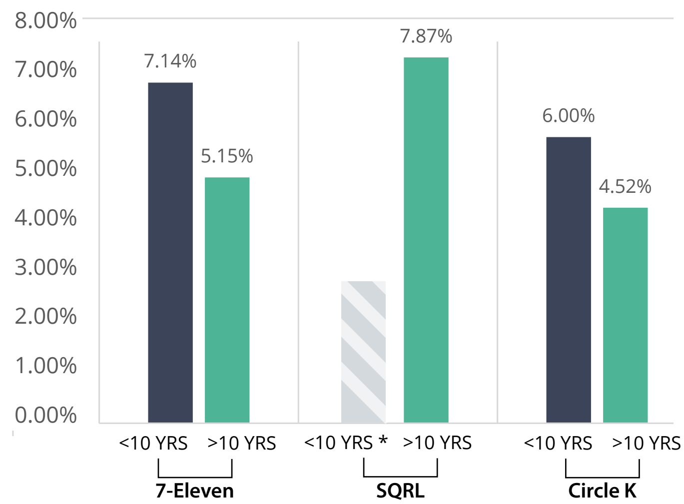
Markets in depth: C-Store

Going against the trend of the above sectors, convenience stores saw a slight decrease in average cap rate, staying relatively steady at 5.20% on average. Transaction volume slowed, with there being 32 observed trades in Q3 as opposed to 40 in Q2. The average term remaining on C-Store transactions increased to roughly 13.77 years, compared to the average observed transactions in Q2; this is as a result of new construction continuing to occur within the sector.

Overall C-Store Cap Rates



C-Store Cap Rates by Term Remaining



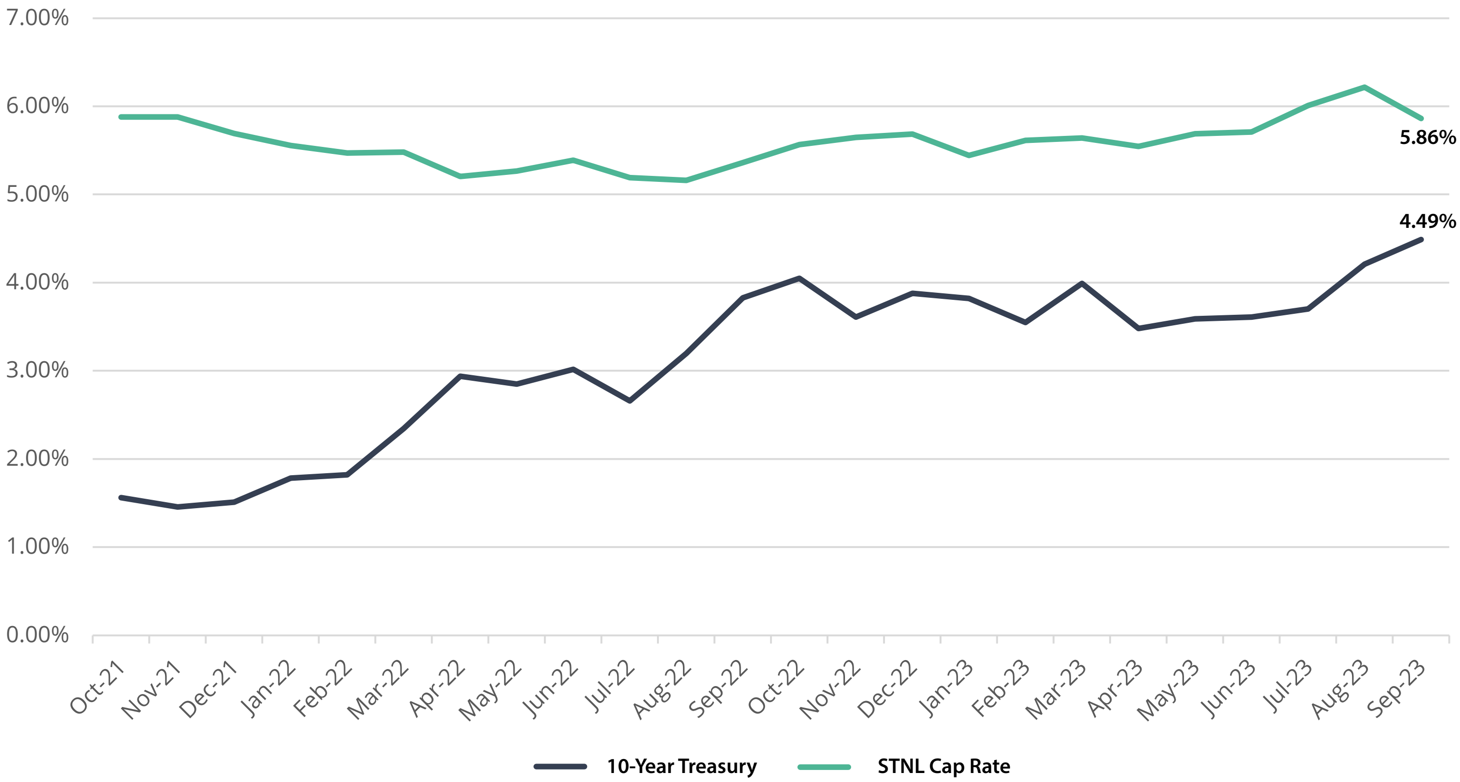
** With SQRL being relatively new to the scene, there is insufficient data to report.*

Brand by brand: Average cap rate changes

Tenants	Q2 2023 Average Cap Rates	Q3 2023 Average Cap Rates	Change (bps)
Dollar General	6.05%	6.47%	41.61
Walgreens	6.00%	5.89%	-11.39
Starbucks	4.99%	5.10%	10.74
CVS	6.59%	6.02%	-56.54
Family Dollar	6.90%	7.13%	22.49
7-Eleven	4.89%	5.41%	51.97
DutchBros	4.97%	5.26%	28.36
Taco Bell	5.03%	5.15%	12.19
Advance Auto Parts	5.94%	6.45%	50.89

*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

While turbulence in the broader economy shows no signs of slowing down, and with the federal reserve refusing to commit to pausing rate hikes, activity will continue to remain in a state of limbo until a capitulation occurs, likely to be on the part of sellers. Cautious optimism seems to be the sentiment amongst net lease investors, as the sector continues to outperform its peers, and consumer spending shows no signs of slowing down despite macroeconomic headwinds. Again, while the sector is resilient, it is not immune to these larger issues, and understanding tenant industries continues to be crucial for investors aiming to capitalize on the opportunity at hand.

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