Q4 2023 Cap rate report

U.S. Capital Markets Net Lease Group

The final quarter of 2023 wrapped up what concluded to be a correction year. All asset classes had some level of price reduction with some property types weathering the downturn better than others. This resulted from macroeconomic conditions such as high interest rates, lender pullbacks, recession fears, and geopolitical factors. While the single tenant net lease (STNL) sector was negatively impacted, it held strong.

Debt markets continue to remain in a state of turmoil. In Q3, bond yields spiked dramatically with the 10-Year U.S. Treasury yield touching 5%, and falling to 3.75% in mid-December. While certainly not viewed as a "risk-free" investment, a net lease acquisition can be assessed as a "bond wrapped in real estate." With 10 to 20-year lease terms, credit rated tenants, and annual rent escalations, investors can capture tax advantages and annual returns that remain higher, on average, than treasury yields. Naturally, investors have not completely sheltered away to the same extent as other sectors.

Since STNL assets are often purchased on an all-cash basis, interest rates and the cost of borrowing have not put a slow down on lower priced deals (< $5 million). Most high-net-worth investors and 1031 exchange buyers with high liquidity viewed the period of rising interest rates as a time to capitalize on higher yields, as the two correlate with one another. Higher priced assets (> $5 million) saw longer days on market, resulting in stale/lost listings. Additionally, re-trades and longer closing timelines became the norm. 1031 Exchange buyers attributed to much of the deal flow in Q3 and, while there were investors who opted out to pay their capital gains tax, many were aggressive for the right asset that checked their boxes.

Overall, buyers and sellers were at a disconnect with price expectations, slowing transaction volume. The average STNL cap rate in Q4 continued to trend upward, registered 6.12%, an increase of 19 bps from 5.93% in Q3. The risk/return for investors appears to have only increased through much of 2023, compared to the average cap rate of 5.64% in Q4 2022. Across all tracked verticals, automotive, big-box retail, and medical saw cap rate compression, while all other sectors witnessed increases in average cap rates. Another noteworthy trend is the shift in term remaining on deals. The overall average dropped under 12 years with half of the sectors showing a decrease in average term with Big Box and automotive showed the most aggressive drops. Most notably, the number of tracked transaction showed another dramatic drop off, falling to 513 in Q4 vs. 575 in Q3. In Q2, there were 656.

Average Cap Rate

6.12%

Average Lease Term Remaining

11.84

Sectors in brief

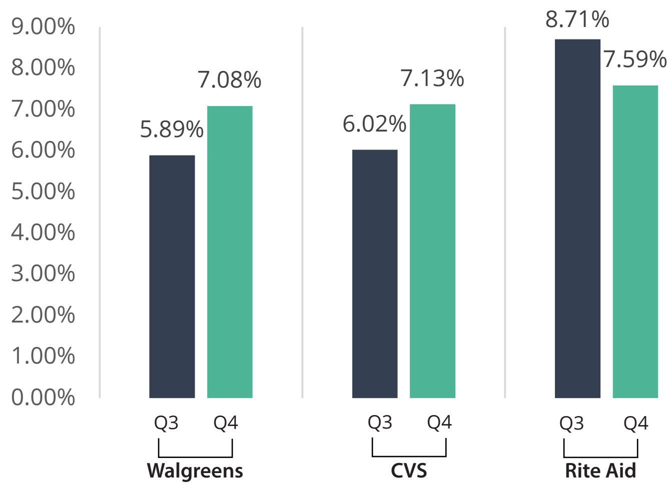
Sectors	Q3 2023					Q4 2023					Change in Avg Cap Rates (bps)	Change in Lease Years (Rem)
	Avg Cap Rate	Low	High	Avg Lease Yrs	Sample Size	Avg Cap Rate	Low	High	Avg Lease Yrs	Sample Size		
Automotive	6.10%	4.50%	13.79%	11.07	32	6.00%	3.81%	8.80%	9.69	24	-10.00	-1.38
Bank	5.78%	4.24%	9.14%	8.28	14	5.88%	4.00%	7.70%	10.15	22	10.81	1.87
Casual Dining	6.00%	4.52%	13.03%	11.99	56	6.00%	4.28%	8.38%	12.04	46	0.00	0.04
C-Store	5.55%	4.00%	8.62%	13.77	26	5.81%	3.20%	8.78%	13.45	51	26.14	-0.32
Dollar Store	6.53%	4.61%	10.27%	11.12	73	6.70%	5.00%	9.49%	11.31	97	16.85	0.19
Big-Box	7.75%	5.45%	10.10%	9.99	7	6.95%	5.00%	9.33%	6.13	9	-80.21	-3.86
Medical	6.48%	5.10%	8.22%	9.75	33	5.91%	5.00%	6.40%	11.04	4	-56.75	1.28
Other Retail	5.89%	3.35%	9.02%	9.13	44	6.25%	4.06%	9.73%	10.15	53	35.95	1.02
Pharmacy	6.00%	5.00%	12.95%	11.44	34	6.77%	5.00%	11.26%	10.91	23	77.00	-0.53
QSR	5.46%	3.00%	9.91%	14.10	171	5.46%	3.75%	9.60%	13.68	144	-0.33	-0.43
Average	6.06%			12.02		6.12%			11.84			
Sample Size					573					513		

[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.

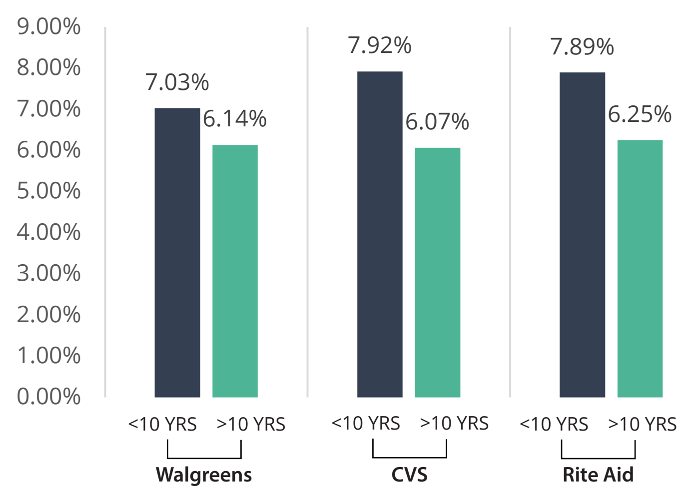
Markets in depth: Pharmacy

The pharmacy sector saw limited transaction volume going into Q4. The average cap rate on observed deals trended upward towards 6.77% (6.0% in Q4) with a low cap rate of 5.0% and high of 11.26%. Not so much CVS, but Walgreens and Rite Aid continue to face a challenging business environment with both having announced credit rating downgrades, investor dividend cuts and layoffs. It will be interesting to see what outcome this has on each brand as well as the entire pharmacy sector.

Overall Pharmacy Cap Rates



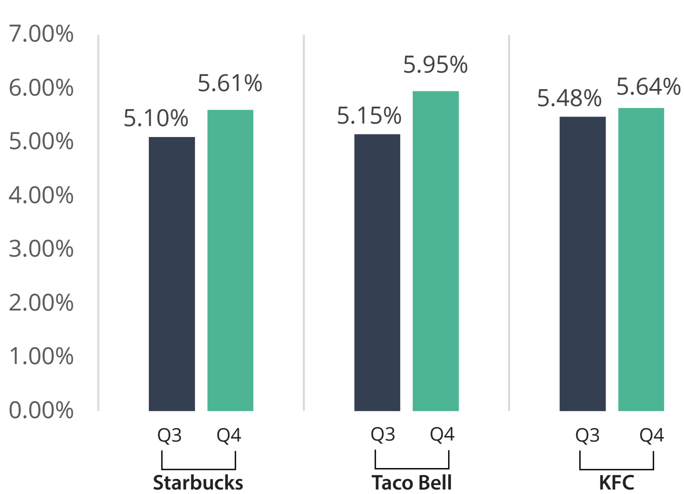
Pharmacy Cap Rates by Term Remaining



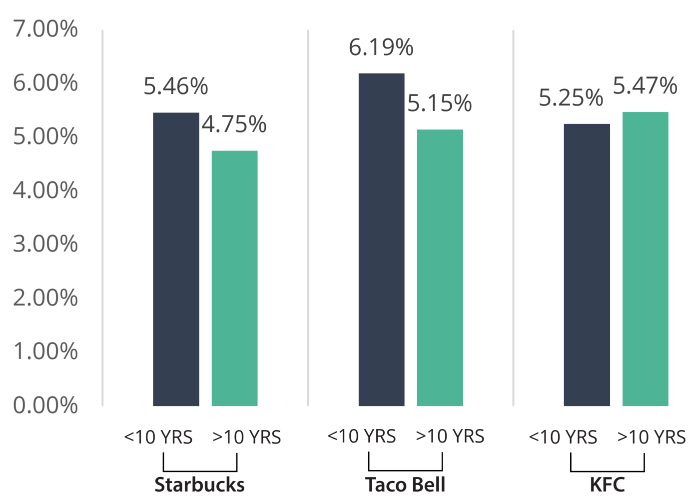
Markets in depth: QSR

Quick service restaurants (QSRs) represent the highest concentration of transactions out of all the tracked verticals, though volume dropped roughly 16%. The average Q4 cap rate held steady relative to the previous quarter while average term remaining dropped slightly, signifying a slowdown in new construction transactions. The sector remains a favorite amongst investors due to economic turbulence, a variety of tenants, and the ability to simply backfill space to new tenants that can lightly modify the space.

Overall QSR Cap Rates



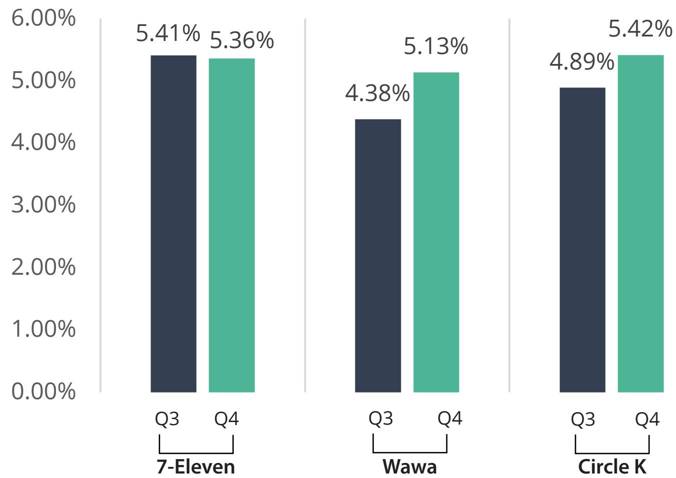
QSR Cap Rates by Term Remaining



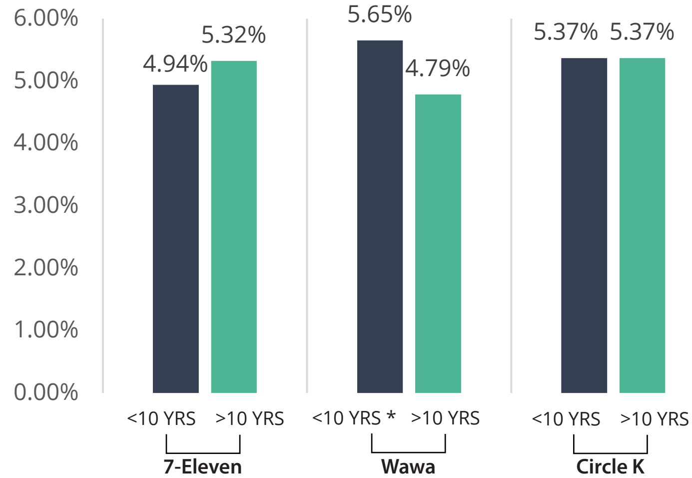
Markets in depth: C-Store

Unsurprisingly, convenience stores saw an increase in average cap rate, rising to 5.81% on average, from 5.55% in Q3. Transaction volume had an uptick, with 51 observed trades in Q4 with an average price of $3,942,261. The average term remaining on C-Store transactions in Q4 lowered to 13.45 years from 13.77 years in Q3; This average remains high because of new construction that continues to occur within the sector.

Overall C-Store Cap Rates



C-Store Cap Rates by Term Remaining

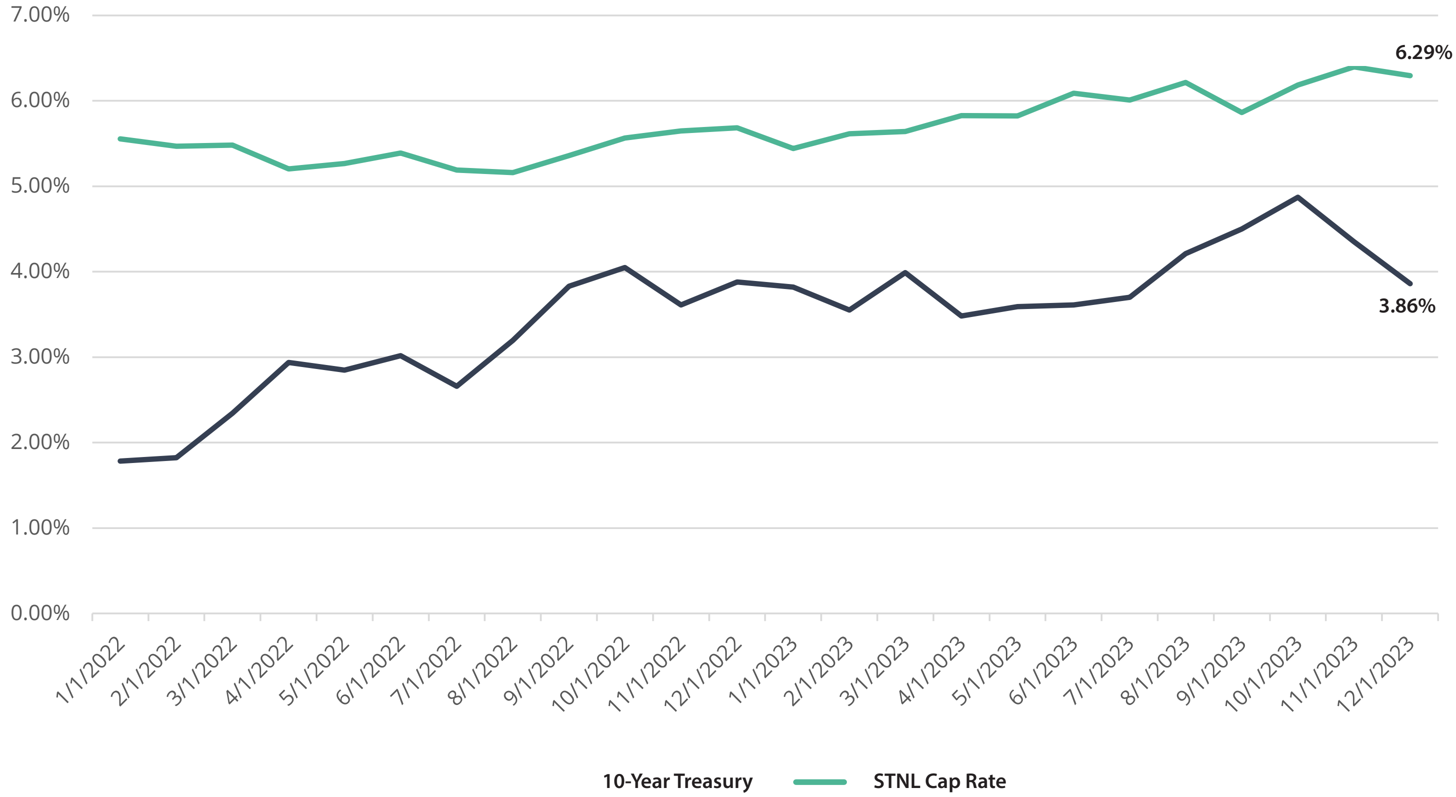


Brand by brand: Average cap rate changes

Tenants	Q3 2023 Average Cap Rates	Q4 2023 Average Cap Rates	Change (bps)
Dollar General	6.47%	6.63%	16.15
Walgreens	5.89%	7.08%	119.38
7-Eleven	5.41%	5.36%	-4.83
Starbucks	5.10%	5.61%	50.71
Dutch Bros	5.26%	5.07%	-18.17
Family Dollar	7.13%	7.21%	7.68
Chipotle	4.58%	4.63%	5.05
Taco Bell	5.15%	5.95%	80.08
CVS	6.02%	7.13%	110.50

*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

After the recent positive update from the Fed's regarding future rate reductions in 2024, investors seem to be anticipating a rebound; however, there is no guaranty that interest rates and treasuries will remain the same. Investors will closely monitor from the sidelines, but it is hopeful that there will be a rebound in activity in 2024 based on the reversal of the negative trends stated in the introduction. Private and institutional investors are in no shortage of capital, and they are looking to place it. So long as buyers and sellers get on the same page with price expectations, the market will see more activity this year.

Let's connect.

SUBSCRIBE

Jonathan Hipp
Principal, Head of U.S. Net Lease Group
D 703 787 4725
C 571 926 2009
jonathan.hipp@avisonyoung.com
avisonyoung.com/netlease

AVISON YOUNG