AVISON YOUNG

U.S. Capital Markets Net Lease Group / February 2020

4Q 2019 Cap Rate Report

Quick Stats

↗

6.58%

Average Cap Rate

↗

11.2 Yrs

Average Lease Years (2019)

Let the Good Times (Continue To) Roll...

Solid, steady cap rate performance was the theme for the closing quarter of 2019. In the face of macro news that we would ordinarily expect to cause ripples in the marketplace--issues such as global tensions, impeachment talk and the looming presidential election--the net lease market failed to flinch.

Despite the threat of issues beyond the control of real estate practitioners, the stock market is setting records, the 10-year treasury has stabilized and the commercial real estate market as a whole continues to fire on all cylinders. Let the good times continue to roll, indeed.

Much of the activity we're charting for the quarter is being pushed by the private side. There's been a trend on the part of REITs to rebalance portfolios over-weighted in retail. That's not a no-confidence vote as much as a diversification strategy (many are looking currently into industrial), and despite a shift in capital sources, the market remains on an even keel.

With a sample size of 544 deals in the third quarter, the overall average cap rate across all tracked verticals was 6.57 percent, with a 10.5-year average lease term. Q4 activity grew impressively to 586 deals, resulting in an average cap rate of 6.58 percent and an average 11.2-year lease term.

Of course, a closer look at the performance of specific sectors reveals much more complex and nuanced market conditions. Of particular interest were the bank, big box, medical and quick-service restaurant (QSR) sectors.

Sectors in Brief

	3Q 2019					4Q 2019						
Sectors	Avg Cap Rate	Low	High	Avg Lease Yrs	Sample Size	Avg Cap Rate	Low	High	Avg Lease Yrs	Sample Size	**Avg Cap Rates (bps)**	**Lease Years (Rem)**
Automotive	6.56%	4.60%	10.48%	10.9	68	6.65%	4.65%	12.03%	12.0	50	9.2	1.1
Bank	6.43%	4.90%	8.53%	5.7	23	6.07%	4.19%	8.96%	7.9	31	-36.2	2.2
Big-Box	7.23%	5.10%	9.50%	8.7	26	6.91%	4.66%	9.50%	13.8	25	-32.4	5.1
Casual Dining	6.54%	4.62%	10.45%	11.6	63	6.51%	4.25%	9.60%	11.9	56	-3.0	0.3
C-Store	5.77%	4.00%	14.30%	14.9	25	5.95%	4.15%	11.38%	14.3	35	17.8	(0.6)
Dollar Store	7.19%	5.85%	10.57%	11.2	92	7.10%	5.75%	11.95%	12.0	113	-9.0	0.8
Educational	7.16%	5.40%	8.50%	7.8	10	7.33%	6.00%	9.00%	10.4	5	16.6	2.6
Medical	6.50%	4.43%	8.50%	9.6	10	7.17%	5.12%	11.30%	7.0	12	67.1	(2.6)
Pharmacy	6.73%	4.25%	13.00%	10.9	41	6.63%	4.18%	10.65%	11.4	68	-10.5	0.5
QSR	5.57%	2.94%	9.58%	14.3	150	5.75%	3.60%	8.61%	13.8	163	18.3	(0.5)
Other Retail	6.59%	4.50%	11.65%	9.3	36	6.33%	4.39%	9.01%	8.9	28	-26.0	(0.5)
Average	6.57%			10.5		6.58%			11.2		1.1	0.8
Sample Size					544					586		

[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.

The average lease term remaining in the Bank sector took a significant jump from quarter to quarter, from 5.7 to 7.9 years. This had the expected result of lowering cap rates, which dropped from 6.43 to 6.07 percent. It should be noted that the number of deals, while small, increased from 23 to 31.

Terms remaining went up significantly in the Big Box sector as well, from 8.7 to 13.8 years and with the same downward impact on cap rates, from 7.23 to 6.91 percent.

A negative three-bp change in Casual Dining cap rates came on lease terms that were virtually unchanged. Deal volume also dropped a bit, by seven deals to 56 in the last quarter of 2019.

Convenience or C-Stores lived the steady-as-she-goes pattern of the broader market. Cap rates inched up 17.8 basis points (bps) on lease terms that, like Casual Dining, remained virtually unchanged, from 14.9 to 14.3 years. This was based on deal volumes of 25 and 35 in Q3 and Q4, respectively.

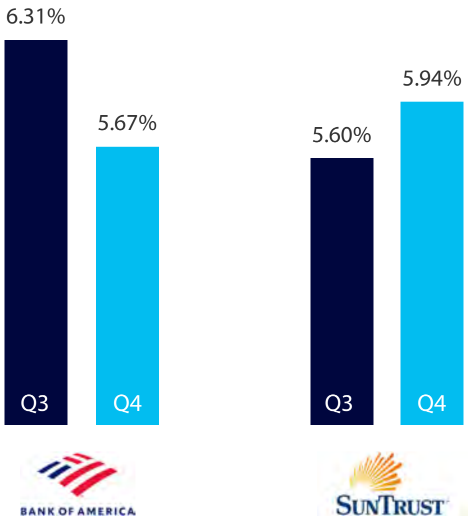
Dollar Store properties continue to flood the market, and deals jumped quarter over quarter, from 92 to 113. Newer properties will generally have higher terms remaining (our sample size rose by a month to 12 years) with the natural downward pressure on cap rates. There was a nine-bp drop in rates, to 7.1 percent.

Of all the markets tracked, the biggest cap rate jump was in the Medical sector, with a 67.1-bp boost to 7.17 percent. We believe this is likely just a transient phenomenon, as the properties that sold this quarter on average had considerably less term remaining than the previous quarter (2.6 years less). There were few deals, 10 in Q3 and 12 in Q4, but assets sold had a shorter time remaining on their leases, along with lower price points.

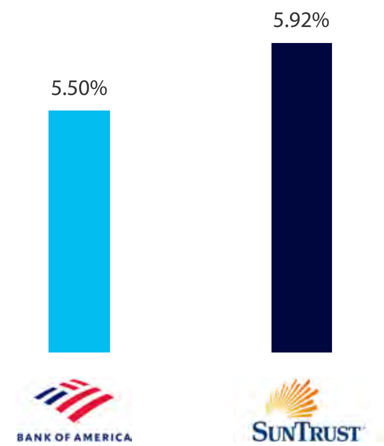
Markets in Depth | Banks

The big news for the quarter, of course, was the merger of SunTrust and BB&T Corp. to form Truist Financial Corp., now the sixth largest commercial bank in the US. As the chart shows, SunTrust's cap rate rose from 5.6 percent to 5.94. But much like Bank of America, the sector as a whole saw a 36.2-bp drop in cap rates. We see sales in the benchmark states of California and Florida (which typically outperform the other 48) as a factor here.

Bank Cap Rates



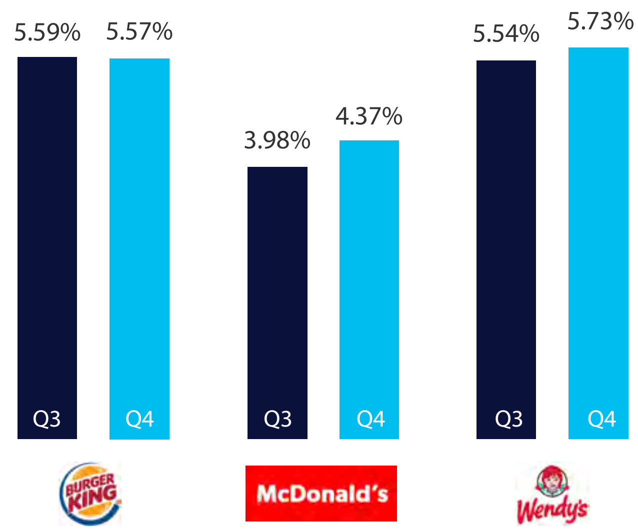
Bank Cap Rates w/ 10+ Years



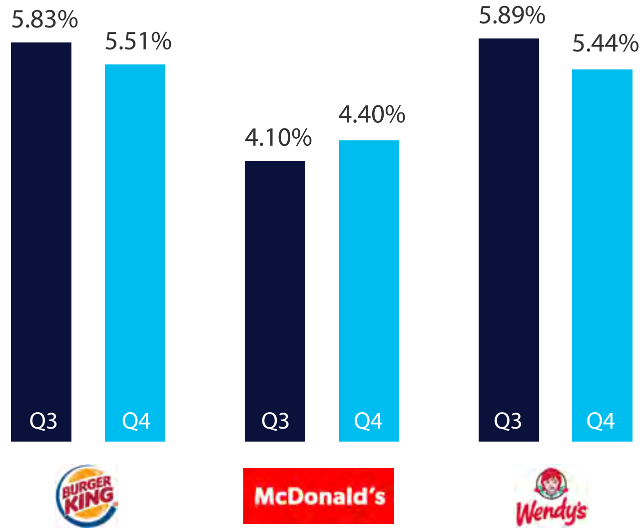
Markets in Depth | QSR

QSR--the largest sector at 163 fourth-quarter deals (up from 150 in the prior quarter)--saw a slight, half-year dip in remaining lease term, pushing cap rates up 18.3 bps to 5.75 percent. Average term length decreased, which will cause cap rates to rise still more, since solid leasing is a hallmark of desirability. The number of sales increased a bit, with an emphasis on the premium markets (California and Florida). The sector is hot now, with an ever-growing list of names entering the fray. It will be interesting to watch the market dynamics as these new entrants gain ground.

QSR Cap Rates



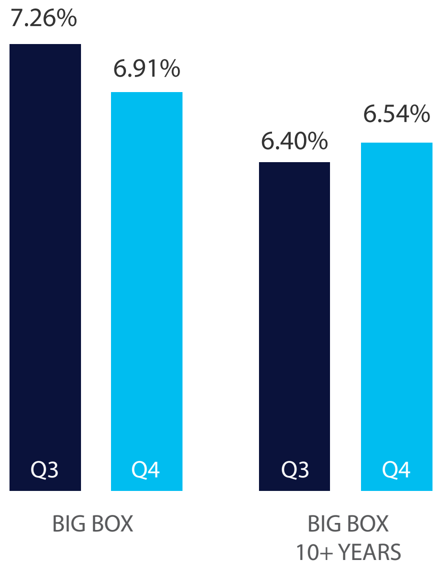
QSR Cap Rates w/ 10+ Years



Markets in Depth | Big Box

There was a major jump in lease years remaining quarter over quarter, from 8.7 to 13.8 years. Not surprisingly, cap rates slipped as a result, by 32.4 bps, to 6.91 percent. While there was virtually no change in the number of sales, the prime activity, much like other sectors, occurred in the premium markets of Florida and California.

Big Box Cap Rates



Brand-by-Brand Average Cap Rate Changes

All calculations are based upon available comps for each specific quarter with 10+ lease term remaining. The total number of sale comps for respective tenants in each quarter also varies significantly.

Tenants	Q3 2019 Average Cap Rates	Q4 2019 Average Cap Rates	Change in Average Cap Rates (bps)
7-Eleven	5.07%	4.50%	-57.0
Arby's	5.96%	5.70%	-26.0
Burger King	5.87%	5.51%	-36.0
CVS	5.70%	5.59%	-11.0
Dollar General	6.70%	6.60%	-10.0
Ruby Tuesday	6.97%	6.54%	-43.0
Taco Bell	5.26%	5.84%	58.0
Walgreens	6.97%	6.45%	-52.0
Wendy's	5.80%	5.44%	-36.0

A 57-bp drop in cap rates to 4.5 percent was driven by a more than two-year hike in avg lease term remaining, from 16.5 years to 18.75.

A rush of deals in the premium markets of California and Florida resulted in a 36-bp drop in cap rates, from 5.87 percent to 5.51 percent from quarter to quarter.

Sales activity jumped significantly from Q3 to Q4, from a relatively small two deals to a much more robust 11. This converted the Q3 cap rate of 5.7 percent to a 5.59 percent. Average lease years also slipped, from 19.38 to 16.86 years.

There was a rise of only five deals quarter to quarter, resulting in a relatively static cap rate picture. Specifically, it slipped by 10 bps to 6.6 percent.

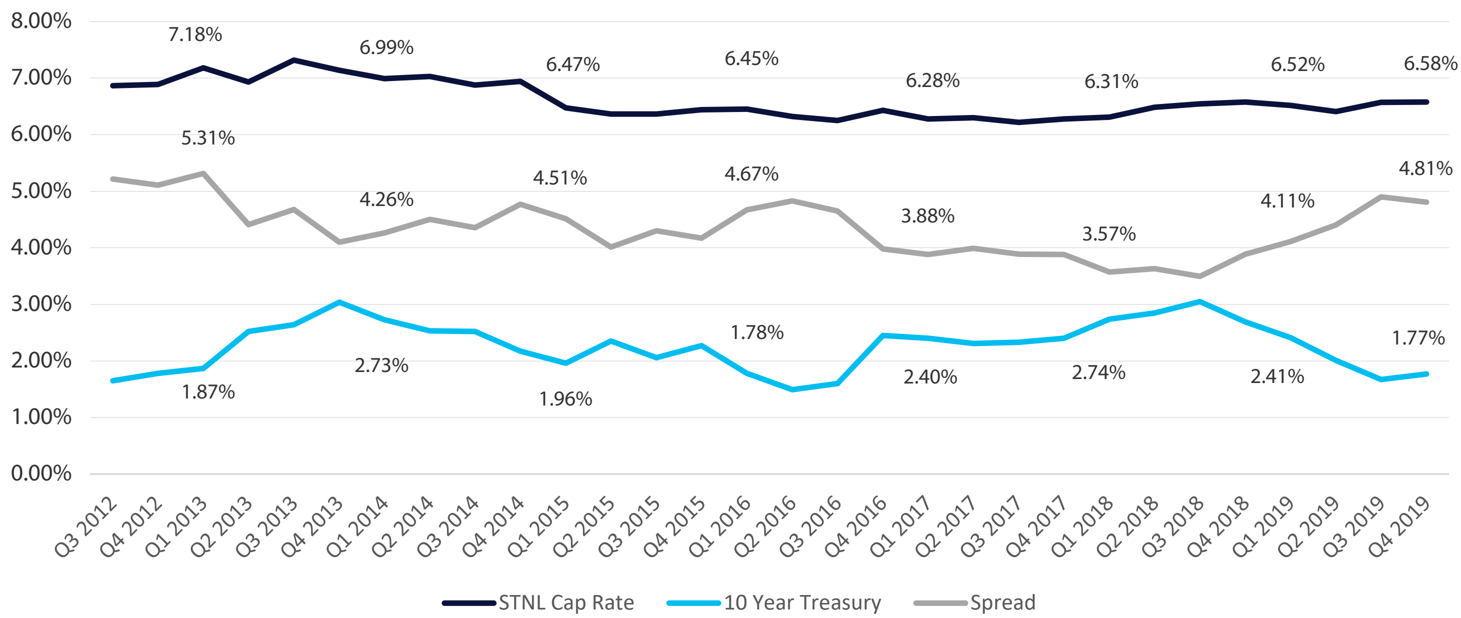
Cap rates rose by 58 bps to 5.84 percent. This was driven by a drop in the remaining lease term, by more than two years.

There were more sales in the benchmark states of Florida and California, much due to the sell-off of non-performing Rite-Aid stores. This, along with an increase in the lease term remaining, pushed cap rates down by 52 bps to 6.45 percent.

Cap rates dropped from 5.8 percent in the third quarter to 5.44 percent, a function of more sales in the two premium markets.

STNL Cap Rates Vs. 10- Year Treasury Rates

The first increase in the 10-Year Treasury since mid-2018 contributed to a closing of the cap rate spread. As discussed elsewhere, these remained virtually unchanged from the third to the fourth quarter of 2019. In addition, the total number of transactions continues to rise.



Conclusion

The groundwork is clearly laid for a 2020 marked by continued slow growth, which has been the mantra of this record-breaking upcycle since the get-go. It is reflected as well in the 40-deal hike we recorded from the third to the fourth quarter, an affirmation of ongoing investor confidence. Barring surprises from the above-mentioned macro forces, the outlook for Q1 and Q2 are for a continuation of the same steady performance that defined the second half of 2019. How this might change as we get closer to the election, obviously, remains to be seen.

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