NATIONAL REPORT

Marcus & Millichap

SINGLE-TENANT NET-LEASE RETAIL

1H/23

One of the Nation's Least Vacant Commercial Real Estate Sectors Benefits from the Ongoing Shift in Consumers' Shopping Habits

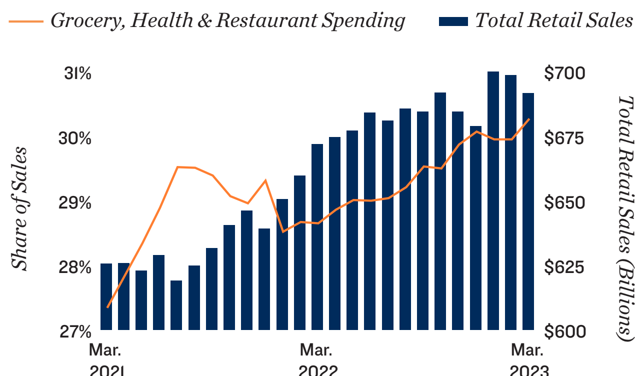
Spending priorities favor single-tenant. The outlook for dining and necessity retail remains positive as summer approaches, despite a flat trend in overall consumer spending. Continued inflation, labor market concerns and high interest rates are influencing households to prioritize social interactions over big ticket items that were popular during lockdowns. In March, restaurant and bar spending was up 13 percent annually, a sign consumers continue to frequent quick service restaurants and fast casual chains, including Chipotle and Noodles & Company, as their budgets reduce. Households are also concentrating their spending on essential goods. In the first quarter, sales in stores — not including restaurants — were up more than 4 percent year-over-year. The divergence between these segments' performance and overall retail spending has positive implications for net-leased fundamentals at a time when single-tenant vacancy is historically low.

Labor market strength trims concerns. While consumers continue to spend more on certain goods and services, the horizon is not free of headwinds. As of March, U.S. consumer debt, which is largely based on credit card balances and auto loans, was 2.1 percent above the year-end 2019 mark, on an inflation-adjusted basis. While this poses some risk to future spending, the labor market has remained resilient. Above-average job creation has kept unemployment at a multi-decade low, while wage growth surpassed inflation in March for the first time in more than two years. Some sector-specific contractions are nevertheless underway, which may increase households' credit usage.

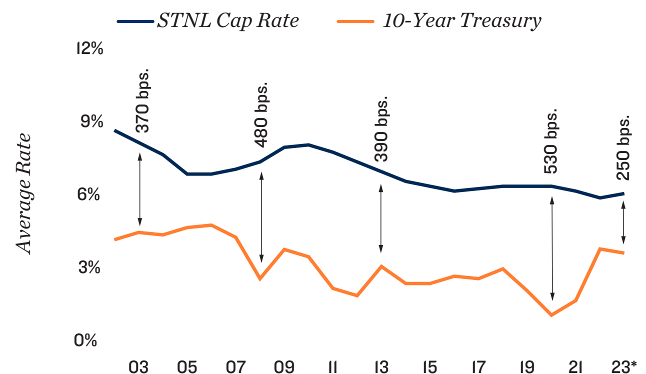
Discount retailers fill the void. Budget tightening is impacting consumers' brand loyalty, with more willing to change where they shop in their quest for pricing relief. Dollar stores and other lower-priced retailers are benefiting, with foot traffic at discount stores up more than 2 percent in the first quarter of 2023 when compared to the same stretch last year. Intent on capturing more market share, dollar stores are broadening their reach, with the national count of these shops growing by 4.4 percent last year. A similar rate of growth may occur in 2023, as Dollar General plans to significantly grow its pOpshelf concept and Five Below intends to open 200 new stores, including some in urban and semi-rural settings. These expansions will largely be achieved by backfilling properties, a boon amid a wave of store closures that includes Party City and Bed Bath & Beyond locations.

Period of realignment underway. Capital costs elevated by tightening policies from the Federal Reserve have constrained transaction velocity for retail and other property types. This has reduced the flow of investment into single-tenant net-lease assets from 1031 exchanges. Nevertheless, a still tight labor market, expectations for a pause in rate hikes and historically low single-tenant vacancy should continue to attract active buyers to net-leased assets. While the average sale price for acquisitions completed over the past year ending in March rose 2 percent, pricing may face downward pressures this year. Trading from the past six months points to upward cap rate momentum, a dynamic that also implies some buyer-seller agreement.

Dining and Necessity Segments Play Larger Role

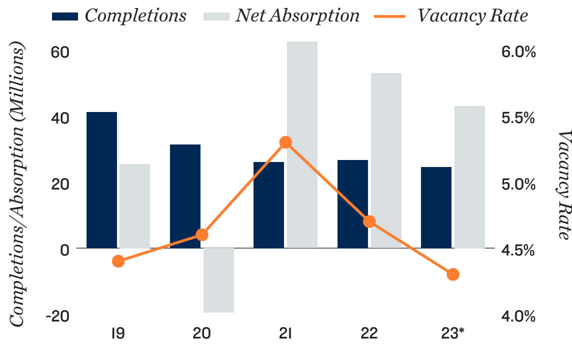


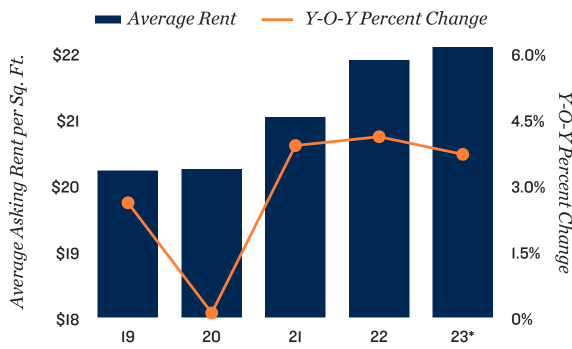
Single-Tenant Cap Rate Trends

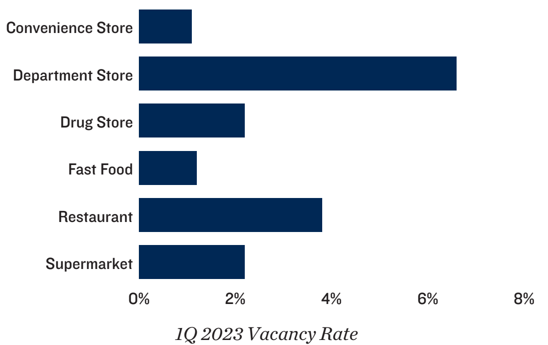


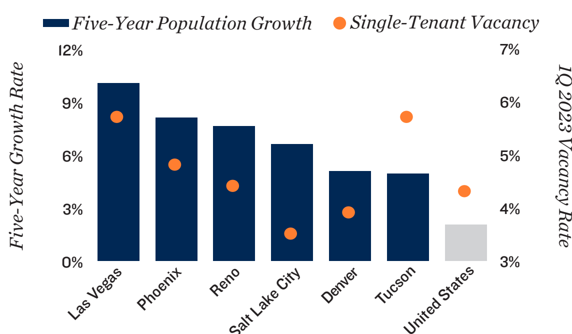
*Average cap rate for trailing 12 months through 1Q; 10-Year treasury rate as of April 28

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve









* As of 1Q; trailing 12 months through 1Q for completions, net absorption
** Population growth from year-end 2022 through 2027
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; U.S. Census Bureau

Single-Tenant Vacancy Remains Extremely Limited Across Property and Market Types

Sector on solid footing. The single-tenant segment entered April on a 10-quarter stretch of positive leasing activity. During this span, tenants absorbed a net of more than 120 million square feet, nearly doubling the volume of supply added. With vacancy now at a record low of 4.3 percent, an uptick in construction is warranted. Instead, higher costs for materials, labor and capital have trimmed the single-tenant pipeline, with properties underway accounting for just 0.5 percent of existing inventory. This restrained pace of development, and an expected pullback in construction starts this year, will steer most expanding retailers to existing spaces, preserving historically tight conditions and record asking rent across markets of various sizes. Entering the second quarter, primary and secondary market vacancy hovered in the low- to mid-4 percent range, with tertiary availability lowest at 3.7 percent.

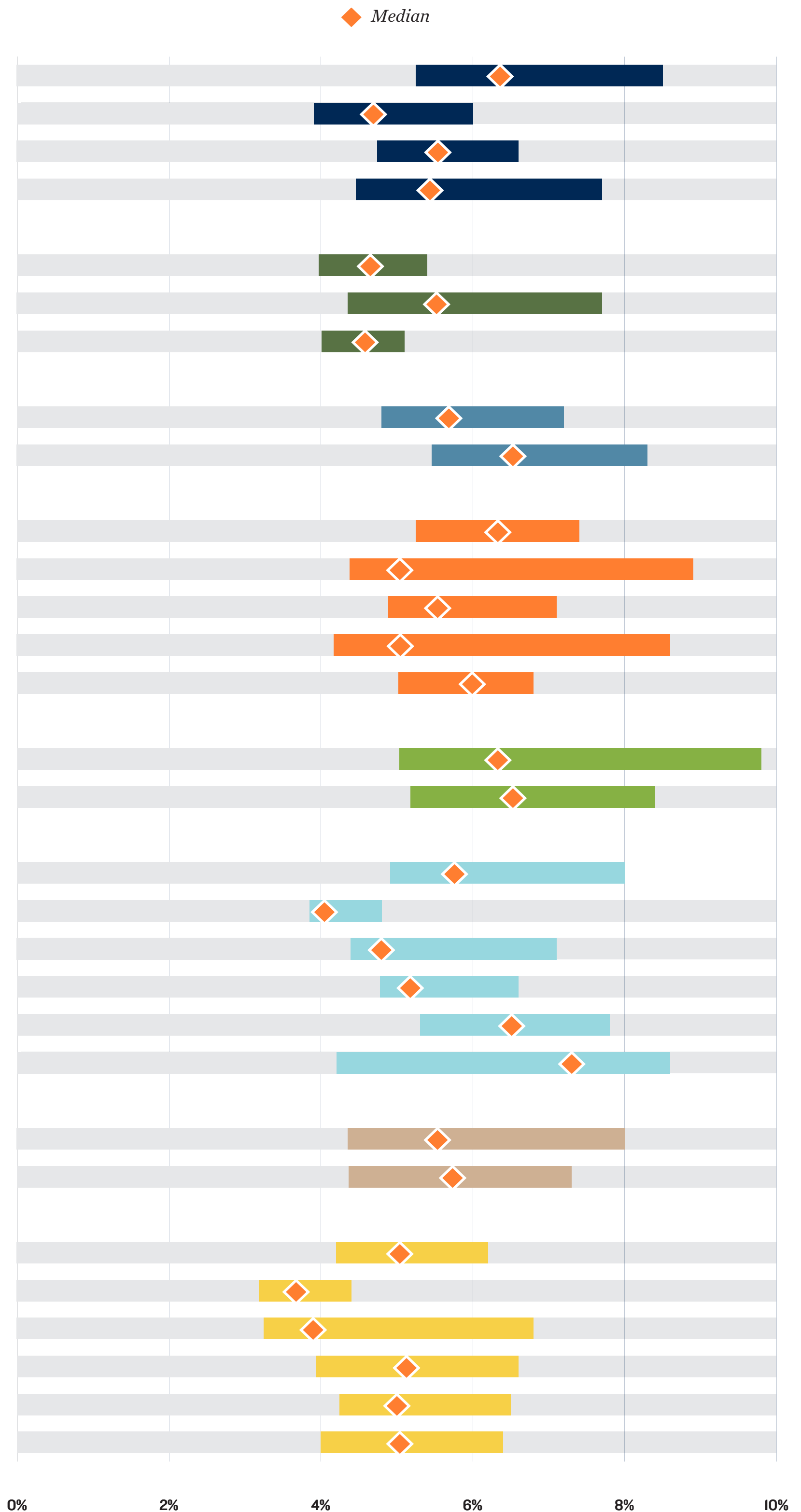
Segment dynamics heat competition for available space. Consumers' prioritization of necessity goods will aid renewal and new leasing activity across certain key types of single-tenant retail. Entering April, vacancy in both the supermarket and drug store subsectors was in the low-2 percent range, with a net of more than 5 million square feet of grocery space absorbed over the past 12 months. Announced expansions by Publix, Hy-Vee and Aldi indicate this momentum will continue, with drug store availability benefiting from a dearth of new construction. The number of convenience stores operating in the U.S. rose last year, reversing a four-year decline. Further bolstering this total, Wawa and Buc-ee's will expand their reach during 2023, holding segment availability below 2 percent. The collective tightness across these subsectors may motivate some retailers to re-evaluate their leasing criteria, considering spaces in urban settings, outlying locations or older shopping centers.

Mountain Region's Recent Performance and Near-Term Projections Stand Out on a National Scale

Strong growth prospects lead investors to the Southwest. During the past 12 months, the Mountain region was the only U.S. zone to note vacancy compression of at least 60 basis points across its collection of major markets. This performance signals net-lease retailers are expanding their presence or establishing a footprint in the region amid expectations for continued job creation and population growth. Spanning the next five years, the resident count in each of the region's four major markets is forecast to elevate by at least 5 percent, led by Las Vegas' nearly 10 percent gain and Phoenix's addition of more than 400,000 residents. Additionally, three of the four metros are expected to register an annual rate of employment growth on par with or above the national increase during 2023. Together, these combined gains will create opportunities for active investors to obtain upside across these markets. Larger resident counts in each area will boost demand for local goods and services, supporting additional leasing activity that could facilitate an increase in asking rents at dark properties and spaces with upcoming lease expirations.

Brand	Locations*
Auto Parts	
Advance Auto Parts	6,395
AutoZone	6,978
Caliber Collision	1,625
O'Reilly Auto Parts	5,938
Convenience Stores	
7-Eleven	9,884
Circle K	11,167
Wawa	975
Dollar Stores	
Dollar General	18,818
Dollar Tree/Family Dollar	16,293
Fast Casual Restaurants	
Applebee's	3,436
Bloomin' Brands	1,159
Chili's	1,645
Darden Restaurants	1,875
Red Lobster	667
Fitness Centers	
LA Fitness	709
Planet Fitness	2,353
Grocery & General Retail	
Kroger	2,720
Aldi	2,156
Safeway	2,272
Sherwin-Williams	4,891
Verizon Wireless	6,358
Walmart	10,586
Pharmacies	
CVS	9,712
Walgreens	8,901
Quick Service Restaurants	
Burger King	29,968
Chick-fil-A	2,704
McDonald's	39,980
Starbucks	35,711
Wendy's	7,080
Yum! Brands	53,994

Closed STNL Cap Rate Range by Brand



** Number of locations globally, cap rate range derived from U.S. transactions*
Cap rates shown above are representative of transactions that closed in the trailing 12 months ended 1Q 2023.
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.

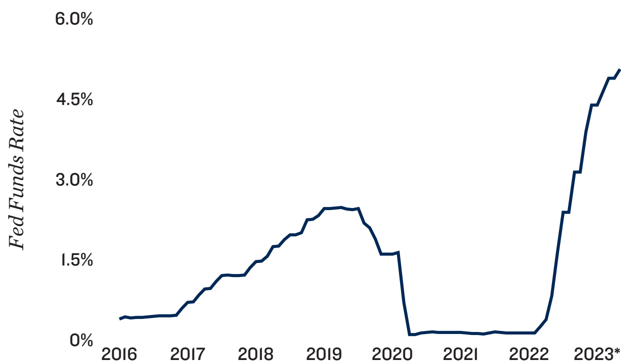
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Moody's Analytics; Real Capital Analytics; U.S. Census Bureau

Rate Stability Catalyzes Deal Flow; Investors Lean on Local and Regional Sources

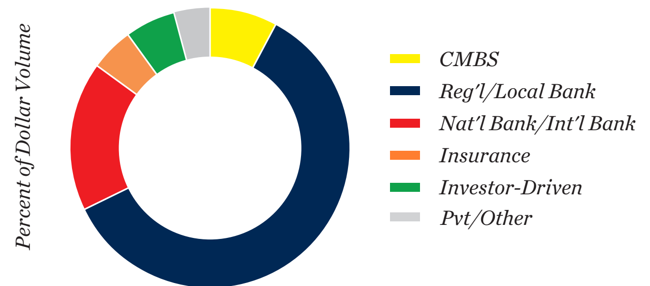
Retail investment landscape poised for a potential turnaround as Fed takes a more measured approach. At its early May meeting, the Federal Open Market Committee raised the federal funds rate for the 10th time in 14 months. The 25-basis-point hike lifted the lending rate's lower bound to 5.00 percent. At the meeting, the FOMC walked back language previously indicating they would continue with ongoing rate hikes. While it is unclear where the Fed will go, market expectations for a stable federal funds rate will aid commercial real estate lending, allowing capital providers to more readily set terms and determine property valuations. While recent bank closures have spurred tighter underwriting over the short-term, recent downward pressure on the 10-year Treasury, together with an overall reduction in rate uncertainty, could deliver modestly lower interest rates to commercial real estate borrowers. Together, these dynamics could translate to buyer-seller pricing expectations moving closer to alignment, which, along with historically low single-tenant vacancy, could fuel a pick-up in transaction activity during the second half of this year.

Net-leased assets represent one of the easier property types to finance. Local and regional banks continue to fill the financing void left by the stark decline in CMBS securitization. Together, the two sources accounted for 46 percent of all retail lending last year, including the bulk of loans under $10 million. Furthermore, the two lender types were responsible for 60 percent of all single-tenant financing in 2022, reflecting a confidence in the outlook for net-leased retail. The increase in capital costs over the past year, however, is requiring investors to take on less leverage. Of late, financing from local and regional banks has been provided at 55 to 65 percent loan-to-value (LTV) ratios, with debt service cover (DSC) ratios in the 1.25 to 1.35 range. Properties occupied long-term by high-credit, institutional-grade tenants, however, have obtained loans at 70 LTV and DSC in the 1.15 to 1.20 band. Lower overall LTVs will require more borrowers to layer the capital stack with additional financing sources, primarily mezzanine and bridge structures. Reduced LTVs and elevated capital costs will also translate to some distress involving higher leverage loans obtained over the past four or five years. Nevertheless, owners of well-performing net-leased properties are unlikely to sell based solely on the higher costs associated with refinancing.

Fed Funds Rate Over Time



Single-Tenant Retail Mortgage Originations By Lender**



** Fed Funds Rate through May 3*
*** Calendar Year 2022; Includes sales $2.5 million and greater*
Sources: Marcus & Millichap Research Services; Federal Reserve; Real Capital Analytics

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; U.S. Bureau of Labor Statistics; Federal Reserve Bank of New York; Statista; PYMNTS; Placer.ai; Winsight Grocery Business; PNC Real Estate; NACS/NielsenIQ Convenience Industry Store Count, Creditntell; Moody's Analytics; Real Capital Analytics; U.S. Census Bureau