National Report

Net-Leased Retail Research

First Half 2018

Tight Labor Market, Enhanced Spending to Continue; Tenants Adapt by Combining Physical and Online Retail

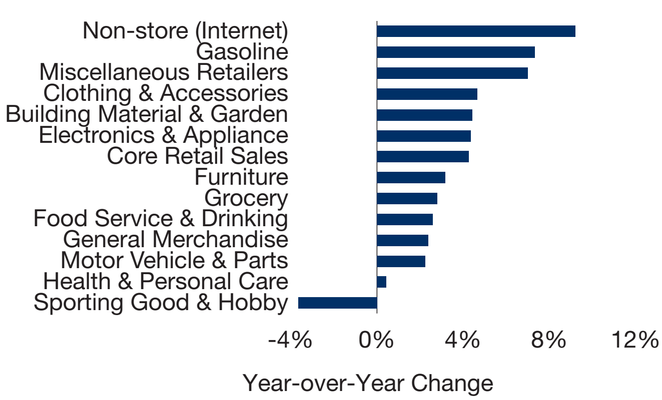
Strengthening economy invigorating consumption. Retail sales will continue to grow this year as discretionary income ascends. Bolstered spending can be linked to advancing wages from a competitive employment market, along with increased take-home pay from the revised tax plan. In 2017, retail sales posted a 4.3 percent increase, with home furnishings playing a primary role in the jump. The category's strong showing can be attributed to the first hike in homeownership since 2009 for those under age 35. Roughly two-thirds of this cohort are first-time homebuyers, leading to more purchases required to fill residences. Electronics and appliances also reported a robust gain as the subset supported the largest increase in holiday retail sales since 2011. This year, retail spending is forecast to post a 4.5 percent advance, buoyed by the continued acceleration of e-commerce growth. Although online stores consistently expand their footprint, the e-commerce sector is just a small part of a much larger retail setting.

Brick-and-mortar personal service keeps online retail at bay. As e-commerce becomes an increasingly popular component of retail sales, brick-and-mortar stores have acclimated to the evolving environment. Physical locations still obtain high levels of personal service and in-store expertise, crucial advantages that Internet vendors simply cannot offer. Auto parts stores have effectively used these assets to their benefit and have proved to be relatively successful amid e-commerce's rising popularity. Even with the Internet's growing use within retail, overall sales among brick-and-mortar stores will continue to improve as consumers value personal service.

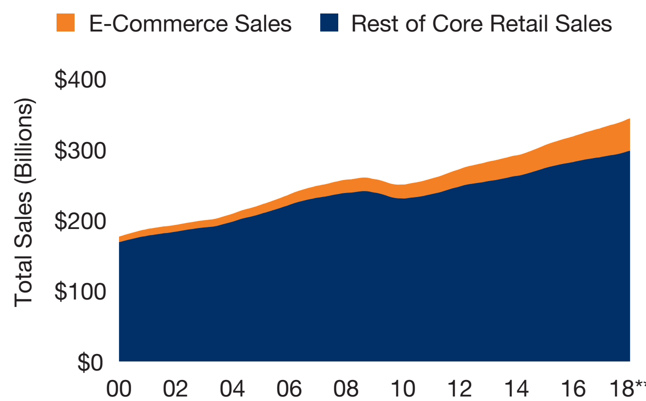
Growing competition from online stores tamed by modernized retail concepts. Despite the convenience factor brick-and-mortar stores offer, the digitally driven landscape prompts many retailers to transform business models to combine benefits of both in-store and nonstore retail. The showroom atmosphere, which integrates technology into the traditional shopping experience, provides customers the option to test the merchandise and have it delivered directly to their home. Many brick-and-mortar retailers have shifted to this reduced inventory strategy in an effort to adapt and improve sales. Best Buy has effectively adopted this strategy and exhibited an exemplary performance in combating the progressively widespread practice of purchasing goods on the Internet. In the coming months, more retailers are anticipated to couple these advantages, as well as create omni-channel business models to seamlessly connect sales platforms.

Promising retail metrics support renewed investor interest. Although news media often focus on the downfall of well-established retail brands, 2017 witnessed far more store openings than closures with a net figure of roughly 4,000 stores. Dollar stores continue to perform well due to their inexpensive convenience items crafted to serve low-income households. Grocery stores remain a highly sought-after asset as well, which can be largely attributed to the continued improvement of the overall experience. Dine-in options, wine and cheese bars, and more quality products keep foot traffic high and occupancy strong for owners of these assets. Necessity-based stores, like grocers, have proved to be relatively resistant to the rise of e-commerce.

Retail Sales Growth *



Internet Sales Continue to Rise

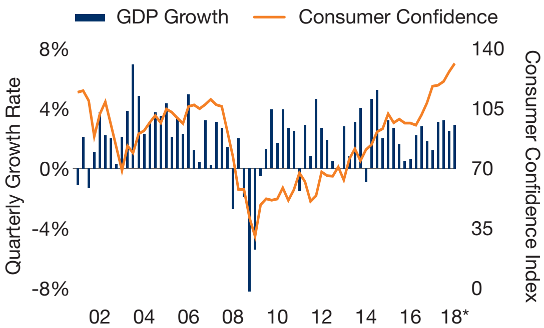


* Through February

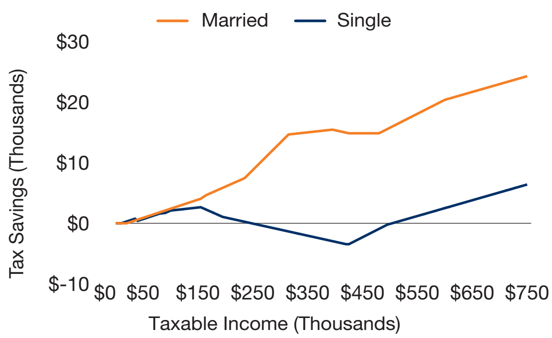
** Through January

Marcus & Millichap

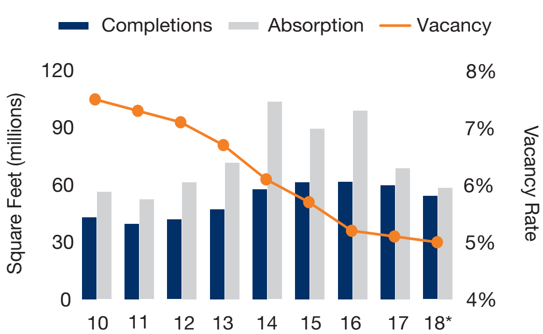
Economic Growth to Accelerate



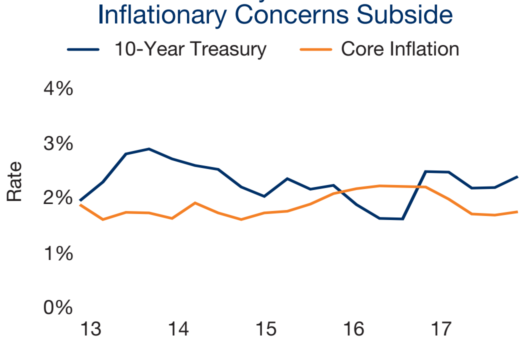
New Tax Law Savings



Retail Supply and Demand



10-Year Treasury vs. Core Inflation
Inflationary Concerns Subside



* Forecast

Tax Reform Boosting Real Estate Prospects; Deductions May Provide Tailwinds

Recently passed tax reform to drive economic growth; corporate capital investment rising. Following the passage of the Tax Cuts and Jobs Act in late 2017, business and consumer confidence rose considerably, boosting prospects for faster growth over the coming year. Numerous firms have committed to paying bonuses to their employees, while several large corporations have announced multibillion dollar investment plans as overseas earnings are repatriated. The combination of these factors, coupled with a national unemployment rate at the lowest level since 2000, will boost economic prospects in the months ahead. Incredibly tight labor markets nationally are beginning to have a significant impact on wage inflation, with average hourly earnings rising 2.7 percent over the past year in January, the fastest annual growth since June 2009.

Key real estate tax provisions remain in place. While early iterations of tax reform highlighted the potential for real estate-related provisions to receive higher levels of scrutiny from lawmakers on Capitol Hill, the final law left the vast majority of the key statutes in place, including the cornerstone tax-deferred 1031 exchange. Lease expenses for businesses also remain fully deductible under new tax provisions, while the deductibility of interest on debt is limited. This could lead to increased use of sale-leasebacks. The strategy aims to increase company profits by positioning expenses to areas that maximize deductibility. This will likely expand the inventory of net-leased assets coming to market. The new 20 percent pass-through deduction, on the other hand, could boost investor demand for these low-management investment options.

Development Benign as Interest Rates Rise

Rising construction costs prompt contracting pipeline. As the retail marketplace has improved throughout the cycle, builders have largely responded by supplying build-to-suit product for net-leased tenants. As a result, single-tenant structures have routinely made up more than two-thirds of annual deliveries since the recovery began in 2009. Despite rising inventory availability due to several high-profile closings, net absorption has remained positive, generating robust growth in the average asking rent, which rose above 2008 levels for the first time in 2017. Elevated development costs that could be bolstered by the new metal tariffs may trigger further upside in asking rents as tenants vie for the limited space coming online.

Interest rates remain on gradual path upward as growth and inflation rise. Following the passage of tax reform, long-term interest rates have reached the highest yield since 2014 as banks expect a pickup in bond rates and inflation. As the yield curve steepens to reflect economic growth potential, investors will take a more measured approach to capital allocation. Moving forward, the Federal Reserve's intention to reduce its balance sheet will place additional upward pressure on long-term rates as well, while its stated goal of three rate hikes in 2018 will tighten overall liquidity in the marketplace. Nonetheless, cap rate spreads remain at historically positive levels, which may temper the overall effect of higher lending rates, particularly as net-lease transactions typically employ large cash components.

Brand	Locations
Auto Parts	
Bridgestone/Firestone	2,200
O'Reilly Auto Parts	4,984
AutoZone	6,023
Advance Auto Parts	5,203
Pep Boys	973
Dollar Stores	
Dollar General	14,321
Dollar Tree/Family Dollar	14,744
General Retail	
Walmart	11,703
Sherwin-Williams	4,230
AT&T	16,000
Verizon Wireless	2,330
Mattress Firm	3,500
Office Depot/Max	1,404
Pharmacies	
CVS	10,014
Walgreens	8,201
Rite Aid	4,404
Quick-Service Restaurants	
Dairy Queen	4,600
Starbucks	28,039
Chipotle	2,374
McDonald's	36,976
Yum Brands	44,352
Burger King	23,742
Wendy's	6,586
Carl's Jr./Hardee's	3,344
Fast Casual	
Chili's	1,682
Darden Restaurants	1,722
Red Lobster	705
Bloomin' Brands	1,491
Applebee's	2,016
Ruby Tuesday	541

Closed Cap Rate Range by Brand*

Cap rates shown above are representative of transactions that closed in 2017. 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.

* For transactions closed in 2017
Sources: CoStar Group, Inc.; CreditNtell; company sources

Capital Markets

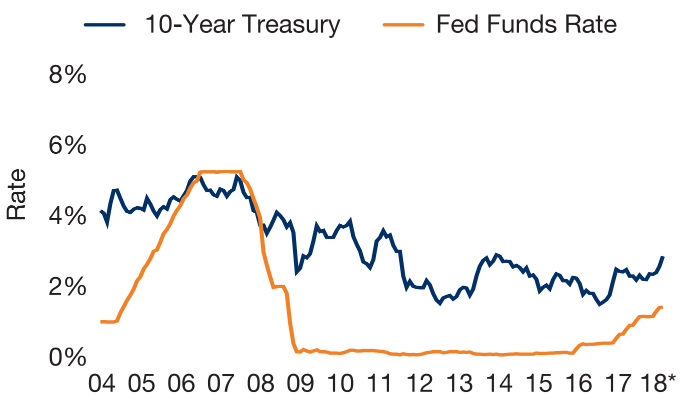
By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

Fed Normalization Signals Rising Interest Rates; Lenders Take Disciplined Approach

Fed carefully considers tighter policies as new chairman takes the helm. The Federal Reserve has hinted at three to four increases of the fed funds rate during 2018 as it hedges against inflation risk amid accelerated economic growth. The potential for higher inflation could prompt a more aggressive approach; however, the Fed will be cautious about pushing rates up too quickly as it does not want to stall the economy. Inflationary concerns and higher interest rates have driven a recent surge of volatility in the equity markets. Investors are worried that rising interest rates will reduce their stock market returns as the elevated costs of borrowing could cut into corporate profits. Additional uncertainty regarding the new untested leadership of Fed Chairman Jerome Powell contributed to the volatility. His policies have yet to be clarified, though he will likely continue reducing the balance sheet in an effort to move long-term rates higher. Despite increased concerns, the economy remains on strong footing and after several years of steady growth in equity markets, a correction was likely. Investors will remain cautious, however, realigning their strategies as necessary to meet their needs. Commercial real estate will offer some of these investors a compelling alternative with relatively less volatility and competitive yields.

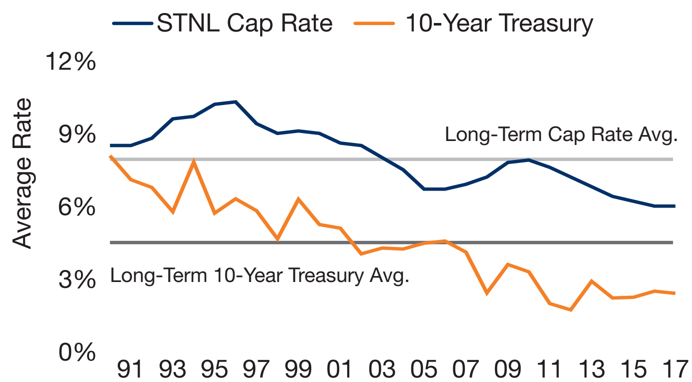
Retail lending environment shifts amid sector uncertainty. National and regional banks have stepped in as key lenders for retail properties as CMBS lending eased amid heightened risk aversion in the sector that has persisted since 2016. In general, credit standards have held steady and the trend should continue into 2018 as lenders search for deals. Many originators are becoming increasingly selective about big-box retail deals as several national retailers have announced closures. Strip centers with grocery-anchored or service-oriented tenants may be favored opportunities moving forward. Construction lending will remain conservative and below-average completions will likely benefit vacancy as the retail landscape evolves.

10-Year Treasury vs. Fed Funds Rate
Fed Funds Rate Steadily Rises



* Through February

Yield Spread Still Supportive Of Net-Lease Investment



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