

STNL – YTD Observations and Projections

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We continue to view the current environment with amazement and curiosity as we are nearly 10 months into the pandemic and the election cycle. We answer the questions that investors are asking:

- What is the impact of COVID on the STNL market?
 - Will demand shift over time?
- What about returns?
 - What are interest rates doing?
 - What is the trajectory of cap rates?
- Timing – Should I buy, sell or hold?
 - What to buy? What to sell?

What is the impact of COVID on the STNL market?

In a nutshell, the COVID environment has clearly benefited investment grade essential businesses such as grocery stores, dollar stores, big box discount retailers. This has created extremely high demand and lowered the supply of quality STNL assets with broker transaction volume reported to be 19% lower thru the 3rd quarter of 2020 vs. the same quarter in 2019. Demand is such that dollar stores are often put under contract within a few days of being offered for sale with many competing offers. Investors are looking for long-term stability and a strong corporate guarantee and having a tough time finding properties in their preferred markets. Not surprisingly, net lease sectors that are dependent upon social distancing continue to struggle.

What about returns?

“Returns” are a function of two factors: **interest rates** and **cap rates**. Lenders will tell investors that there is plenty of money to lend and **interest rates** will be good even after the presidential election. This is true, BUT lenders are underwriting deals much more stringently than pre-COVID. They are turning away deals in smaller markets and requiring even the strongest of borrowers to demonstrate financial strength via larger down payments with closing cycles taking longer as well. Additionally, **cap rates**, due primarily to limited supply, continue to compress, even for properties with shorter remaining lease terms.

According to the 3rd Quarter Morgan Stanley Net Lease, survey that Bull Realty participates in, year-to-date, interest rates are down 42 bps for both the STNL and the industrial sector, while cap rates are down 19 bps. (*FYI and not surprising, interest rates and cap rates have INCREASED in the office sector.*)

Timing – Should I buy, sell or hold?

Buying? So long as you are buying on the basis of solid fundamentals, it is always a good time to buy! What are the fundamentals? *To name a few - quality of tenant/guarantor, strong site characteristics, rent increases/options, tenant is good match for area, appropriate demos, and overall positive economic trends in the locale.*

What to buy? First, determine your risk tolerance and budget. Don't rule out strong investment grade properties, even with shorter lease terms, if they meet the fundamentals just mentioned. Consider QSR's. Many are coming back stronger than ever. Also, auto parts/repair tenants are likely to remain desirable (as reflected in lower cap rates) since we are likely to continue driving more for the foreseeable future (vs. flying for business and pleasure.)

Selling? Investors that have held an asset for a long time and have experienced the bulk of their depreciation should consider selling in the current environment. Now is the time to upgrade the portfolio and use current low interest rates and cash out to acquire a new, longer term lease. Do not worry about cap rates (e.g. that you may be buying into a cap rate that is lower than you initially bought this asset!) Be joyous that you will be able to do this again in the next cycle.

Holding? If you are uncertain about selling or in the middle of a long lease, consider when your property will be at peak value to maximize your returns. Talk with a STNL expert to see what the benefits of selling vs. holding are.

In summary, we advise STNL investors to weather through the opportunities and challenges of the current environment. Despite obstacles investors may have faced, this asset class has proven to provide exceptional returns and relatively low risk.

