EXAMINING THE EFFECT OF RISING INTEREST RATES ON NET LEASE REITS

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INTRODUCTION

The net lease market has been highly competitive for the first half of 2013 with buyers pursuing office and industrial product at all-time low cap rates. Net lease REITs rely on modest leverage to make acquisitions, and these facilities are often at the mercy of the interest rate environment. If interest rates go up, borrowing costs go up, which impacts spread and REIT profitability. Since May, the 10-year treasury note has risen steadily causing investors to pull back from their REIT allocations and require higher risk adjusted returns.

With the Fed keeping interest rates at rock bottom for the past several years, rising rates have been expected by REITs. It can be argued that a rising interest rate environment is a result of an improving economy driven by the housing market, job growth, and a decline in office vacancy. All these economic factors result in NOI growth for the REIT sector. Moreover, many REITs have already taken steps to protect themselves by using interest rate caps, swaps, and other financial tools to lock in low rates and profitability on their existing NOIs. However, investor speculation has arisen as to whether the anticipated increase in rates will hurt REITs' ability to acquire accretive assets in volume, which has come to be expected for NNN REITs that have grown exponentially over the past 24 months.

We have analyzed several indicators to gain further insight into this issue including:

- Institutional Acceptance of Net Lease Asset Class and Market Size

- Interest Rate Forecasts and Fed Guidance

- Cap Rates & REIT Performance

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INSTITUTIONAL ACCEPTANCE OF NET LEASE ASSET CLASS

The net lease sector has vastly expanded over the last few years, as evidenced by the growing sales volume, with $24.3 billion in 2012 and $12.3 billion through June 2013. In the wake of the Great Recession, there has been a flight to quality and current cash flow. Investors traded speculative appreciation for fixed income yield, which was the allure of the net lease sector. Investing in net lease real estate leased to an investment grade company generates a higher yield than its corporate bond equivalent, and arguably results in a higher expected value due to higher recovery rates. The higher recovery rates are driven by owning the hard asset and also the probability that the tenant will reaffirm their lease and operate their business as they emerge out of bankruptcy. The higher yield coupled with the higher recovery rates results in a superior risk-adjusted return to investors looking for capital preservation. The higher expected value coupled with the high yield are the reason why the niche sector has exploded and become an accepted real estate asset class among both retail and institutional investors.

The current enterprise value of the net lease REITS has increased from $30 billion in 2006 to a current value of $83.4 billion, or approximately 10% of the NAREIT index. It is expected to increase to approximately $100 billion over the next 3 years. The influx of capital into the net lease space will only increase as more investors realize that it has performed well in both a bull and bear market. The inflow of new capital will not be enough to absorb the $2 trillion domestic market that continues to grow. This includes real estate on corporate balance sheets, existing single tenant properties, government properties, and to be built facilities. In 2012, there was approximately 180,000,000 SF of built to suits under construction, up from 82,000,000 SF in 2011. Assuming an average of $80/sf for new construction, this is approximately $15 billion dollars of new product that will enter the marketplace in 2013-2014.

With the ample supply of new product coupled with the predictable income stream, the net lease sector has demonstrated the scalability of the business model and has transformed the niche strategy into a relevant asset class. This is evidenced by the large consolidations and IPO announcements that have transpired over the last 18 months. American Realty Capital Properties Inc. recently announced its plans to buy CapLease, Inc. and Truststreet Properties for an acquisition total of $3.65 billion. Spirit Realty Capital Inc. merged with Cole Credit Property Trust II to create a combined enterprise value of $7.1 billion. In addition, Realty Income acquired American Realty Capital Trust for $2.9 billion.

The $2 trillion domestic net lease market will continue to be fragmented so the opportunity to buy one-off properties at attractive yields will still be available. What has become evident is the cap rate compression that has occurred for large portfolios of net lease properties. The public and non-traded public REITs will continue to pay a premium for investment grade portfolios that increase their size and drive down their cost of funds.

INTEREST RATE FORECASTS AND FED GUIDANCE

The FOMC has kept the Federal Funds Rate at 0 - 0.25% and currently anticipates this low range as long as unemployment remains above 6.5%. Inflation is projected to be is projected to grow no more than 0.5% percent over the next two years with the long-term objective of stabilizing at 2% year over year. When the FOMC decides to remove policy accommodation, it is expected to take a balanced approach consistent with its long-term objectives.

Unemployment currently stands at 7.4%. The Fed is still buying $85 billion in bonds every month while the economy modestly improves. No changes are imminent to interest rates, but the bond buyback program is expected to be trimmed back in the near future. Recent remarks indicate this “quantitative easing” program to continue through 2014.

As illustrated in Exhibits 1 and 2, both LIBOR and the 10-Yr Treasury are expected to make steady advances beginning in 2015 and continue for the next several years. At this point, it’s safe to assume that rates will rise in the next few years, but it appears unlikely there will be any sizeable increases as rates normalize around 4.5% over the next 10 years.

Exhibit 1: 30-Day LIBOR Forward

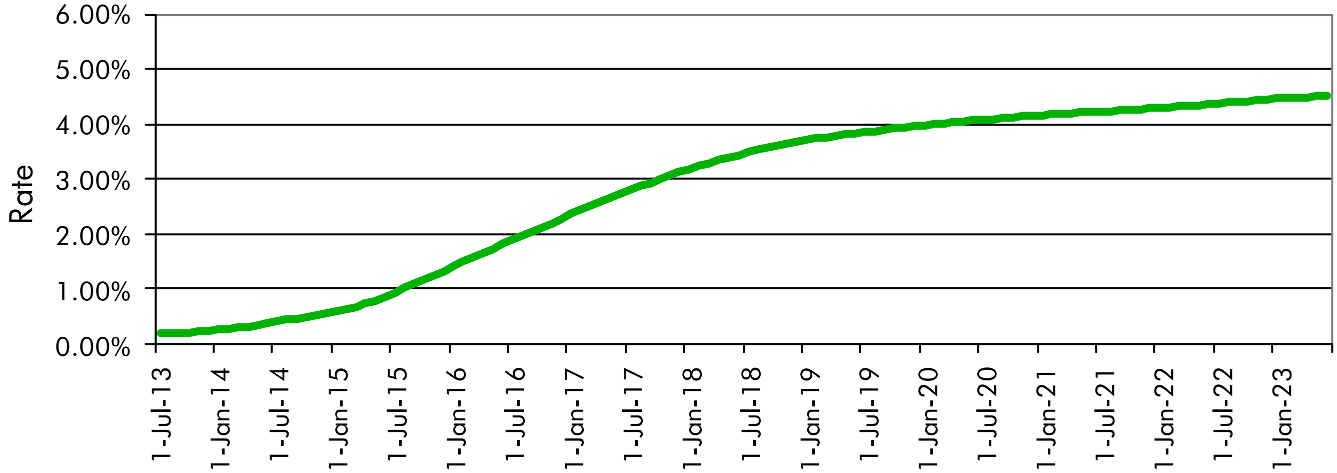
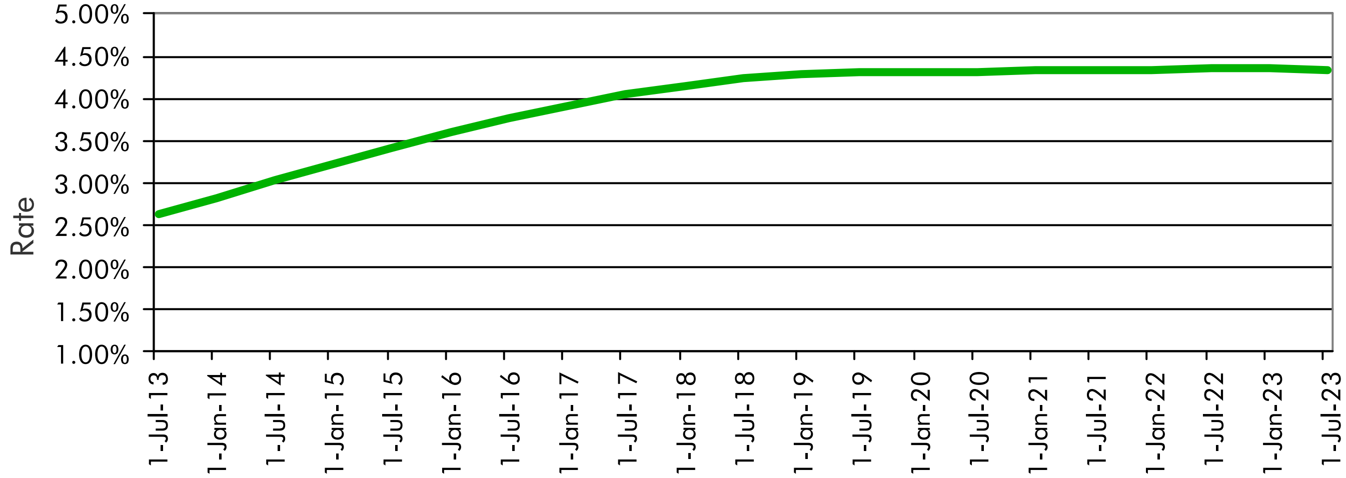


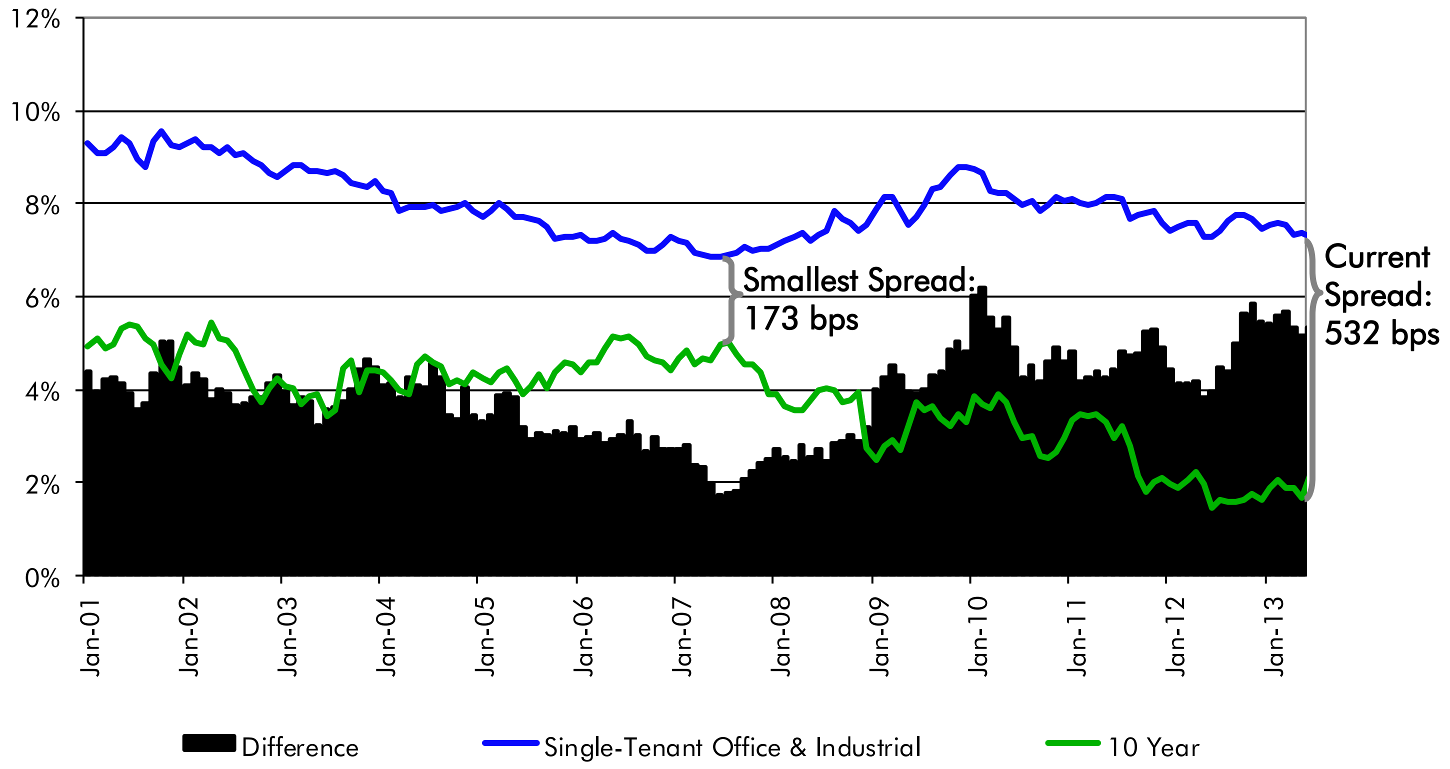
Exhibit 2: 10-Yr Treasury Forward



SOURCE: CHATHAM FINANCIAL

CAP RATES & REIT PERFORMANCE

Exhibit 3: Single-Tenant Office/Industrial Cap Rates vs. 10-Yr Treasury



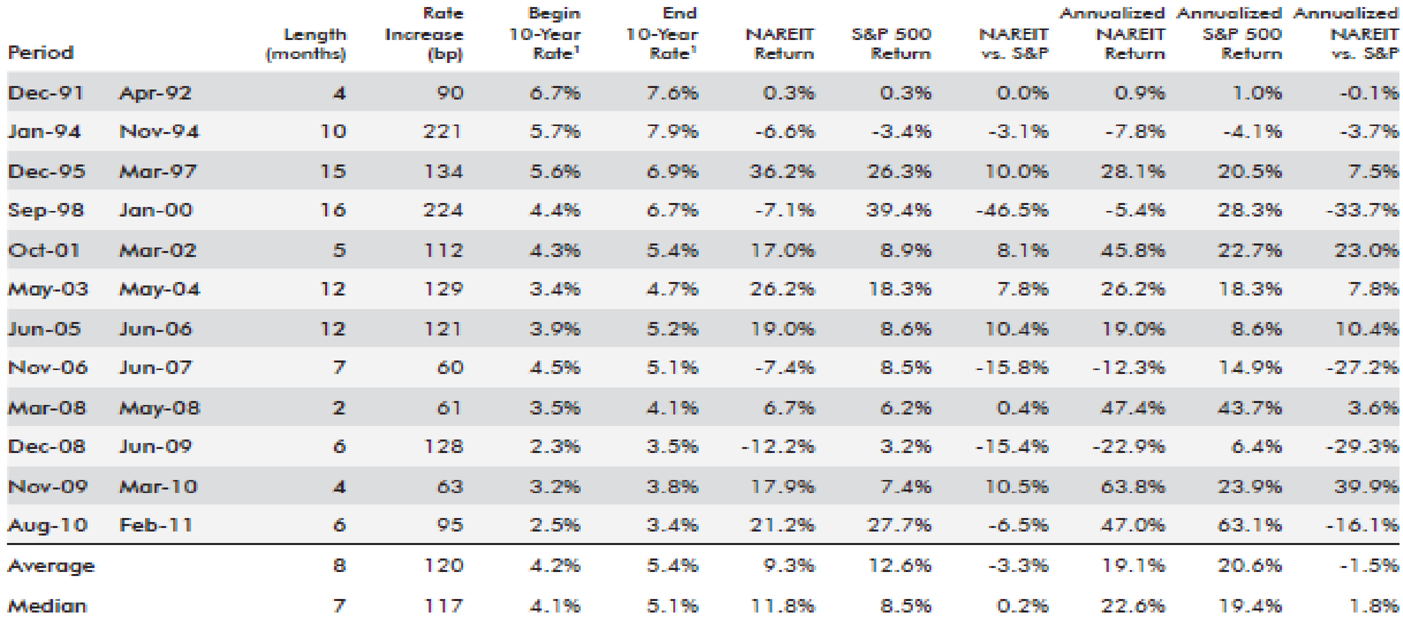
SOURCE: REAL CAPITAL ANALYTICS & FEDERAL RESERVE

There has been significant cap rate compression in the last few years, but cap rates have recently started to stagnate. The overall market continues to be in the mid-to- high 7% range with some of the larger REITs sporadically paying premiums for "trophy" net lease assets and investment grade portfolios at cap rates closer to 6%.

Interest rates were at the highest point of the last 10 years in 2006-08. However as demonstrated in Exhibit 3, cap rates were reaching all-time lows during that period of time, even with the increased interest rates.

Interest rate increases in regards to REITs are typically viewed in a negative light but can be two-fold. Interest rate increases also signal an improving economy and growth prospects with the potential to improve occupancy and rental rates. As demonstrated in Exhibit 4, under certain conditions, REITs have actually shown strong performance during times of rising rates. Since the Fed is only going to be increasing rates for signs of an improving economy, REITs will be able to continue to find accretive acquisition opportunities for their existing portfolio.

Exhibit 4: Rising Interest Rates and Listed Real Estate Performance



Period		Length (months)	Rate Increase (bp)	Begin 10-Year Rate[1]	End 10-Year Rate[1]	NAREIT Return	S&P 500 Return	NAREIT vs. S&P	Annualized NAREIT Return	Annualized S&P 500 Return	Annualized NAREIT vs. S&P
Dec-91	Apr-92	4	90	6.7%	7.6%	0.3%	0.3%	0.0%	0.9%	1.0%	-0.1%
Jan-94	Nov-94	10	221	5.7%	7.9%	-6.6%	-3.4%	-3.1%	-7.8%	-4.1%	-3.7%
Dec-95	Mar-97	15	134	5.6%	6.9%	36.2%	26.3%	10.0%	28.1%	20.5%	7.5%
Sep-98	Jan-00	16	224	4.4%	6.7%	-7.1%	39.4%	-46.5%	-5.4%	28.3%	-33.7%
Oct-01	Mar-02	5	112	4.3%	5.4%	17.0%	8.9%	8.1%	45.8%	22.7%	23.0%
May-03	May-04	12	129	3.4%	4.7%	26.2%	18.3%	7.8%	26.2%	18.3%	7.8%
Jun-05	Jun-06	12	121	3.9%	5.2%	19.0%	8.6%	10.4%	19.0%	8.6%	10.4%
Nov-06	Jun-07	7	60	4.5%	5.1%	-7.4%	8.5%	-15.8%	-12.3%	14.9%	-27.2%
Mar-08	May-08	2	61	3.5%	4.1%	6.7%	6.2%	0.4%	47.4%	43.7%	3.6%
Dec-08	Jun-09	6	128	2.3%	3.5%	-12.2%	3.2%	-15.4%	-22.9%	6.4%	-29.3%
Nov-09	Mar-10	4	63	3.2%	3.8%	17.9%	7.4%	10.5%	63.8%	23.9%	39.9%
Aug-10	Feb-11	6	95	2.5%	3.4%	21.2%	27.7%	-6.5%	47.0%	63.1%	-16.1%
Average		8	120	4.2%	5.4%	9.3%	12.6%	-3.3%	19.1%	20.6%	-1.5%
Median		7	117	4.1%	5.1%	11.8%	8.5%	0.2%	22.6%	19.4%	1.8%

SOURCE: CBRE

CONCLUSION

REITs were still buying assets at 7.5% caps in the 2006-08 period, even when the 10-yr treasury was at 5.5%. The lowest spread between interest rates and cap rates in the past ten years was 1.73% in June 2007, as shown by Exhibit 3. Currently the spread between cap rates and interest rates is 5.32%, which offers room for interest rates to increase while continuing to create yield. Even with the interest rate normalized at 4.5%, the spread would still be approximately 300 bps, which is a historically accepted risk premium for commercial real estate investments.

Even with the increased appetite for net lease product, cap rate levels have remained similar to those in the past. When interest rates start to meaningfully increase in 2015, cap rates are projected to stay steady with a modest increase. There will be periods when cap rates may jump 50bp as investors get spooked by rate increases, but these will only create buying opportunities for the investors who understand the market. In the long run, there will be great demand for net lease office and industrial product due to net lease becoming an “institutionally accepted” asset class.

The net lease REIT space has seen significant consolidation in the past few months, and with this consolidation and growth comes a cheaper cost of capital. In essence, REITs are competing to become the biggest and gain the cheapest cost of capital. As REITs continue to grow, they will need to acquire more assets. With these levels of expected growth, REITs will continue to pay a premium for investment grade, net lease portfolios.

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