EXAMINING THE EFFECT OF RISING INTEREST RATES ON THE NET LEASE SECTOR

December 2016

INTRODUCTION

Given the attractive yields and strong preservation of capital offered by the sector, the net lease space has seen an influx of capital from both domestic and foreign institutional investors. Furthermore, the income stability and wealth preservation of the net lease sector makes it an attractive asset class in various points of both economic and real estate cycles. With that said, after several years of the Federal Reserve keeping interest rates at low levels, continued signs of gradual economic progress have increased market expectations that a gradual increase in interest rates is likely forthcoming. As a result, investor speculation has arisen as to how the anticipated increase in rates will impact yields and returns for net lease investors.

However, as mentioned prior, the net lease sector provides valuable yields and returns to investors at various points in economic cycles, and the net lease space is well positioned for the current environment for several reasons including improving U.S. economic conditions, a wide spread between treasury yields and cap rates, and an increasing level of liquidity in the sector as capital continues to flow into the net lease space. This influx of capital should provide additional stability to cap rates as interest rates rise. Additionally, historic evidence has shown that REIT shares typically perform well during periods of rising interest rates, which provides support that commercial real estate investors directly benefit from the underlying improvement in economic forces that typically drive interest rates higher.

Within this paper, we have analyzed several indicators to provide 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

Following the Great Recession, there has been a flight to quality and current cash flow. Investors have traded speculative appreciation for fixed income yield, which has drawn attention to the net lease sector. Real estate assets that are net leased to tenants with high credit quality on a long term basis provide stable and predictable cash flow at a risk that compares favorably to the fixed income profile of a tenant's equivalent corporate bond. Net lease real estate may provide a higher investment yield than unsecured bonds, and the investment is collateralized by hard assets that have the potential for capital appreciation upon exit. Additionally, the probability of default on an unsecured bond is similar to tenant bankruptcy. In a net lease, however, the real estate provides additional forms of recovery relative to unsecured corporate bonds.

The enterprise value of the net lease REITs has increased from $24 billion in 2010 to a current value of approximately $102 billion as of December 1, 2016. Additionally, annual investment activity in the U.S. net lease sector has grown substantially over the last several years as evidenced by the increase in sales volume from $26.2 billion in 2012 to $48.4 billion in 2015. As more investors realize the space has shown the ability to perform well in both bear and bull markets, capital is expected to continue to pour into the net lease space. With that said, the inflow of new capital will not be enough to absorb the $2.4 trillion domestic owner-occupied real estate market that continues to grow. The market includes real estate on corporate balance sheets, existing single tenant properties and government properties, and growth will be driven by both corporations and businesses building new facilities over the next several years as well as corporations who are seeking to monetize their real estate holdings by utilizing the sale leaseback market. More specifically, estimated planned construction starts (including build-to-suits) in the U.S. manufacturing, office and healthcare sectors are expected to be approximately $180 billion in each of the next four years.

The ample supply of new product and the predictable income stream of the net lease sector have demonstrated the scalability of the business model and have transformed a once considered niche strategy into a highly relevant asset class. New and existing investors are looking to credit and lease quality as a means of risk mitigation and the net lease sector's ability to limit real estate investment risk is expanding the demand for single tenant assets with long lease terms. Also, as global markets remain volatile, foreign investors have shown an increased interest in the net lease sector, and through the first nine months of 2016, foreign investment in the net lease sector has reached approximately $2.9 billion, according to JLL Research. Moving forward, the amount of foreign capital entering the market is expected to continue to increase over the next several years. Consequently, there will be significant opportunities for both private and public real estate managers to grow their platforms by partnering with foreign investors. The platforms with unique strategies, proven track records, and experienced management teams capable of producing the best risk adjusted returns will benefit from this influx of capital which in turn will spur organic growth in the industry.

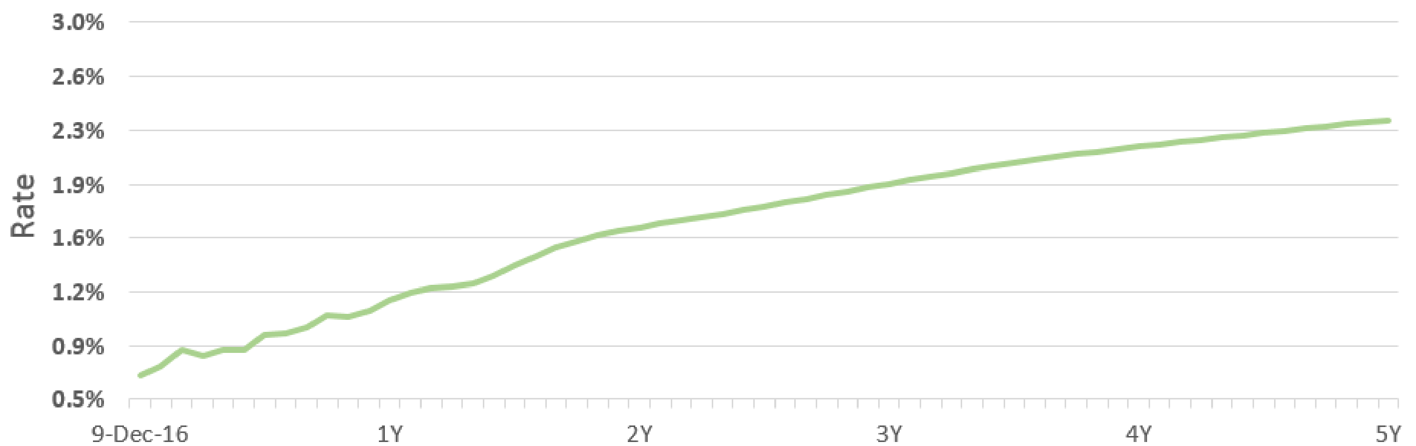
Looking forward, institutional and foreign investors are expected to continue to seek stable returns through net lease assets and the reclassification of real estate to its own GICS headline sector is expected to bring more attention and transparency to the industry. Additionally, given the fragmented nature of the $2.4 trillion domestic owner-occupied real estate market, the opportunity to buy one-off properties at attractive yields is expected to remain viable moving forward.

INTEREST RATE FORECASTS AND FED GUIDANCE

In December of 2016, the FOMC raised Federal Funds Target Rate Range by 25 basis points to 0.50% - 0.75% driven by recent increases in economic growth. Additionally, the Federal Reserve members anticipate three additional interest rate hikes in 2017. With that said, Janet Yellen noted that inflation remains persistently low and future rate hikes will follow a path of "gradual increases". Thus, as economic indicators are showing gradual improvement and, with the outcome of the presidential election settled and employment and inflation slowly rising, most economists and market participants expect an increasing interest rate environment in the U.S. over the next several years.

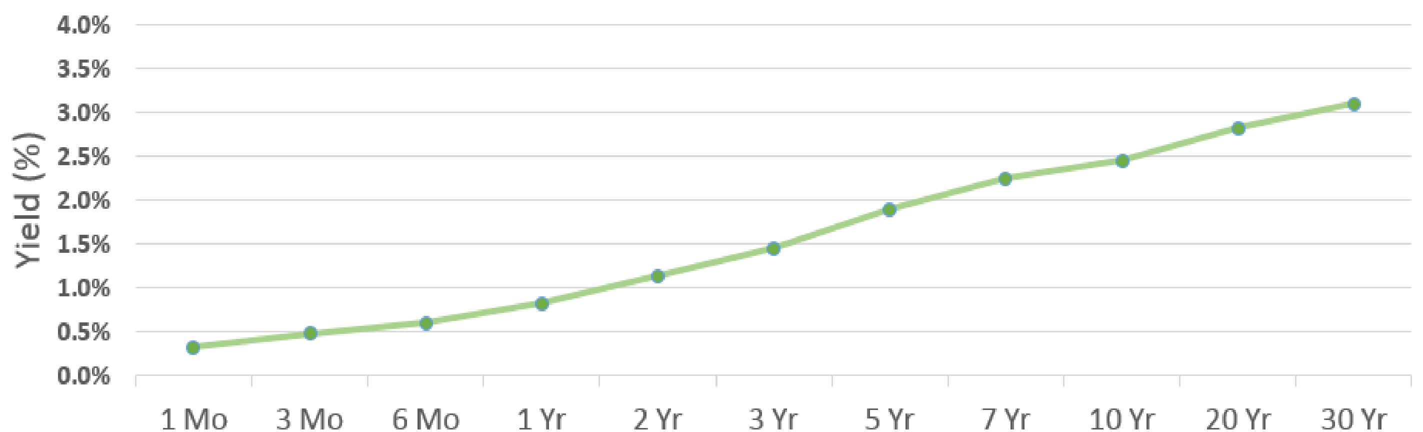
As illustrated in Exhibit 1, LIBOR is expected to make steady advances beginning in December of 2016 and throughout the next several years. As illustrated in Exhibit 2, the current treasury yield curve presents a fairly normal, upward sloping structure suggesting interest rates will likely rise moving forward. Considering current economic conditions, economic outlook and federal reserve policy, it seems relatively safe to assume that interest rates will rise over the next few years. With that said, it is important to note that the rise in interest rates is expected to occur in a gradual, steady manner over several years.

Exhibit 1: 30-Day LIBOR Forward (as of December 9, 2016)



Source: Thomson Reuters

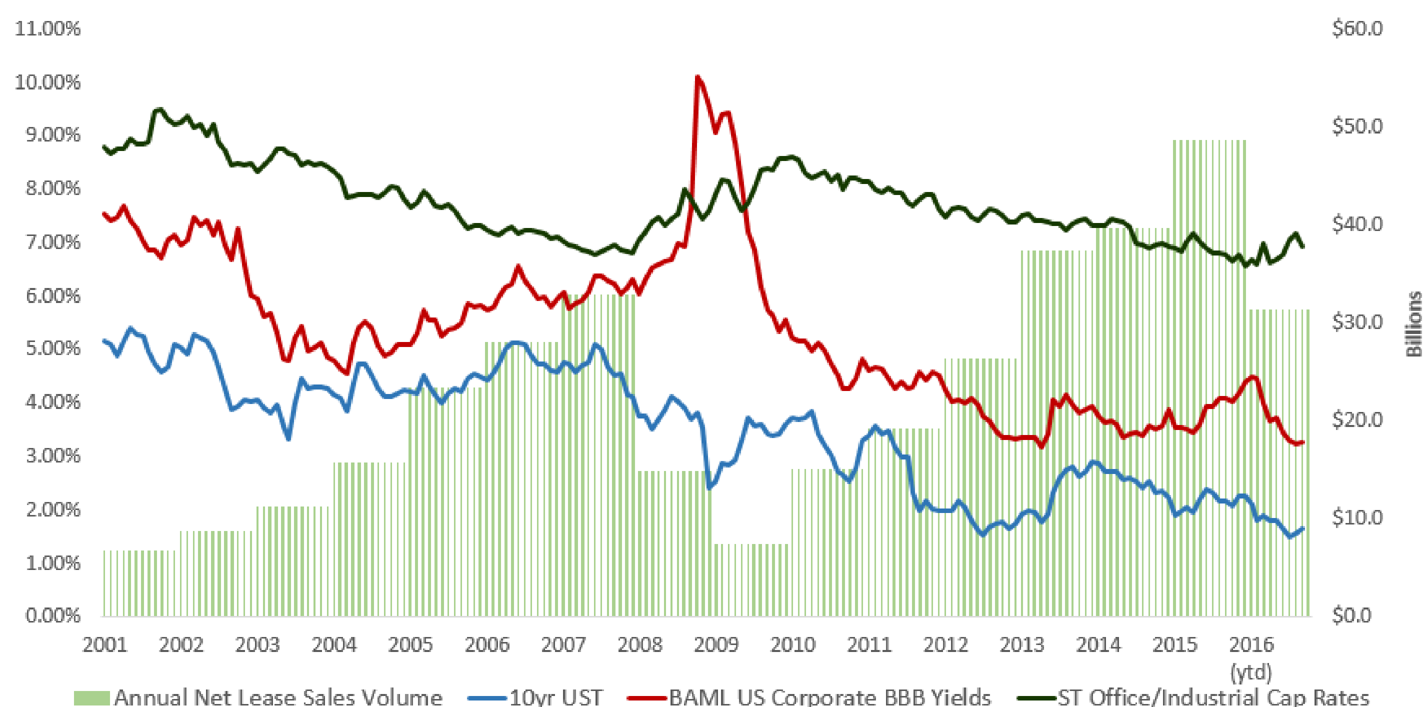
Exhibit 2: Treasury Yield Curve (as of December 1, 2016)



Source: U.S. Department of the Treasury

CAP RATES & REIT PERFORMANCE

Exhibit 3: Historical Cap Rates vs. 10yr UST and BBB Bond Yields



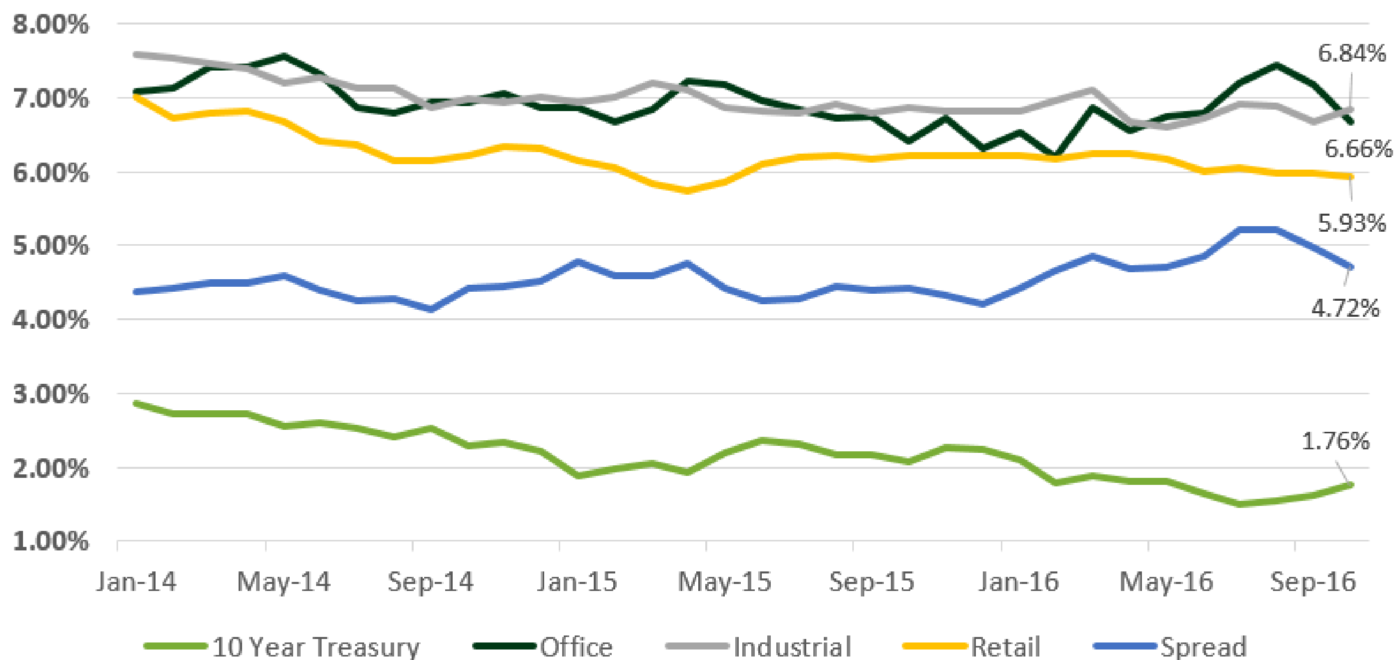
Sources: Real Capital Analytics, U.S. Department of Treasury, Federal Reserve Economic Data
Time Period: 1/1/2001—10/31/2016

As shown in the graph above, net lease cap rates have remained relatively stable over the past nearly 15 year period. Additionally, the belief that cap rates move in lockstep with interest rates is generally misguided. As shown in the 2003 through 2007 period, cap rates generally declined from approximately 8.5% to 7.0% driven by increased demand for net leased assets and consistent growth in sales volumes. During that same period, the 10yr UST increased approximately 150 basis points and the spread between interest rates and cap rates closed fairly significantly. The Great Recession led to a subsequent widening of the spread as interest rates declined and cap rates increased, but it's important to note that although net lease cap rates did increase, the move was fairly limited and cap rates did not jump as sporadically as bond yields. Additionally, as the economy improved, net lease transaction volume returned to a growth pattern and cap rates began their gradual descent to the 6.0% - 7.5% range currently seen in the industry today (see chart and discussion on page five for further detail on short term cap rate trends).

Additionally, historical data has shown that the spread between interest rates and net lease cap rates has a stronger correlation with the 10yr UST than net lease cap rates. We believe this indicates that when interest rates decrease, the spread between interest rates and net lease cap rates generally widens and, in periods of rising interest rates, the spread between interest rates and net lease cap rates generally shrinks. In particular, in the 2010 through year to date 2016 period, both interest rates and net lease cap rates decreased, but interest rates decreased substantially more than cap rates, leading to a widening of the spread. We believe this widening of the spread above historical levels has created room for interest rates to rise while still allowing net leased investors to obtain additional risk-adjusted yield over treasury yields at current cap rate levels.

CAP RATES & REIT PERFORMANCE (Continued)

Exhibit 4: Single-Tenant Office/Industrial/Retail Cap Rates vs. 10-Yr Treasury



Source: Real Capital Analytics

Moreover, looking at a more short-term period following a period of cap rate compression, cap rates remained relatively stable at low levels from the beginning of 2014 through October of 2016. As a whole, net lease cap rates continue to remain in the 6.0% - 7.5% range and the spread over treasury yields has widened over last several years relative to historical levels. Currently, the spread between net lease cap rates and the 10yr UST is 4.72%, which, as mentioned prior, offers room for interest rates to rise while continuing to allow net lease assets to offer an attractive risk-adjusted yield premium relative to treasury rates. More specifically, even after assuming a significant move to a more "normalized" treasury yield of 4.00%, the spread would still be approximately 248 basis points, which is a historically accepted risk premium for commercial real estate investments.

In regards to REITs' profitability and performance, increases in interest rates are typically viewed in a negative light, but historical evidence has shown REIT shares benefit from the underlying improvement in economic forces that generally cause rates to move higher. Commercial real estate is typically a direct beneficiary of economic growth as improving economic conditions translate to higher occupancy levels and rental rates which can drive increases in net operating income and potentially capital values.

As demonstrated in Exhibit 4 on the next page, sell-off periods for REITs during periods of increasing interest rates are generally short-term in nature and REITs have actually been able to deliver strong performance during periods when interest rates are rising. Moreover, since the FOMC's interest rate policy is highly predicated on signs of an improving economy, REITs should be able to benefit from improving economic conditions when rates gradually rise over the next several years.

Exhibit 5: Rising Interest Rates and REIT Performance

Sell-Off Period		Days	Rate Rise During Sell-Off	Acute Periods of Interest Rate Fears: REITs Return	S&P 500 Return	REITs vs. S&P	Subsequent REIT Returns Post Sell-Off Period[1]: 180 days	1 Year	Subsequent S&P 500 Index Returns Post Sell-Off Period: 180 days	1 Year
Jun-94	Nov-94	159	0.93%	-11.1%	-1.4%	-9.7%	8.8%	24.1%	7.8%	36.5%
May-99	Dec-99	157	0.72%	-18.6%	4.8%	-23.4%	23.8%	33.9%	3.8%	-6.5%
May-04	May-04	26	0.70%	-14.4%	-1.5%	-12.9%	24.4%	33.5%	5.6%	7.0%
Mar-06	May-06	48	0.37%	-10.1%	-3.6%	-6.5%	27.6%	27.1%	11.0%	23.4%
Nov-10	Nov-10	8	0.31%	-9.1%	-3.8%	-5.4%	18.5%	11.2%	13.9%	7.2%
May-13	Aug-13	74	1.11%	-16.0%	1.5%	-17.4%	16.9%	26.3%	14.8%	22.9%
Jan-15	Jun-15	108	0.71%	-13.4%	3.0%	-16.5%	--	--	--	--
Averages		**83**	**0.69%**	**-13.2%**	**-0.1%**	**-13.1%**	**20.0%**	**26.0%**	**9.5%**	**15.1%**

Source: CBRE

CONCLUSION

Considering current economic outlook and federal reserve policy in the US, it seems relatively safe to assume that interest rates will rise over the next few years. With that said, many believe the rise in interest rates is expected to occur in a gradual, steady manner, in line with economic trends. In terms of the impact on cap rates, the spread between net lease cap rates and the 10yr UST is currently 4.72%, which, as mentioned before, offers room for interest rates to rise while continuing to allow net leased assets to offer attractive risk-adjusted yield premiums vs. treasury yields at current cap rate levels. Said differently, the current spread between cap rates and treasury yields is wide enough that a rise in interest rates would not necessitate an increase in cap rates to allow the net lease sector to continue to offer attractive risk-adjusted yield relative to treasury yields. Nonetheless, there will likely be periods when cap rates jump 50 basis points or so as the market is often discomforted by rate increases, but these short term movements will only create buying opportunities for seasoned investors who understand the market. Additionally, increasing interest rates should move concurrently with improving economic conditions which benefits the fundamentals of the commercial real estate industry and the net lease sector in particular.

Overall, in the long run there will be immense demand for net leased office and industrial assets due to strong underlying market forces as well as the net lease space becoming a more widely accepted asset class by both retail and institutional investors alike. Moving forward, both foreign and domestic investors will continue to look to credit and lease quality as a means of risk mitigation, and the net lease sector's ability to deliver impressive risk-adjusted returns will lead to increased demand for net lease assets, drive increased net lease sales volumes, provide support to cap rates and increase capital flow into the space.

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