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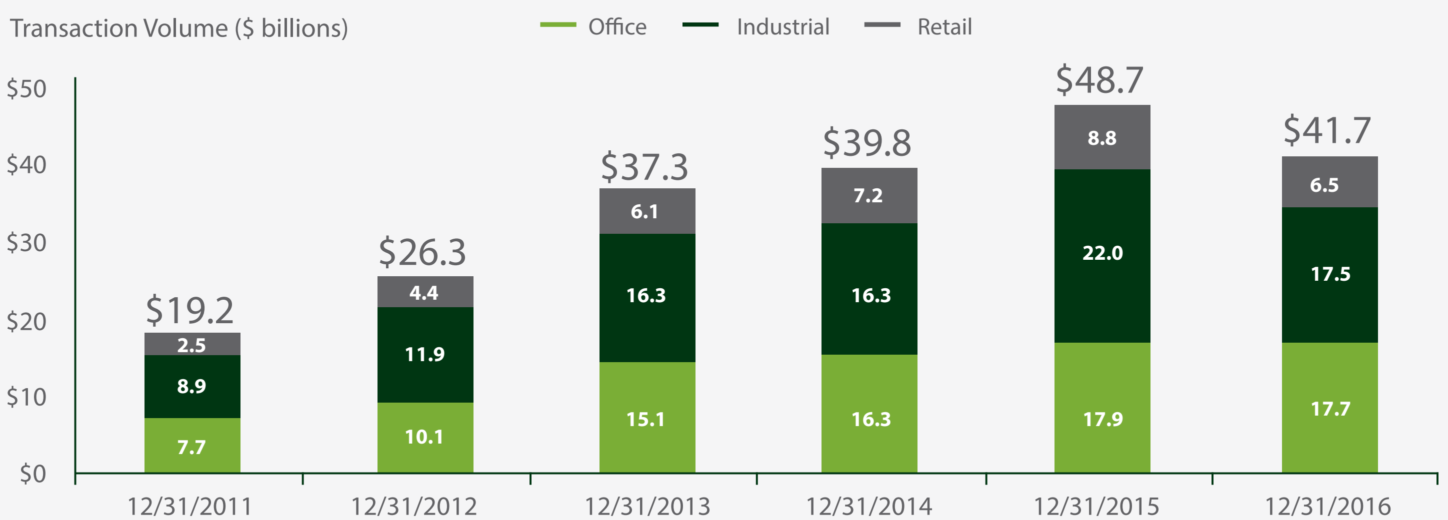
2016 Review and 2017 Outlook

Net Lease Market Remains Liquid:

Despite global market volatility and political uncertainty, the U.S. net lease sector had another historic year in 2016 as stable income and wealth preservation attracted capital from both domestic and foreign investors. As a result, transaction volume for net leased office, industrial and retail assets remained strong in 2016 at $41.7 billion. Despite being below the level of volume seen in 2015, annual sales hovered above historical levels and represented a continuation of liquidity in search of current income:

Annual Single-Tenant Net Lease Sales ($ billions)



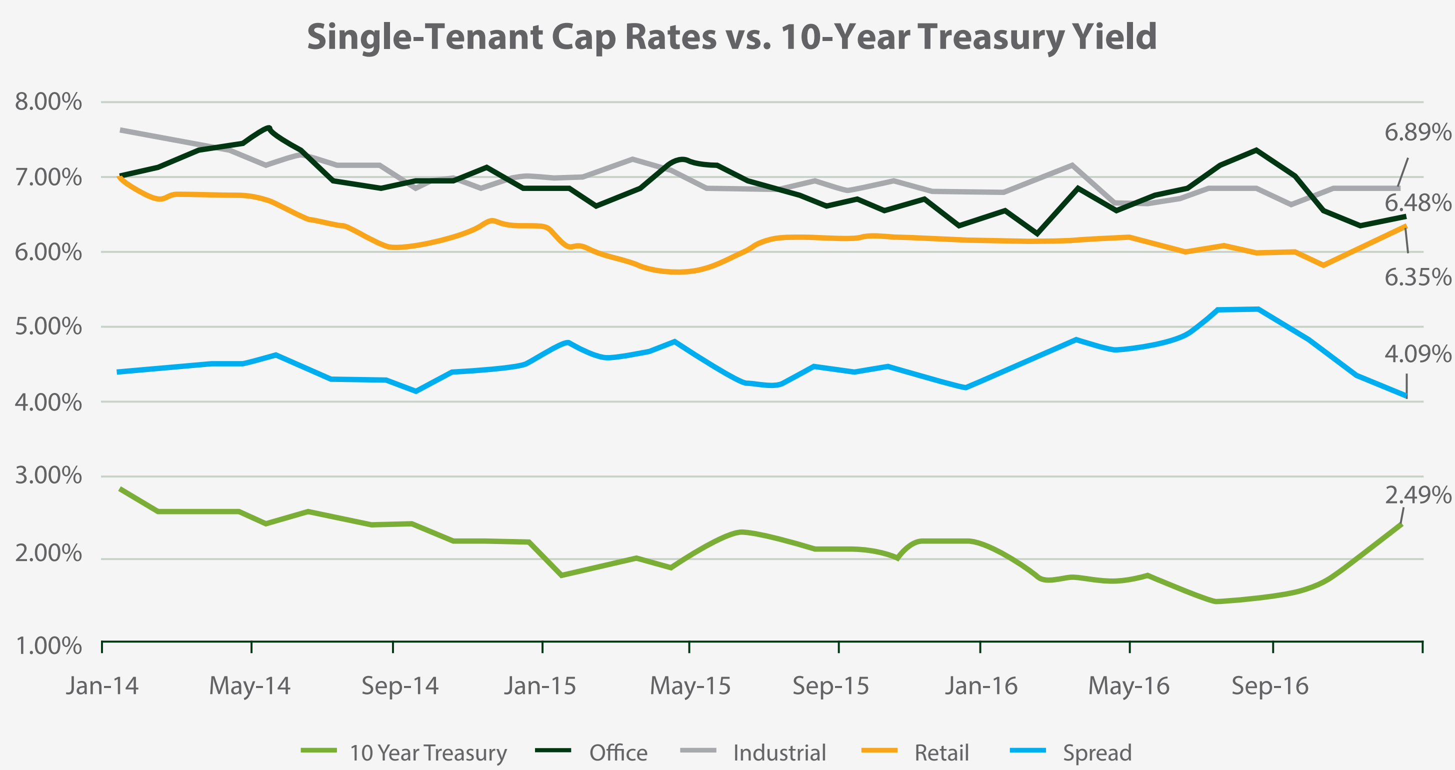
Source: Market data from RCA as of December 31, 2016.

Net lease sales volumes correlated with broader commercial real estate transaction volumes in 2016, which declined 11% year-over-year to $488.6 billion vs. $546.9 billion in 2015. The year-over-year decline in transaction volume was primarily a result of a drop in portfolio sales coupled with many institutional investors sidelined and recovering from their buying spree in 2015. Looking forward to 2017, liquidity in the net lease sector is expected to remain flat as net lease transaction volume will benefit from corporate build-to-suit activity driven by e-commerce and manufacturing, continued interest from foreign investors, and healthy risk-adjusted spreads given the historically low interest rate environment.

2016 and 2017 Review Outlook (continued)

Interest Rates & Cap Rates:

As shown in the graph below, cap rates for net leased retail assets reflected a slight uptick in the fourth quarter given the low cap rate levels over the last several years. In contrast, cap rates for industrial and office assets remained fairly stable in 2016 despite the increase in the 10 year U.S. treasury yield in the fourth quarter. The spread between net lease cap rates and the 10 year U.S. treasury yield compressed in the fourth quarter as net leased cap rates remained relatively stable. With that said, the spread between net lease cap rates and bond yields, per the Bank of America Merrill Lynch U.S. Corporate BBB index, is currently 2.85%, which is above the 15 year historical average spread of 2.42%. Theoretically, there is still 43 bps of embedded cushion to absorb any additional rise in interest rates before cap rates begin to rise.

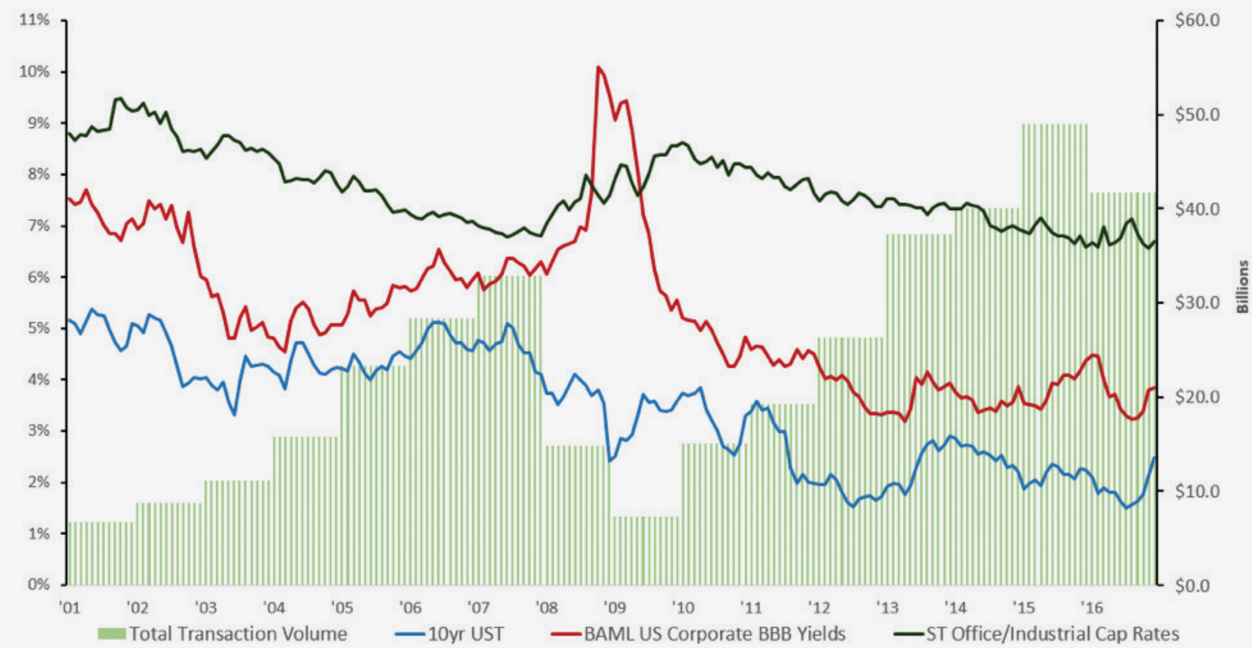


Source: Market data from RCA as of December 31, 2016.

Following the increase in interest rates in 2016 related to the presidential election, most market analysts expect interest rates to continue to rise in 2017. The Federal Reserve anticipates three additional interest rate hikes in 2017 as economic indicators continue to show improvement in the U.S. economy. Many market participants expect the 10 year U.S. treasury yield to gradually rise to 3.00% by the end of the year, which would be a year-over-year increase of approximately 50 basis points. At the same time, interest rates and yields are expected to remain volatile in the near term as political and market uncertainty remains high, but the market should be tempered considering there is an inherent cap at approximately 3.00% driven by modest GDP growth and near-zero interest rates in Japan and Europe. In terms of the impact on commercial real estate markets, a rising interest rate environment does not necessarily indicate that cap rates will rise. The belief that cap rates and interest rates are 100% correlated is generally misguided. As shown in the graph below, cap rates and interest rates can move in opposite directions as experienced from 2003 to 2007. At the peak of the market in 2007, cap rate spreads over the 10 year U.S. treasury compressed to 167 bps, which is approximately 250 bps below the current spread.

2016 and 2017 Review Outlook (continued)

Net Lease Cap Rates vs. 10-YR U.S. Treasury Yield and BBB Bond Yields



Sources: RCA, US Department of Treasury, Federal Reserve Economic Data. Period: 1/1/2001 – 12/31/2016.

Bank of America Merrill Lynch recently completed a correlation study on publicly traded net lease REITs. The analysis showed that despite being called bond proxies, net lease REITs have very low correlations to changes in bond yields. There is no clear relationship between bond market movement and net lease REIT performance. In the study, the correlation between changes in net lease REIT yields and treasury yields was less than 0.10. The correlation between net lease REIT yields and yields for the BAA 10-year corporate bond index was only 0.18. Bank of America Merrill Lynch also looked at the correlation between bond yields and net lease REIT's share prices. In like manner, the correlations were relatively low across all the key bond yields analyzed. The highest correlation was between the BAA 10-year corporate bond index and net lease REIT's share prices, which was only (0.22). The correlation is negative because a decline in a bond's yield generally corresponds with an increase in a net lease REIT's share price. This correlation study provides substantial evidence that the relationship between net lease REIT yields and bond yields is relatively weak. Additionally, E&Y completed a study that concluded there has been no strong correlation between the 10 year U.S. treasury yield and commercial real estate cap rates. These studies prove that net leased assets are not highly correlated to movements in interest rates and bond yields. Bank of America Merrill Lynch also analyzed historical net lease REIT performance vs. the MSCI US REIT Index (RMZ) and the S&P 500. Based on data ending December 30, 2016, net lease REITs, excluding VER, have outperformed both the RMZ and the S&P 500 over all periods analyzed (10 years, 5 years, 3 years and 1 year). Over the last 10 years in particular, net lease REITs, excluding VER, outperformed the RMZ by 101pp and the S&P 500 by 67pp on a total return basis.

Additionally, credit spreads have tightened in recent months. The tightening of spreads is partially driven by a lack of supply as well as superior collateral for CMBS tranches as banks now need to post risk retention capital against CMBS securitizations. According to Trepp research, the new issue market welcomed its first conduit of 2017, which is the first retention deal designed with a hybrid L-shaped structure. In this issuance, Citi and Deutsche will retain a vertical slice amounting to 1.9% of the face value of each class in the $1.3 billion CD 2017-CD3. KKR will invest in the B-piece which is the horizontal portion comprised of sub-investment grade bonds. Pricing on January 27, the CD-3 deal closed at 90 basis points over swaps for the LCF AAA bonds and 380 basis points for the BBB-. This is significantly tighter than the spreads seen in December issues and will set prevailing pricing levels for subsequent transactions that will come to market (below the 100-mark for benchmark spreads).

E-Commerce & U.S. Manufacturing Drive Industrial Demand

Net leased industrial assets should benefit from a growing manufacturing footprint. The new administration stated its intention to lower corporate taxes and implement a tax repatriation plan that will reduce tax rates on overseas cash, which should spur increased corporate investment in labor, capital expenditures and infrastructure. This will increase build-to-suit development in the U.S. As an example, in January of 2017, Ford announced the cancellation of its plan to build a new plant in Mexico as the company opted instead to invest $700 million in its plant in Flat Rock, Michigan.

Additionally, U.S. e-commerce sales continue to grow rapidly, as evidenced by the 7.5% year-over-year increase in 2016 to $372.5 billion, according to IMS Worldwide. U.S. e-commerce sales are expected to increase by similar growth rates in 2017 and 2018 as large e-commerce players, such as Amazon, continue to significantly grow their sales. In terms of the impact on real estate, demand for warehouses and distribution facilities is expected to increase immensely as businesses will need to expand their distribution and supply chain infrastructure in order to remain competitive in this new economy. Companies that increase their real estate footprint and build out their distribution network will be well positioned to be successful in the current environment and solidify their market share in the battle for the last mile. In total, all of these factors are reasons why industrial assets will remain the "soup du jour" as they represent the bridge to consumers and supply chain efficiencies for Corporate America.

Foreign Capital Influx

Foreign capital will be another major theme impacting the net lease sector in 2017. Over the last several years, foreign investors have turned to the U.S. real estate market as a safe haven in the midst of global turmoil and political instability. Furthermore, foreign investors are dealing with a structural issue of excess savings and a limited number of attractive risk-adjusted investment opportunities. Accordingly, with significant amounts of capital to invest and a lack of cash flowing opportunities in their countries, foreign investors' appetite for U.S. commercial real estate is expected to continue to increase in 2017.

In 2016, foreign capital identified net lease as one of those safe havens given its inherent characteristics of long-term cash flows and predictability. Furthermore, through the first nine months of 2016, foreign investment in the net lease sector reached approximately $2.9 billion, according to JLL Research. In particular, foreign investors are becoming increasingly interested in net leased industrial assets, due to e-commerce growth, as well as secondary markets due to the additional yield offered in these markets. In the third quarter of 2016, approximately one-third of all industrial acquisitions completed by foreign buyers were net leased assets. According to JLL Research, foreign investment in secondary markets reached $752.3 million through the first six months of 2016. Given the heightened level of competition in primary markets, this trend in investment in secondary markets will continue to provide liquidity in the net lease sector that was unavailable in past real estate cycles.

Summary:

Transaction volume is expected to stabilize in 2017 as the sector will benefit from a historically low interest rate environment, a continued influx of foreign capital, and a growing demand for industrial assets. It seems relatively safe to assume that interest rates will rise over the medium term, but empirical data has shown that cap rates and interest rates have moved in opposite directions in an improving economic environment, especially in 2003 through 2007. Bank of America Merrill Lynch research shows that there is little to no correlation between NNN REITs and BBB corporate bond yields, and E&Y research shows that there is little to no correlation between the 10-year U.S. treasury yield and cap rates. Nonetheless, current conditions may result in a period where cap rates increase around 50 basis points as the market undergoes price discovery. These short term movements will only create buying opportunities for seasoned investors. Sellers that are looking for a short-term gain for 2015-2016 vintage assets may resort to a longer term hold as bid/ask spreads converge. In contrast, deals that are priced today and sellers with a pre-cycle basis will continue to achieve attractive gains even in a rising interest rate environment.

For more information regarding this newsletter or other related net lease matters, please contact Wes Walker or Jason Ridgway at:
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