



What is Net Lease?

Before comparing net lease and fixed income yields, we have first summarized the fundamental characteristics of the net lease market. The net lease market is a sub-sector of the commercial real estate asset class. The name, net lease, is derived from a net lease's expense structure. Leases denoted as "triple net" are structured so that the tenant is responsible for all operating expenses associated with the property. For example, a tenant generally will pay for the property-level insurance, taxes, utilities, maintenance and capital expenditures in a triple net lease. As a result, the landlord's rental income is net of operating expenses. This income is also known as net operating income or NOI.

Typically, net leases have relatively long lease terms (i.e. 10-20 years) and investment grade companies represent a major component of the sector's tenant base. The leases often feature fixed annual rental escalations that are intended to provide a hedge against inflation. In light of these characteristics and the predictable cash flow stream of net lease assets, they are often compared to fixed income investments. Additionally, we believe net leased assets with investment grade tenants offer cash flow profiles more similar to fixed income instruments issued by investment grade borrowers. As a result, we have focused this paper on a comparison between net lease assets with investment grade tenants and investment grade bonds.

Gross vs. Net Leases

Real estate leases can feature different structures that specify the party responsible for paying property operating expenses. To understand a triple net lease, it is helpful to compare the characteristics of the two primary types of commercial real estate leases: gross and net leases. Gross and net leases can generally be grouped into the following sub-categories:

- 1) **Full-Service Gross Lease:** A full-service gross lease is a commercial lease where the tenant pays a fixed base rent, and the landlord is responsible for all property operating expenses, including insurance, taxes, utilities, maintenance, and capital expenditures.
- 2) **Modified Gross Lease:** A modified gross lease is a commercial lease where the tenant pays a fixed base rent but takes on a share of the operating expenses. For example, the tenant may be responsible for paying for utilities and maintenance while the landlord pays for the property taxes and insurance.
- 3) **Triple Net Lease (NNN):** A triple net lease is a commercial lease where the tenant pays a fixed base rent (often with fixed annual increases) and is responsible for all taxes, insurance, utilities, maintenance and capital expenditures associated with the property.

In summary, we believe that the tenant's contractual obligation to pay all of the operating expenses in a triple net lease provides landlords with superior insight into the long-term cash flow of the property relative to other lease structures. From a tenant's perspective, a net lease enables tenants to maintain greater control over their occupancy costs and operating expenses while also securing long-term control of mission critical properties. As a result, landlords and tenants often view net leases as mutually beneficial lease structures.

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Fixed Income Yield Compression

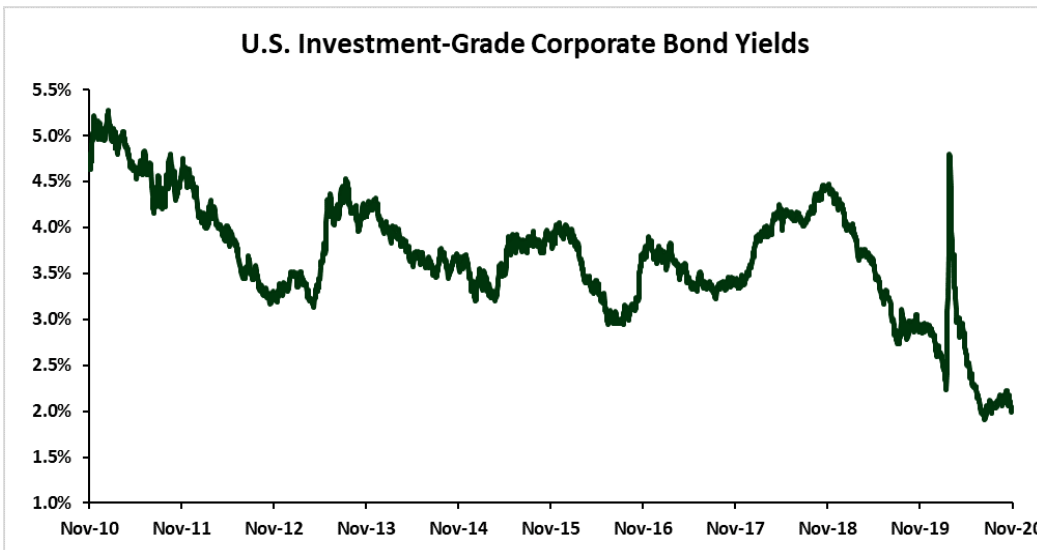
Review of Fixed-Income Yields Over the Last Decade

As shown in the diagram below, the 10-year U.S. treasury yield has traded near historic lows throughout the coronavirus pandemic. More specifically, the 10-year treasury reached a low of 0.5% in March of 2020 but has sold off slightly over the last few months. As of November of 2020, the 10-year U.S. treasury yield is approximately 0.9%, which is still significantly below the average yield of 2.2% since November of 2010.



Source: St. Louis Federal Reserve; 10-Year U.S. Treasury Yield

Following a similar trend over the past 10 years, as shown in the chart below, U.S. investment grade bonds are trading at historically low yields. Due to the uncertainty of the pandemic, yields on investment grade bonds rose to 4.8% in late March of 2020. However, since the selloff in March, investment grade bond yields have compressed significantly as a result of improving economic conditions, robust fiscal and monetary stimulus, and the scarcity of yield in the current investment environment. For example, the BofA U.S. Investment Grade Bond Index's yield is currently 2.0%, which is lower than the average yield of 3.7% since November of 2010.



Source: St. Louis Federal Reserve; BofA U.S. Investment Grade Bond Index

The Net Lease Yield Environment

The Fundamentals of Net Lease Yields

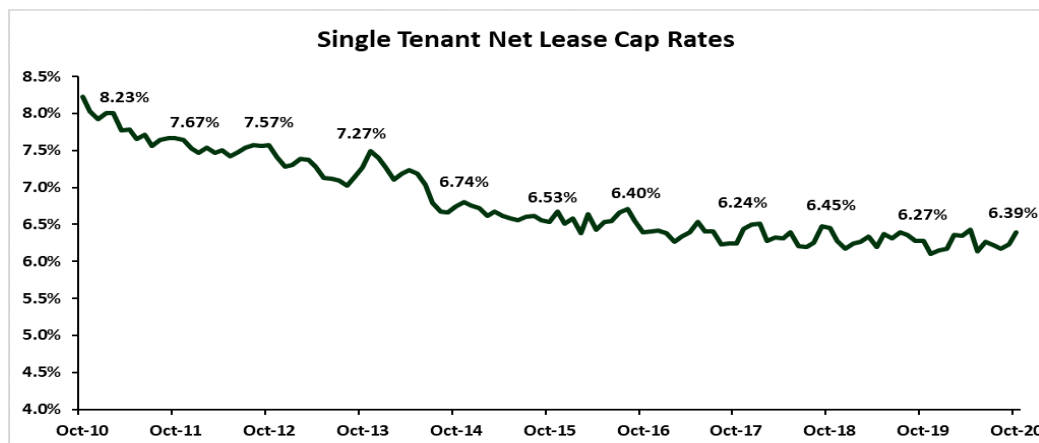
In the fixed income market, investors often focus on a bond's yield to maturity (often abbreviated as "yield") to measure a bond's potential unlevered annualized return. While bond yields reflect various macroeconomic and capital market factors such as the interest rate environment and yields on competing investments, issuer credit quality is the fundamental risk characteristic that drives pricing. Thus, bonds issued by investment grade rated companies trade at lower yields than bonds issued by non-investment grade issuers.

In the real estate market, investors use capitalization rates (known as "cap rates") to measure the unlevered annual return or expected yield on investment. Thus, cap rates may be understood as analogs for bond yields within the real estate market. Like bond yields, cap rates generally move higher or lower depending on the risk profile of the property. While a bond's risk is primarily centralized around issuer credit quality, we believe measuring risk for net lease assets is primarily a combination of 1) tenant default risk and 2) residual real estate risk. We measure tenant default risk as the probability of a tenant defaulting under a net lease and therefore defaulting on their lease payment obligations (in this sense, similar to bond default risk). We measure residual real estate risk as the risk that a landlord cannot maintain or grow their yield when re-leasing the property at lease expiration. In other words, we analyze the residual value for a particular leased property following the expiration of its lease. Some of the primary factors that contribute to residual value include a particular property's submarket fundamentals, asset class, and age.

Due to the two factored risk profile of net lease investments, net leased assets that mitigate residual real estate risk provide cash flow profiles more similar to investment grade fixed income investments (i.e. tenant default risk becomes the singular risk characteristic). As a result, we believe that a newly constructed property located in either a gateway/primary market or a growing secondary market would likely trade at a lower cap rate than an older, obsolete facility located in a tertiary market. The higher value (lower cap rate) for the well located, recent vintage property is due to both a higher tenant renewal probability and a higher recovery rate in a tenant default scenario. Recent vintage, well located assets typically have higher renewal probabilities due to their mission critical nature. They also provide higher recovery rates because the asset is perpetual and can maintain value in a re-lease scenario.

Review of Net Lease Yields Since 2010

Historically, single tenant net lease cap rates have compressed over the past 10 years. However, the compression has been more modest than the compression of bond yields over the same period. In 2010, net lease cap rates were approximately 8.0% while cap rates hovered near 6.4% in 2020. Over the same period, yields for bonds issued to investment grade companies decreased from approximately 5.0% to 2.0%. Thus, net leased assets may offer a stronger risk adjusted return relative to bonds at current yields.



Source: R.C.A. Please note that net lease cap rate data differentiated by tenant credit quality is not available. Thus, the cap rate data presented herein represents cap rates for properties leased to investment grade and non-investment grade tenants.

Comparing Investment Characteristics of Net Lease & Bonds

Similarities

Net lease real estate assets leased to investment grade tenants and corporate bonds issued by investment grade companies often feature similar investment profiles due to their low tenant/issuer default risk, current yield generation, and visibility into long term cash flow generation (often 10-20 years). Both investments involve an agreement between two parties to borrow something in exchange for monthly payments. In the case of a net lease asset, the tenant essentially borrows a building and makes monthly payments to the landlord. In the case of a bond, a borrower receives a principal amount and agrees to make monthly interest payments and return principal. This passive payment structure makes both investments attractive to investors focused on generating stable cash flows and seeking predictable yield.

Both net lease real estate and corporate bond risk profiles are also highly dependent on the tenant or issuer's credit quality. If an issuer defaults, the fixed income investor would lose future coupon payments and likely their original investment or principal. If a tenant defaults, the landlord would not receive future rent payments until a new tenant leases the facility. Thus, investors in both asset classes often pay a premium for investment grade tenants/issuers due to their lower default risk. However, net lease properties likely provide higher recovery rates in tenant default scenarios as described in the differences section below.

Differences

While fixed-income investments and net lease real estate feature many similarities, there are a few differences.

First, the majority of net lease agreements feature annual rental escalations while coupon payments for bonds are often fixed until maturity. Rental escalations intend to provide a hedge against inflation through consistent income growth throughout the lease term. For example, a 10-year bond that yields 2.0% will yield 2.0% in year 10 since coupon payments are fixed over the life of the bond. In contrast, a 10-year triple net lease purchased at a 6.4% cap rate with 1.5% annual rental escalations will yield 7.3% in year 10. Thus, the bond's coupon payments lose relative value over time (taking into account inflation and other factors), while the rent received from the net lease property grows throughout the investment period.

Second, when a landlord leases a property, the tenant agrees to either renew the lease or return the asset at lease expiration. When a corporation issues bonds, they agree to return principal at face value to investors at maturity. The difference between these repayment methods offers an additional potential hedge against inflation. While the bond's repayment figure at maturity is fixed, the real estate asset offers the potential for appreciation or yield growth at lease maturity. For example, an investor may be able to re-lease a well located, top tier real estate asset at a higher rental rate relative to the initial lease. Furthermore, the aforementioned ability to generate consistent or growing yield in a re-lease scenario indicates net leased assets may offer higher recovery rates than unsecured corporate bonds. From 1987 to 2018, the historical recovery rate for senior unsecured bonds was 48% (Source: Moody's 2019 Default Research Study). In contrast, a newly constructed, well located net lease property can potentially offer recovery rates closer to 100% or higher, but the high recovery rate is predicated on investing in properties that maintain their value over a long-term horizon.

Third, net lease real estate is less liquid than the bond market. While bonds are often traded on a daily basis, real estate dispositions generally occur over a longer time period. This liquidity risk may partially explain why net lease assets have traded at higher yields relative to fixed-income investments. However, the underlying cash flow profiles can be relatively similar in nature. Thus, an investor with a longer-term investment horizon may view the lower liquidity as an attractive opportunity to obtain higher yield. Additionally, the spread between bond yields and net lease cap rates has expanded significantly over the last decade despite significant growth in net lease transaction volume, which we believe further enhances the investment opportunities in net leased assets (Source: RCA).

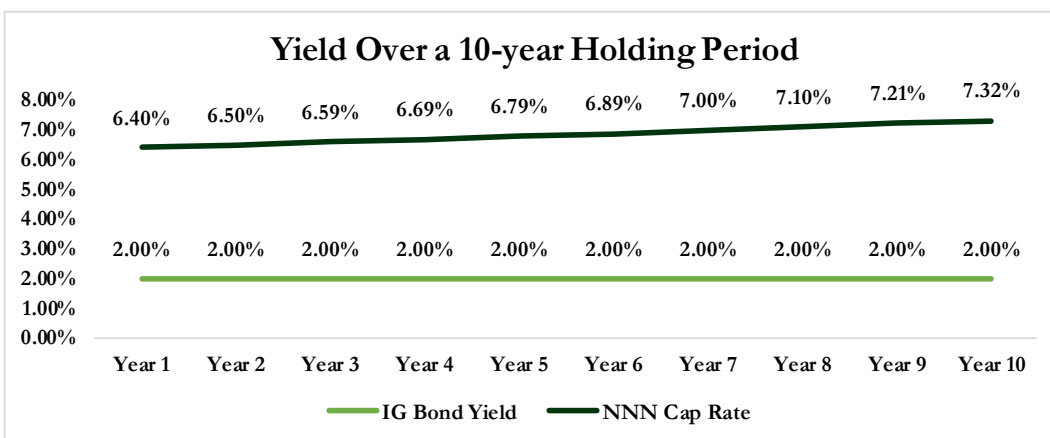
Comparing Yield: Scenario Analysis

The scenarios below compare hypothetical cash flows generated from a net lease asset leased to an investment-grade tenant for a term of 15 years and a 15-year investment grade corporate bond purchased at par yielding 2.00%. The example real estate asset assumes a going-in cap rate of 6.40% (equal to the average single tenant net lease cap rate as of October of 2020 per RCA) with a lease that contains 1.50% annual rental escalations. Each scenario assumes a purchase price of \$1,000, and cash flows are presented on an unlevered basis.

Review of Current Yield During 10-Year Hold Period

As shown in the table and chart below, the yield on the investment-grade corporate bond remains fixed at 2.00% while the net lease asset's yield grows to 7.32% in year 10 due to the benefit of the fixed 1.50% annual rental escalations. As a result, the net lease investment provides the investor with ~532 basis points of positive yield spread in the 10th year of the investment. Additionally, the average yield generated from the net lease asset is 6.85%, offering the investor ~485 basis points of average spread over the investment-grade bond yield during the 10-year period.

Yield Comparison	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
IG Bond Yield	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
Coupon Payment	\$20	\$20	\$20	\$20	\$20	\$20	\$20	\$20	\$20	\$20
Average Yield	2.00%									
NNN Cap Rate	6.40%	6.50%	6.59%	6.69%	6.79%	6.89%	7.00%	7.10%	7.21%	7.32%
Annual NOI	\$64	\$65	\$66	\$67	\$68	\$69	\$70	\$71	\$72	\$73
Average Yield	6.85%									



Next, we analyzed the return of principal for the example net lease asset under two scenarios.

Exit Scenario One - Selling at the Entry Cap Rate

In scenario one, we assume the investor could sell the net lease asset at a cap rate equal to the entry cap rate (i.e. 6.40%) in year 10. As a result, we assume the buyer would apply a 6.40% cap rate to the net operating income in year 10, which results in a sale price of \$1,143 (\$73.18 / 6.40%). As a result of the sale, the unlevered IRR of the net lease investment is equal to approximately 7.80% compared to the bond's unlevered IRR of 2.00%.

Scenario One	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Sale
NNN Cap Rate	6.40%	6.40%	6.50%	6.59%	6.69%	6.79%	6.89%	7.00%	7.10%	7.21%	7.32%	6.40%
Annual NOI	(\$1,000)	\$64	\$65	\$66	\$67	\$68	\$69	\$70	\$71	\$72	\$73	\$1,143
IRR	7.8%											

Comparing Yield: Scenario Analysis & Conclusion

Exit Scenario Two - Sale Price that Equivocates Bond Yield

In scenario two, we analyzed a sample downside scenario where the net lease asset's sale price results in an unlevered IRR that equals the yield or unlevered IRR of the investment-grade bond. To reach this result, the exit cap rate of the net lease asset has to expand by ~900 basis points relative to the going in cap rate (i.e. 15.53% sale cap rate vs. 6.40% acquisition cap rate). The 15.53% sale cap rate results in a sale price of \$471 (NOI of \$73.18 / 15.53%, equals 47.1% of original purchase price). As a result of the low sale price, the IRR of the net lease investment falls to 2.00%, which is equal to the investment-grade bond's unlevered IRR. Despite the ~52.9% loss on the original investment, the net lease asset's higher yield and annual rental escalations helped provide protection against deteriorating market conditions. Additionally, the 15.53% cap rate is approximately 2.0x higher than the highest point for cap rates over the last 10 years and approximately 2.5x higher than net lease cap rates in 2020. Thus, even a material deterioration in pricing for net lease assets would not result in the unlevered returns of the two asset classes mirroring each other.

Scenario Two	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Sale
NNN Cap Rate	6.40%	6.40%	6.50%	6.59%	6.69%	6.79%	6.89%	7.00%	7.10%	7.21%	7.32%	15.53%
Annual NOI	(\$1,000)	\$64	\$65	\$66	\$67	\$68	\$69	\$70	\$71	\$72	\$73	\$471
IRR	2.00%											

Conclusion

Both net lease assets leased to, and bonds issued by, investment grade companies may provide investors with predictable long-term cash flow streams. However, we believe investors in investment grade net lease assets can obtain significantly higher yield relative to investment grade bonds in exchange for two main risks: less liquidity and residual real estate risk. In terms of liquidity, we believe that investors with long-term investment horizons are likely being compensated for this lower level of liquidity with ~3x higher yields. In terms of residual real estate risk (the value of the property at lease maturity), we believe investors should focus on a subset of the net lease sector that substantially mitigates this risk. Newly constructed net lease assets located in strong, growing markets may decrease the risk of losing yield in a re-lease scenario at lease maturity. Moreover, this subset of the net lease sector may provide appreciation or yield growth at lease maturity, which in combination with fixed annual rental escalations provides a potential hedge against inflation. Thus, by focusing on net lease assets with investment grade tenants and strong underlying real estate characteristics, we believe that investors can create fixed income like perpetual cash flow streams at significantly higher yields with additional inflation hedging characteristics.

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