Where's the Yield? Fixed Income vs. Net Lease

Part 2: High Yield Bonds Comparison

ELMTREE FUNDS
PRIVATE EQUITY REAL ESTATE

Net Lease vs. High Yield Bonds

In our most recently published newsletter, we compared net lease properties to investment grade bonds given both net lease assets leased to, and bonds issued by, investment grade companies may provide investors with predictable long-term cash flow streams. We concluded that, in our opinion, 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. Additionally, we believe investors with long-term investment horizons are likely being compensated for the 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.

As a follow up to the previous newsletter, we have chosen to compare net lease assets leased to investment grade tenants to corporate bonds issued by companies that are not rated investment grade by credit rating agencies (i.e., commonly known as high yield or junk bonds). While the underlying credit risk of the two asset class varies more than the previous comparison due to the higher historical default probability of high yield bonds, the yield profile of high yield bonds and the net lease sector is more comparable in nature. Thus, investors may compare net lease properties and high yield bonds when targeting a certain yield profile for a specific allocation within their investment portfolios.

To compare the two asset classes, we analyzed the historical and current yields for both asset classes. 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. 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. Additionally, we analyzed the similarities and differences of both asset classes along with the potential strengths and weaknesses of investing in each asset class in the current investment environment.

As discussed in more detail hereinafter, we believe net lease assets offer investors superior risk-adjusted returns in the current market relative to high yield corporate bonds due to superior inflation hedging characteristics, lower default probabilities and higher potential recovery rates.

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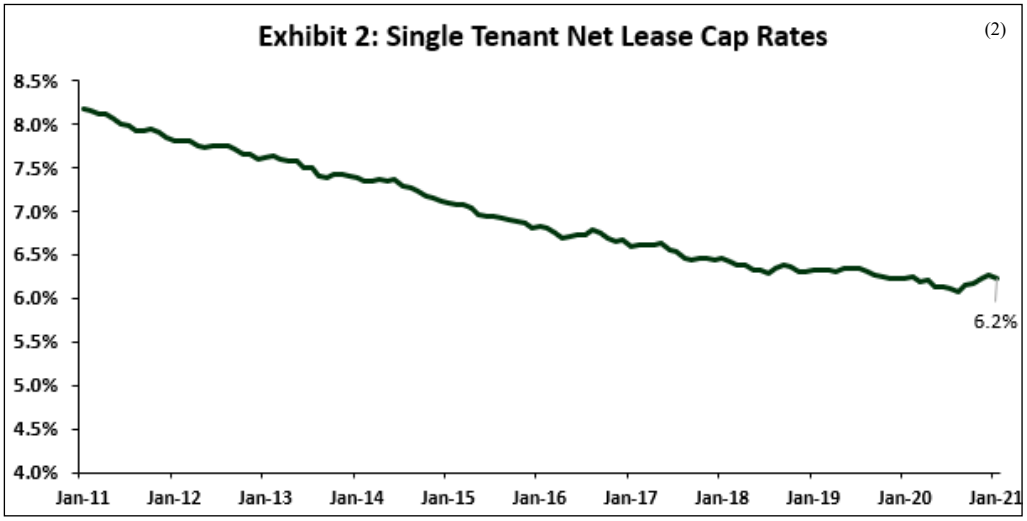
Historical Yield Environment

Review of High Yield Bond Yields Over the Last Decade

As shown in the chart below, high yield corporate bonds are trading at historically low yields. Due to the uncertainty of the pandemic, yields on high yield bonds rose to nearly 10% in late March of 2020. However, since the selloff in March, high yield 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 S&P High Yield Bond Index's yield is currently 4.7%, which is lower than the average yield of 6.6% since January of 2011.

Review of Net Lease Yields Over the Last Decade

Generally, 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 2012, net lease cap rates were approximately 8.0% and, in 2021, cap rates are currently near 6.2%, which represents 180 bps of compression. Over the same period, yields for high yield bonds decreased from approximately 8.0% to 4.7%, which represents 330 bps of compression. Thus, net leased assets appear to be priced more conservatively than high yield bonds when considering historical average yields for each asset class.



Comparing Characteristics of Net Lease & High Yield Bonds

Similarities

Net lease real estate assets leased to investment grade tenants and high yield corporate bonds are similar in that they both offer long-term current yield to investors. Both investments involve an agreement between two parties to borrow something in exchange for monthly or semi-annual 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 typically make semi-annual interest payments and return principal. This passive payment structure makes both investments attractive to investors focused on generating long-term 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.

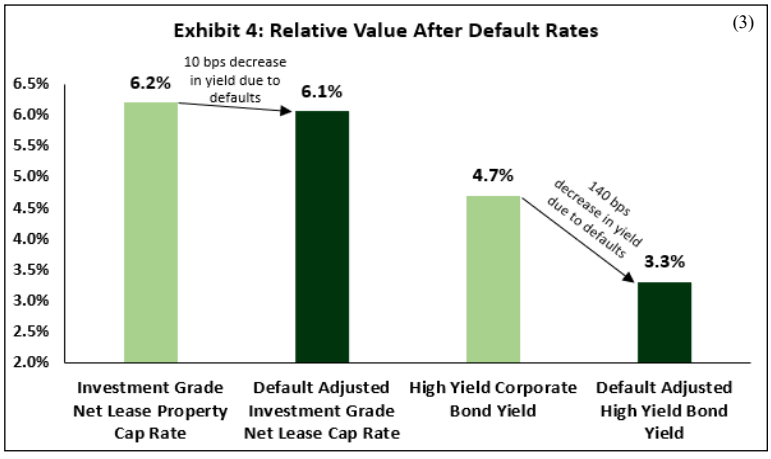
Differences

While high yield corporate bonds and net lease real estate assets with investment grade tenants feature some similarities, we believe there are several significant differences, which are described in detail below.

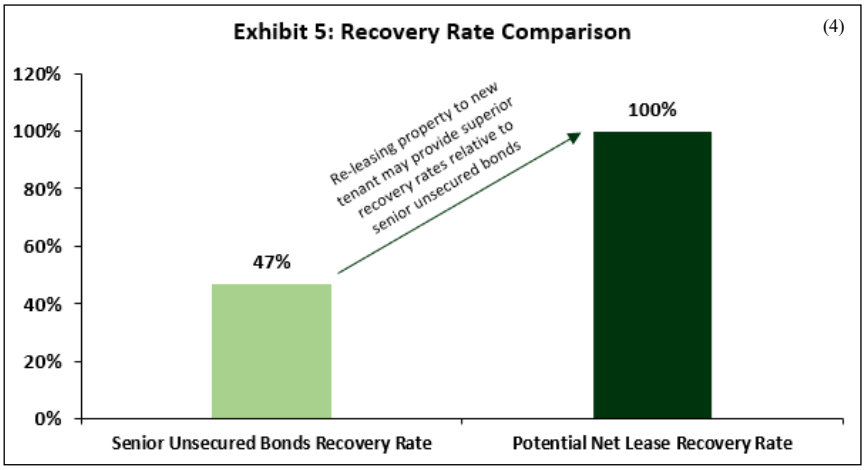
Default Probabilities: According to Moody's research, the historical cumulative default rate for sub-investment grade issuers is approximately 29.6% over a 10-year period. The historical cumulative default rate for investment grade issuers is approximately 2.2% over a 10-year period. In Exhibit 3 below, we summarize the yields of both asset classes after making adjustments for historical default probabilities.

Exhibit 3: Yields Adjusted for Default Rates	(3)
High Yield Corporate Bond Yield	4.7%
Historical 10-Year High Yield Issuer Cumulative Default Rate	29.6%
Default Adjusted High Yield Bond Yield	**3.3%**
Investment Grade Net Lease Property Cap Rate	6.2%
Historical 10-Year IG Issuer Cumulative Default Rate	2.2%
Default Adjusted Investment Grade Net Lease Cap Rate	**6.1%**

Exhibit 3 calculates the adjusted yields by multiplying each asset's yield by (i) 100% less (ii) the historical cumulative default rate. For example, high yield corporate bonds currently have a yield to maturity of 4.7%. Multiplying the 4.7% yield by (100% - 29.6%) results in a default adjusted yield of 3.3%. Thus, by focusing on net lease assets leased to investment grade tenants, investors can obtain higher yields than high yield corporate bonds, particularly after adjusting yields for the higher historical default rates of high yield bonds relative to investment grade rated tenants.



Recovery Rates: From 1987 to 2020, the historical recovery rate for senior unsecured bonds was 47% (Source: Moody's 2020 Default Research Study). Thus, an investor in high yield bonds faces the potential of losing a significant portion of their principal in an issuer default scenario. In contrast, a newly constructed, well located net lease property can potentially offer recovery rates closer to 100% or higher. If a tenant defaults on the lease, and the asset is well located with competitive building characteristics, the landlord can likely re-lease the asset to a new tenant at a comparable or potentially higher rental rate than the prior lease.



Inflation Protection: Net lease assets offer two characteristics that are not typically offered by high yield corporate bonds and may serve as partial hedges against inflation

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 15-year high yield bond that yields 4.7% will yield 4.7% in year 10 since coupon payments are fixed over the life of the bond. In contrast, a 15-year triple net lease purchased at a 6.2% cap rate with 1.5% annual rental escalations will yield 7.1% 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 renew or re-lease a well located, top tier real estate asset at a higher rental rate relative to the initial lease. Thus, well located net lease assets may maintain value more than high yield corporate bonds in an inflationary environment due to potential growth in residual property values.

Liquidity: Net lease real estate assets with investment grade tenants are generally less liquid than high yield corporate bonds. While high yield 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 typically traded at higher yields relative to high yield corporate bonds. However, an investor with a longer-term investment horizon may view the lower liquidity as an attractive opportunity to obtain higher yields as well as, arguably, superior risk-adjusted returns. As noted above, investment grade companies have significantly lower historical default rates relative to high yield bond issuers, and well located, newly constructed net lease assets may offer higher recovery rates than senior unsecured bonds. Thus, investors in net lease assets may be able to arbitrage lower liquidity in exchange for higher yields, lower default rates, additional inflation hedging characteristics and higher recovery rates.

Comparing Yield: Scenario Analysis

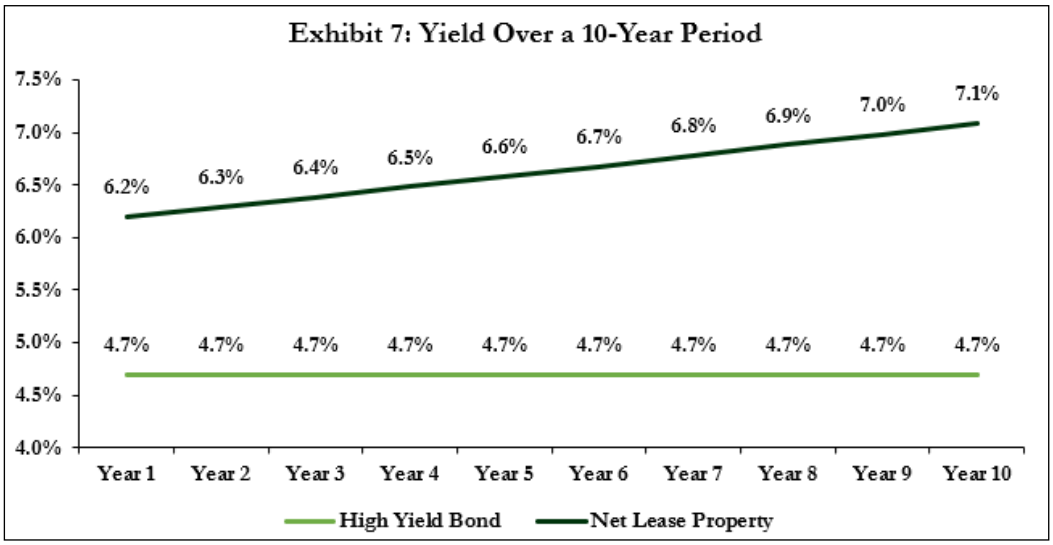
The scenarios below compare hypothetical cash flows generated from a net lease asset leased to an investment-grade tenant for a term of 15 years and a 15-year high yield corporate bond purchased at par yielding 4.7%. The example real estate asset assumes a going-in cap rate of 6.2% (equal to the average single tenant net lease cap rate as of January 2021 per RCA) with a lease that contains 1.5% 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 high yield corporate bond remains fixed at 4.7% while the net lease asset's yield grows to 7.1% in year 10 due to the benefit of the fixed 1.5% annual rental escalations. As a result, the net lease investment provides the investor with ~240 bps of positive yield spread in the 10th year of the investment. Additionally, the average yield generated from the net lease asset is 6.6%, offering the investor ~190 basis points of average spread over the high yield bond during the 10-year period.

Exhibit 6: Yield Comparison	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
High Yield Bond	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%
Coupon Payment	$47	$47	$47	$47	$47	$47	$47	$47	$47	$47
Average Yield	4.7%									
Net Lease Property	6.2%	6.3%	6.4%	6.5%	6.6%	6.7%	6.8%	6.9%	7.0%	7.1%
Annual NOI	$62	$63	$64	$65	$66	$67	$68	$69	$70	$71
Average Yield	6.6%									

(5)



(5)

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. 6.2%) in year 10. As a result, we assume the buyer would apply a 6.2% cap rate to the net operating income in year 10, which results in a sale price of $1,143 ($70.9 / 6.2%). As a result of the sale, the unlevered IRR of the net lease investment is equal to approximately 7.6% compared to the bond's unlevered IRR of 4.7%.

Exhibit 8: Scenario I	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Sale
Net Lease Cap Rate	6.2%	6.2%	6.3%	6.4%	6.5%	6.6%	6.7%	6.8%	6.9%	7.0%	7.1%	6.2%
Annual NOI	($1,000)	$62	$63	$64	$65	$66	$67	$68	$69	$70	$1,214	$1,143
IRR	7.6%											

(6)

Exit Scenario Two - Exit Cap That Equates IRR & 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 high yield bond. To reach this result, the exit cap rate of the net lease asset has to expand by ~310 basis points relative to the going in cap rate (i.e. 9.3% sale cap rate vs. 6.2% acquisition cap rate). The 9.3% sale cap rate results in a sale price of $765 (NOI of $70.9 / 9.3%, equals 76.5% of original purchase price). As a result of the low sale price, the IRR of the net lease investment falls to 4.7%, which is equal to the high yield bond's unlevered IRR. Despite the ~23.5% 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 9.3% cap rate is higher than the highest point for net lease cap rates over the last 10 years. Thus, even a material deterioration in pricing for net lease assets would likely not result in the unlevered returns of the two asset classes mirroring each other.

Exhibit 8: Scenario II	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Sale
Net Lease Cap Rate	6.2%	6.2%	6.3%	6.4%	6.5%	6.6%	6.7%	6.8%	6.9%	7.0%	7.1%	9.3%
Annual NOI	($1,000)	$62	$63	$64	$65	$66	$67	$68	$69	$70	$836	$765
IRR	**4.7%**											

(6)

Conclusion

Both net lease assets leased to investment grade tenants and high yield bonds offer investors the ability to generate long-term yield. However, we believe net lease assets with investment grade tenants offer more attractive risk-adjusted returns in the current market. Net lease cap rates are currently ~150 bps higher than high yield bond yields (cap rates are currently 6.2% vs. current high yield bond yields of 4.7%). In addition to offering higher yields, net lease assets with investment grade tenants likely feature several benefits over high yield bonds including lower default probabilities, superior inflation hedging characteristics and higher recovery rates. The primary weakness of net lease assets relative to high yield bonds is lower liquidity. However, we believe the strengths for net lease assets outweigh the lower level of liquidity, particularly for investors with long-term investment horizons that typically have the ability to allocate a portion of investable capital into less liquid asset classes.

Disclaimer

Sources & Footnotes

1) Source: S&P as of February 26, 2021; High Yield Corporate Bond Index
2) Sources: RCA single tenant industrial and office cap rates as of March 2021. 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. However, ElmTree believes the cap rate data presented herein is generally representative of cap rates for net lease assets leased to investment grade tenants.
3) Sources: S&P as of February 26, 2021; High Yield Corporate Bond Index. Moody's 2020 Annual Default Study. RCA single tenant industrial and office cap rates as of March 2021. 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. However, ElmTree believes the cap rate data presented herein is generally representative of cap rates for net lease assets leased to investment grade tenants. Default adjusted yields are calculated by multiplying the reported yield by (i) 100% less (ii) the respective historical cumulative default rate.
4) Source: Moody's 2020 Annual Default Study. The net lease recovery rate represents ElmTree's estimated recovery rate for well located, newly constructed net lease assets. The recovery rate assumes the landlord could re-lease the asset at a comparable or higher rental rate than the in-place lease at the time of default. The actual recovery rate for net lease properties may be lower if the underlying asset does not feature competitive characteristics that allow for a successful re-lease scenario.
5) Sources: S&P as of February 26, 2021; High Yield Corporate Bond Index. RCA single tenant industrial and office cap rates as of March 2021. 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. However, ElmTree believes the cap rate data presented herein is generally representative of cap rates for net lease assets leased to investment grade tenants.
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About ElmTree Funds

ElmTree Funds, LLC, headquartered in St. Louis, Missouri, is a real estate private equity firm that manages capital on behalf of institutional and private investors. ElmTree's investment philosophy focuses on creating attractive risk-adjusted returns for its investors in the commercial real estate net lease and build-to-suit sectors with a focus on industrial and office properties. Since its founding in 2011, ElmTree Funds has acquired, developed, or financed an extensive portfolio of commercial real estate. ElmTree Funds targets commercial real estate investments in primary and secondary markets across the United States that are net-leased to investment grade tenants on a long-term basis.