CALKAIN RESEARCH
2010 CAP RATE REPORT

"Are we there yet? Are we there yet? Are we there yet?"
Bart Simpson

Are we there yet? No, but the steady rise of cap rates in 2009, born of the recession, bail-outs, defaults, and fall in consumer confidence has given way to a modest stabilization as financial indicators have subtly improved in the first quarter of 2010. Across the country, decreased transaction volume brought on by a still conservative lending environment and the impact of the recession in all but a few standout markets has prevented a true return to normalcy. Those factors have also turned investors towards key primary markets where real estate fundamentals remain strong, the impact of the recession is less severe and debt placement more readily available. Cap rates in these select primary markets have stabilized and even dropped to an extent as the influx of investors from across the country has led to a scarcity of quality inventory. The net result of the transaction volume in these primary markets is a modest downward compression of cap rates across all sectors.

Net lease investments continue to represent a large portion of the transactions taking place, proving that there is a significant flight to quality as buyers seek out properties with strong credit tenants. Single-tenant net lease retail properties, priced between $1M and $10M, have become the sweet spot for many investors and 1031 buyers. A quick analysis of these types of transactions points to the possibility of 2010 being a plateau year with potential cap rate compression coming in 2011. Today, most net lease properties have been trading at cap rates between 6.50% – 8.75%.

RETAIL AND CONSUMER BEHAVIOR:

Overall, retail has observed an upturn in 2010. April retail and food services sales were recorded at $366.4 billion, an increase of 0.4% from the previous month and 8.8% above April 2009. Sales between February and April were up 7.3% from the same period a year ago. This indicates that consumers are beginning to spend again as the nation recovers from a recession.

In March, private wage and salary disbursements increased by $11.8 billion compared to $6.8 billion in February. Likewise, personal income and disposable personal income also increased, rising by $36.0 billion (0.3%) and $32.3 billion (0.3%) respectively. As of May 2010, retail sales have been up every month since September 2009 as the US consumer has proven resilient despite global financial tensions, and consumer discretionary stocks have surged nearly 10% since the start of the year.

In connection with the rise in personal income, personal consumption expenditures increased by $58.6 billion (0.6%) in March from $56.4 billion (0.5%) in February.
Personal savings totaled $304.0 billion in March, compared to $332.2 billion in February. As a percentage of disposable personal income, it was 2.7 percent in March, compared with 3.0 percent in February.

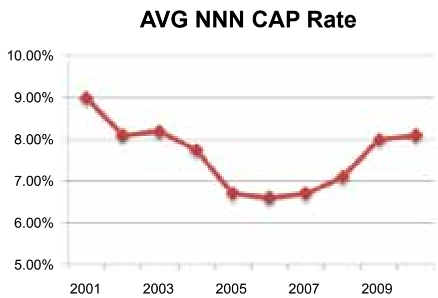
Other favorable signs lie in the S&P 500, as Bloomberg reports that, "combined price estimates from over 2,000 forecasters tracked by Bloomberg show the S&P 500 will rise 27 percent in the next year."

Analysis points to the market being better today than yesterday. However, consumers and investors were hit hard by the credit bubble and many are wary about spending in the quantities of years past. Many speculate a new era will emerge with an emphasis on savings rather than credit driven purchases, but investments will still be made.

In times such as these, it is vital for the investor to change their appetite for certain investments rather than overhaul their entire investment strategy. As long as banks hold excessive reserves and the fed funds rate continues to hover around 0%, the yield on bank deposits and Treasuries will continue to decline due to a sharpening yield curve that rewards risk. As interest rates remain at all time lows and consumer spending begins to improve, this economy will prove appealing to the opportunistic investor.

NNN RETAIL ACTIVITY:

Overall investment activity in the net lease market has increased as buyers are looking for cash-flow, credit, and stability. The following data, taken from 1,658 net lease transactions, highlights trends across different segments of the market, which appears to be stabilizing. The four retail segments analyzed represent some of the most actively traded single-tenant property types over the past twelve months: Dollar Stores, Banks, Pharmacies, and Quick Service Restaurants (QSR).



Deal flow of single-tenant net lease properties has stabilized during 2010 as economic conditions have improved. Buyers view net lease investments as reasonably safe during all economic climates and thus their demand remains relatively stable. Due to encouraging economic data and the return of 1031 buyers, cap rates have begun to stabilize. Average net lease cap rate for 2010 year-to-date is 8.10%, only slightly up from 8.00% in 2009. In contrast, cap rates rose from 7.10% to 8.00% in 2008-09. It should be noted that a major issue in 2010 will likely be a lack of quality, well-located properties and that may serve to further compress cap rates as investors target what little becomes available throughout the year.

Dollar Stores

Dollar stores have been one of the prime beneficiaries of the economic downturn. While many other retail chains closed stores, dollar stores underwent unprecedented expansion. Dollar General Corp., the largest chain with more than 8,800 stores, plans to add 600 more this year. Family Dollar and Dollar Tree, the next two largest chains with 6,600 and 3,800 locations respectively, both plan on opening 200 or more new stores this year.

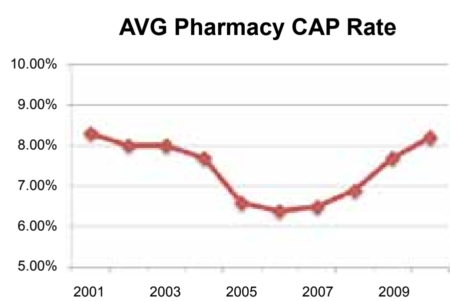
Dollar stores tend to be located in secondary and tertiary markets and carry higher cap rates when compared to pharmacy, bank, and QSR properties. As we come to the close of the second quarter of 2010, cap rates for dollar stores have averaged 9.50%, a slight increase from 9.20% in 2009. However, compared to 2008-09, when they jumped from 7.40% to 9.0%, our data indicates a stabilizing market.

Cap rates differed only slightly between the major dollar store tenants. Dollar General recorded an average cap rate of 9.53% while Family Dollar was at 9.48%. This indicates that cap rate fluctuations were the result of sector wide influences rather than tenant specific ones. It should also be noted that many new dollar stores are to be structured as NNN leases, a change from the previous double net standard. The new lease structure and low price point will likely drive investor demand and may result in lower cap rates.

In its fiscal year ending Jan. 29, Dollar General observed a 9.5% rise in sales at stores open at least a year, an increase from 9% the previous year and the best showing in the sector. Fourth quarter sales for Dollar General rose 7.5%, a decline from 9% last year. Family Dollar has witnessed a similar trend, its most recent quarterly sales rose 3.6% compared with 6.4% a year ago. Only Dollar Tree bucked the trend, observing a same store sales increase of 6.6% in its most recent period, compared with 2.2% a year earlier.

Pharmacy

Pharmacy tenants remain one of the most stable sectors in the industry. The creditworthiness and lease terms for pharmacy tenants drive much of the demand for these net lease properties. Walgreens highlights this attractive sector: considered by many the gold standard of NNN properties.



Jim Collin's book Good to Great, a New York Times #1 best seller and one of the most recognizable business books of all time, highlights Walgreens as one of only eleven Fortune 500 companies to ever go from good to great. According to Collins, this requires a Fortune 500 company to be in business for an extended period while posting positive gains before suddenly outperforming the market by three times over a 15-year period.

"From December 31, 1975, to January 1, 2000, $1 invested in Walgreens beat $1 invested in technology superstar Intel by nearly two times, General Electric by nearly five times, and Coca-Cola by nearly eight times, and the general stock market (including the NASDAQ stock run-up at the end of 1999) by over fifteen times" (Collins).

Walgreens continues to perform today. Walgreens reported an increase of 9.5% to $16.4 billion in Q1 2010 sales over the prior year, while second quarter sales increased 3.1% to $17.0 billion. First half year sales rose 6.1%, totaling $33.4 billion. Prescription sales were the dominant factor, rising by 10% and 3.2% from the year prior to account for 66.2% and 63.3% of sales in the first and second quarters respectively.

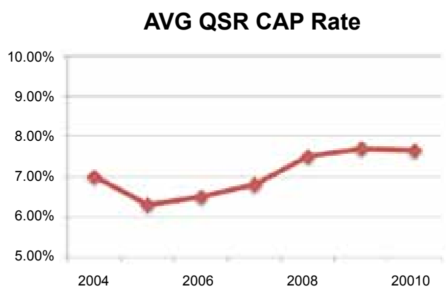
If a NNN investor cannot get their hands on a Walgreens store, there are other attractive options in the Pharmacy arena. CVS net revenues increased $11.8 billion in the three months ended March 31, 2010, a 2.6% increase over the same period in 2009. For an investor who likes to take on risk there is Rite Aid, who has reported negative growth year to date.

As a sector, 2010 Pharmacy cap rates increased but at a reduced rate. The slight increase is likely driven by the rising cap rates for Rite Aid properties and the fact that there was an oversupply of Pharmacy properties on the market. The average Pharmacy cap rate for Q1 2010 was 8.20%, a 50 bps rise from the 2009 average of 7.70%. However, this 50 bps increase is less than the 80 bps jump in 2008-2009, when cap rates moved from 6.90% to 7.70%.

Unlike dollar stores, cap rates for individual Pharmacy tenants have ranged widely with some certain concepts viewed more favorably by investors of real estate as well as equities. Walgreens posted an average cap rate of 7.70%, easily the lowest of the group and equal to Pharmacy cap rate averages in 2009. Given their lower credit ratings, it is not surprising that CVS and Rite Aid had higher average cap rates in Q1 2010, 8.55% and 9.65% respectively. Although Walgreens remains the star of this sector, the pause in expansion and ensuing lack of product may serve to drive cap rates lower. CVS in particular may benefit as its fortunes rise on Wall Street. Real estate investors show a growing appreciation for the CVS lease, which has rent increases (unlike Walgreens) and a growing list of stores located in dense urban markets. These differences highlight the ever changing competitive environment and investment opportunities associated with the Pharmacy sector.

QSR

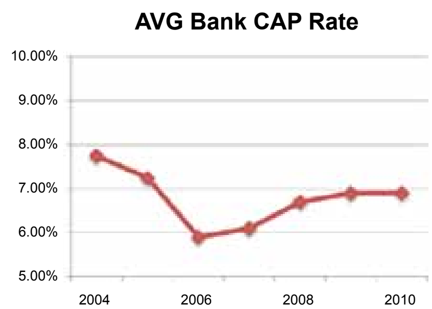
Of all the retail segments examined, QSR was the only one to experience cap rate compression in 2010, going from 7.70% to 7.65%. Driving this trend is the fact that most QSR properties have lower price points, are located in major markets, have strong performing tenants and broad brand recognition through intensive marketing across the media. This slight cap rate compression is a very positive sign and a good indicator that the market has stabilized and is potentially trending in a positive direction when dealing with first class assets.



Within the QSR segment, there is a wide range of cap rate fluctuation depending upon corporate versus franchisee guarantees, national versus regional brands, and new versus seasoned leases. Stronger cooperate tenants, like McDonald's and Chick-fil-a represent a class of QSR that is always in high demand and limited supply. At McDonald's, "franchise applications in the United States totaled more than ten times the number of outlets available" (Wall Street Journal). Cap rates for these "flight-to-quality" tenants are commonly sub-7 and often sub-6 percent. As an example, the average cap rate for McDonald's during Q1 2010 was 5.75%. The second tier of QSR tenants including Wendy's, Arby's and other franchise operations traded at higher cap rates closer to 8% - 8.50% in the current market. The appeal of QSR properties is likely to continue given the segment's stability and the evident underlying real estate value of these properties.

Banks

For all the turmoil in our financial sector, retail banks have been relatively stable. From 2006-10, the average bank ground lease cap rate has only risen 100bps, 5.90% to 6.90% rarely exceeding a 7.00% cap rate. Bank ground lease cap rates remained stable from 2009-10, staying at 6.90%.



This stability has been due to a number of factors. Banks are usually placed in well positioned and highly trafficked areas, often in shopping centers. This ensures access to a large supply of customers. Furthermore, the service banks provide can be considered "non-discretionary" in that almost everyone uses banks and requires the continuation of that relationship regardless of the economic situation.

NNN Bank properties and the tenant leases that underlie the investment are typically structured as ground leases. In a ground lease, the investor-landlord owns only the land and collects rent from the tenant (the bank) for the right to construct a building and make improvements to the land for the operation of its business. The actual bank building remains the property of the tenant for as long as the lease is in force. Bank ground leases, offer many advantages to prospective investors. The tenant incurs significant expense in constructing the building and making improvements to the land that ties them to the property making them a more stable and predictable tenant for the investor-landlord. In addition, the bank typically signs a long term lease with increases and will assume responsibility for all repairs and maintenance to the property. Finally, at the end of the lease term or on the tenant's default the building and all improvements (remember that the tenant paid for the construction of all of it) become the property of the investor-landlord.

CONCLUSION:

Though data suggests an improved economic climate, a number of factors continue to prevent significant cap rate compression. Investors are facing a shortage of high-quality properties, conservative lending standards and high bid-ask spreads. That said the net lease market is picking up momentum.

There are opportunities to invest in various asset classes that should benefit from an improved economy and price appreciation. As financing becomes more available we expect to see increased transaction volume and the entrance of new product into the market. There will be a preference for stability, cash flow and well located properties in major markets, where potential appreciation in value following the down market should create unmatched opportunity for investors.

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