CALKAIN
AMERICA'S NET LEASE COMPANY®

Sage Policy Group, Inc.

Net Lease Economic Report

Semi-Annual Edition | June 2017

Overview

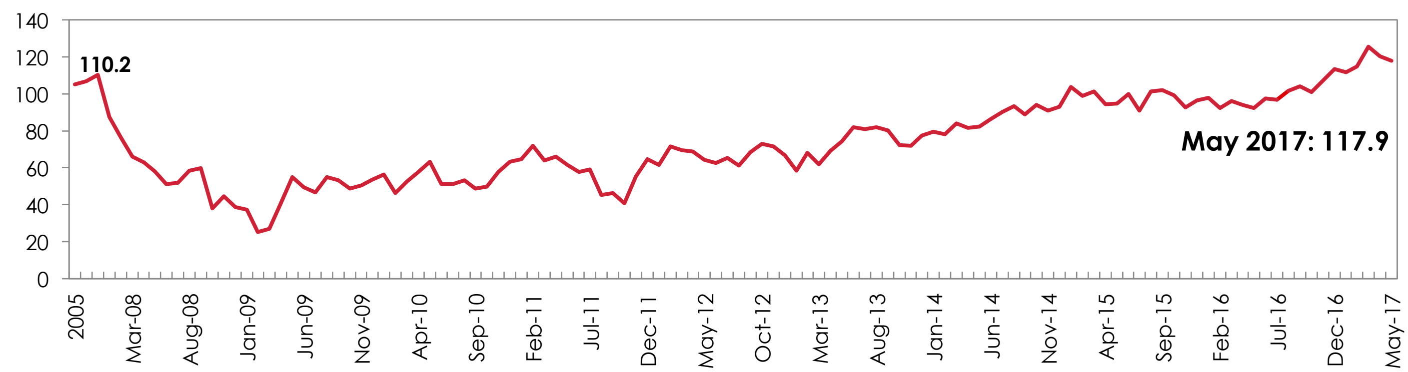
If robust consumer and business sentiment was a reliable way to measure the performance of an economy, then the U.S. would be in the midst of a historic economic boom. According to various confidence measures, business is either already booming in America or is on the verge of takeoff.

For example, the National Federation of Independent Business' (NFIB) Small Business Economic Trends index reports that business confidence is at the 97th percentile. In other words, business confidence has been higher than it currently is only 3 percent of the time throughout the history of the series. As reported by the NFIB, the "remarkable surge in small business optimism that began in November of last year was sustained in March … Small business owners remain optimistic about the future of the economy and the direction of consumer confidence. We are encouraged by signs that optimism is translating into economic activity, such as capital investment and job creation."

Thanks to a recent surge in March, the Consumer Confidence Index peaked at a level last seen almost 17 years ago in December, 2000. That date has some significance since it represents the tail end of the tech-boom-led expansion that began in the early 1990s. That expansion was associated with massive gains in productivity and rapid economic growth.

The problem is that measures of confidence, which are considered soft data, frequently do not align neatly with hard data. As an example, even as confidence surged among businesses and households, the economy managed to expand just 1.2 percent on an annualized basis during the year's initial quarter.

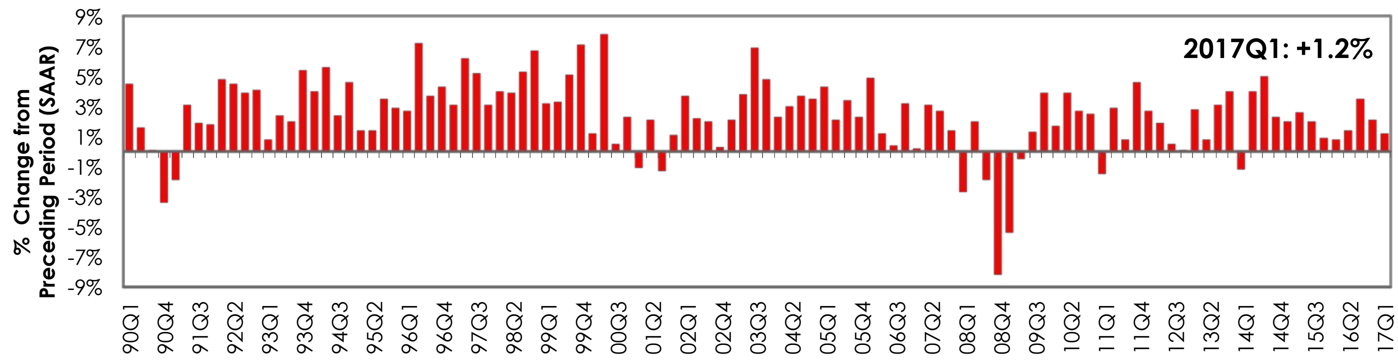
Consumer Confidence Index, 2005 – April 2017



Source: Conference Board

After languishing in March, retail sales rebounded slightly in April. Overall, sales were up 4.5 percent year-over-year. According to the U.S. Commerce Department, after dropping a revised 0.1 percent in March, retail sales increased by 0.4 percent in April. Total sales between the months of February and April were up 4.7 percent.

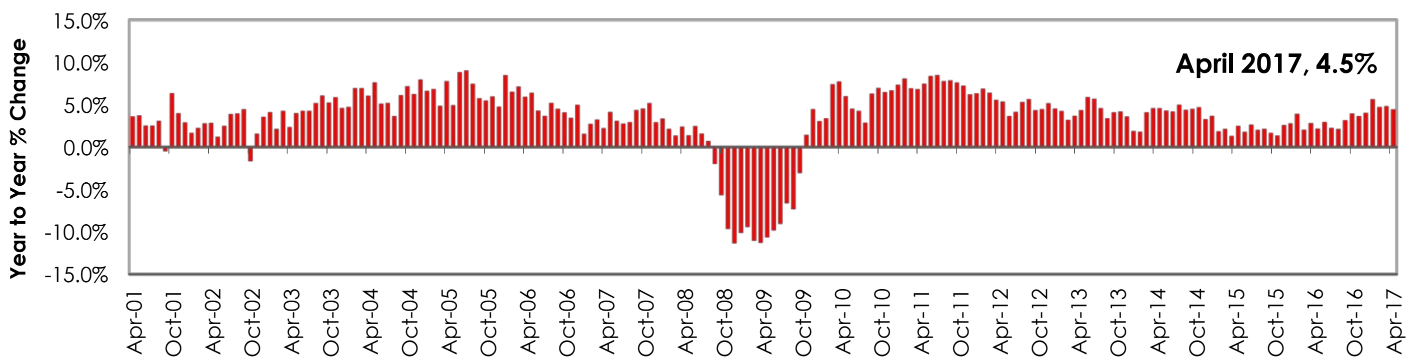
Gross Domestic Product, 1990Q1 – 2017Q1



Source: Bureau of Economic Analysis

Presumably, this economic weakness impacts the single-tenant net lease sector, which is populated by companies that depend heavily upon household spending, including national chain pharmacies like CVS and Walgreens, quick service restaurants like McDonald's and Burger King, dollar stores, auto parts dealers, and convenience stores.

U.S. Retail and Food Service Sales, 12-Month Percentage Change, April 2001 – April 2017



Source: Census Bureau

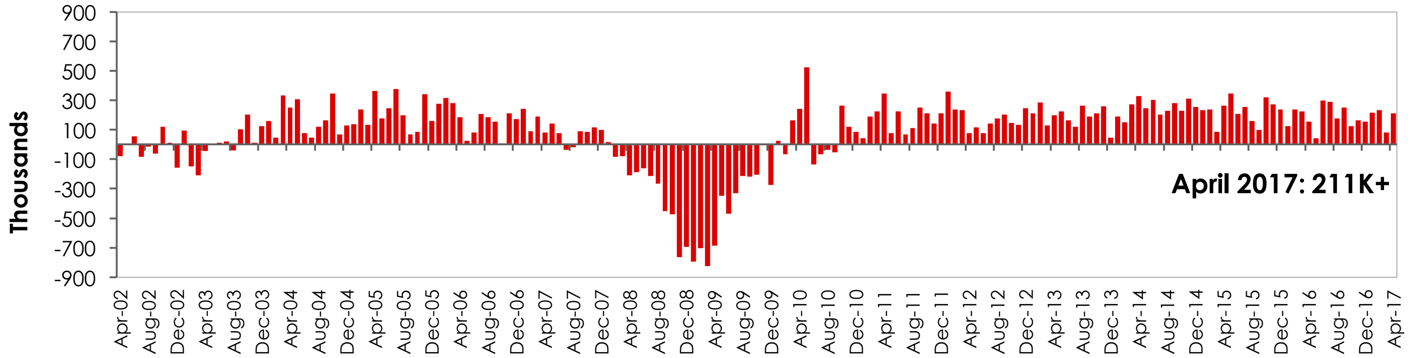
However, there are countervailing forces at work. During periods of household belt-tightening, people tend to shift more of their spending from expensive white linen restaurants to the casual, quick service market. That tends to benefit the single tenant net lease sector. Moreover, bargain hunters may be a bit keener to shop online to take advantage of easy-to-access deals and to more easily compare prices. The single tenant lease market (STNL) tends to be significantly more insulated from online competition than many other categories of retailers.

Conventional wisdom suggests that the economy's first quarter weakness will be supplanted by a second quarter bounce back. A number of high profile economic forecasters expect second quarter 2017 growth to be in the range of 4 percent. For that to happen, businesses have to spend more, as do consumers. Based on recent data, there are indications that businesses have been spending a bit more aggressively on equipment and also hiring in large numbers.

Accordingly, for those looking for work, the U.S. job market remains promising. In April, the country added

211,000 net new jobs, a significant rebound from March. This represents strong confirmation that March's weak job creation was a weather-induced fluke rather than a meaningful indication of economic softening. During 2017's first four months, the nation added 738,000 net new jobs. Compared to the same period one year ago, the nation supports 2.3 million more jobs, which translates into expanding consumer spending power. At 4.3 percent, the nation's unemployment rate is at its lowest point since May 2001.

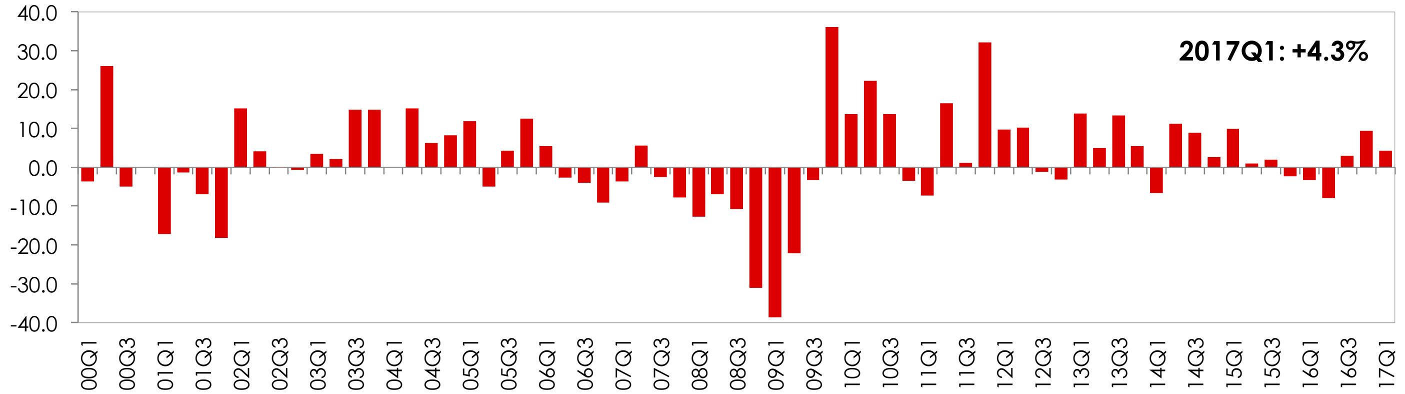
Net Change in Jobs, April 2002 – April 2017



Source: Bureau of Labor Statistics

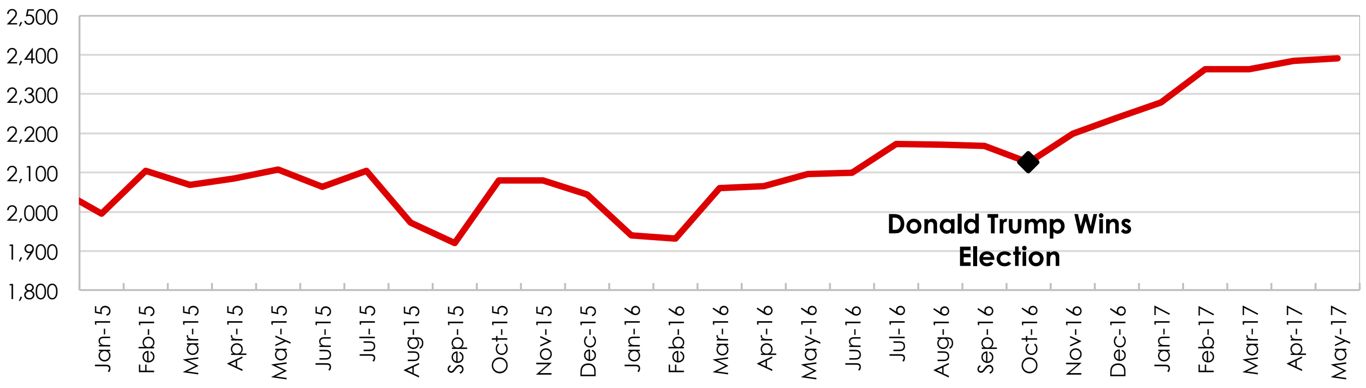
Decision makers continue to express confidence regarding their own futures as well as the broader economy. A recent survey by the National Association of Manufacturers showed that 93 percent of manufacturing executives are optimistic about the future of the economy. In fact, as early as December 2016, a measure of small business confidence generated by the National Federation of Independence Business had risen to a 12-year high. Other data, including hard data relating to investment in nonresidential structures, indicate that some economic actors have already increased their rate of investment as a response to a more pro-business political climate.

U.S. Gross Private Domestic Investment (SAAR), % Change from Previous Quarter 2001Q1 – 2017Q1



Among all of President Trump's promises, perhaps none has captured the minds of corporate America as much as his plans to revamp the country's corporate tax system and simplify the individual income tax regime. The administration has stated on multiple occasions a desire to reduce the corporate tax rate from 35 percent to 15 percent. Though this could be the President's opening gambit, with the ultimate goal being a reduction to something closer to 25 percent, it is an indication that many in the nation strongly believe that far too much activity has been offshored in part due to America's archaic tax regime.

S&P 500 Historical Prices*, January 2015 – May 2017



Source: Yahoo! Finance
*Close price adjusted for dividends and splits.

To date, very little of the president's pro-business agenda has been implemented. Financial markets appear largely undaunted, with the S&P 500 and NASDAQ hitting all-time highs at the time of this writing. Based on the behavior of financial markets, it might be tempting to conclude that investors never really built Donald Trump's pro-business agenda into their asset pricing models. For example, on the day of FBI Director James Comey's firing, U.S. equity markets failed to meaningfully respond despite the fact that the immediate political fallout would appear to have rendered it less likely that the President will be able to implement proposed tax cuts or an infrastructure-led stimulus package. It is safe to assume that any event that reduced the probability of pro-business policy shifts would have caused stock prices to fall, but that didn't happen.

Because of this, it is possible that U.S. equity market investors never really priced in the probability of policy implementation, but rather have responded more forcefully to the combination of positive economic data, improving corporate earnings, stable long-term interest rates, and the fact that Trump's opponent in the presidential campaign was planning a series of anti-business policies that will now not be implemented. Conversely, it is conceivable that the marketplace does not view all the noise coming from Washington, D.C. related to Russian activities or other sources of political storminess as altering the probably of tax cuts given the fact that the Republicans continue to be in control and can pass legislation easily as long as they remain sufficiently united.

Another element of Trump's platform revolves around deregulation of America's banking sector. Each quarter, the Federal Reserve Bank conducts a survey of senior loan officers at major U.S. banks. The most recent survey determined that lending standards across all three major types of commercial real estate loans tightened during the first quarter. Survey respondents also indicated that there is shrinking tolerance for risk. Once again, circumstances facing the STNL segment are likely to be different given the lower risk profile of tenants. During times of growing concern regarding the performance and fate of commercial real estate, the STNL segment generally emerges as an even more favored category for those seeking to deploy capital.

Cap Rates Fall Slightly as Higher Fraction of Deals Take Place in Premium Markets

Based on the weak performance of retailers, one might have expected that cap rates would have ticked higher during the first quarter of 2017. That didn't happen. Instead, there was a very slight compression of 11 basis points in single tenant net lease cap rates.

Few retailers have delivered as jarring sales data as Target has. According to Target Chairman and CEO Brian Cornell, the company's poor results in the fourth quarter of 2016 "reflect the impact of rapidly changing consumer behavior, which drove very strong digital growth, but unexpected softness in our stores." The company has also stated that it expects earnings for its full fiscal year to be lower than Wall Street analysts have been predicting – a statement that hammered away at Target's share price.

Target is hardly the only struggling department store chain. As reported by Yahoo! Finance, during the first four days of a recent week, shares of Macy's were down more than 17 percent, Dillard's by 20 percent, Kohl's by 11 percent, and Nordstrom's by about 15 percent. The shift toward online retailers has become increasingly apparent, including giant-slaying Amazon and other online players like Wayfair.

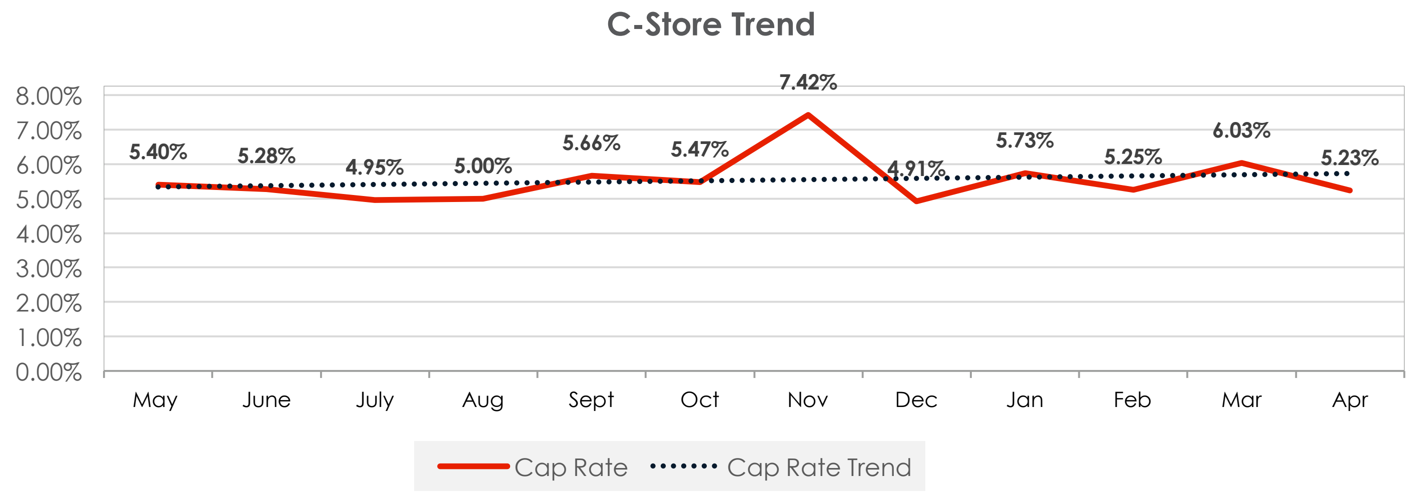
It is conceivable that lower credit profile tenants are now experiencing greater difficulty transacting. Purchasers of single tenant properties are more wary given the relentless gains in market share of Amazon and other online retailers. One implication is that additional retail consolidation is likely as weaker players are offered less attractive leasing terms to offset the growth in perceived delinquency risk. This is consistent with the notion that a shrinking number of healthy brick and mortar retailers will gobble up weaker retailers, using the opportunity to squeeze out underperforming capacity.

The logic is retail vacancy will continue to rise in many markets. This will render high-performing single tenant net lease properties even more attractive, which could result in even lower cap rates in an environment characterized by growing risk and rising interest rates. This is hardly speculative since these dynamics appear to have been at work during the first quarter.

There are other possible explanations for falling cap rates. For instance, despite a soft first quarter, many economists describe economic conditions as improving. The Labor Department recently reported that employers collectively added 211,000 jobs in April after adding just 79,000 jobs the month prior. Hiring in April was broad based, with particularly large gains registered in business services and healthcare and many economists believe that March's slowdown in job creation was simply a weather-related one month blip.

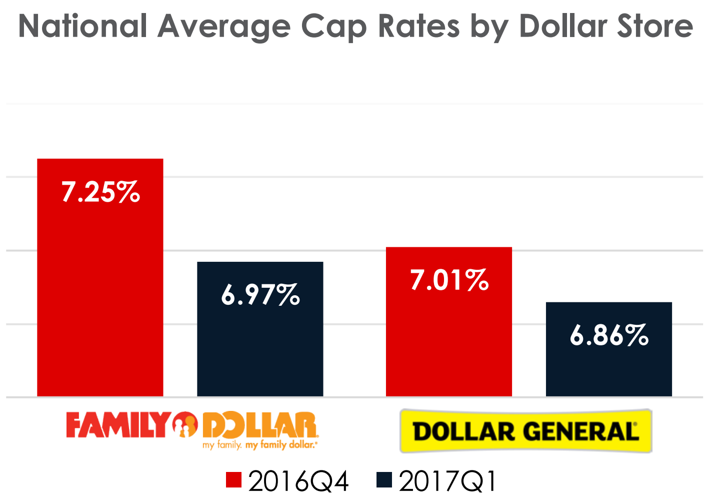
The official national unemployment rate stands at 4.3 percent, nearing the lowest point in 15 years, an indication that wage pressures will continue to build. This will, presumably, support higher consumer spending. While it is true that consumers appear to have taken some time off during the first quarter, they are likely to spend more aggressively as the weather warms. The U.S. savings rate rose to 5.9 percent in March as continued wage growth encountered weak consumer outlays. Partially in response to recent improvements in economic data, forecasters like those at Macroeconomic Advisers are projecting annualized economic growth of roughly 4 percent during the second quarter of 2017.

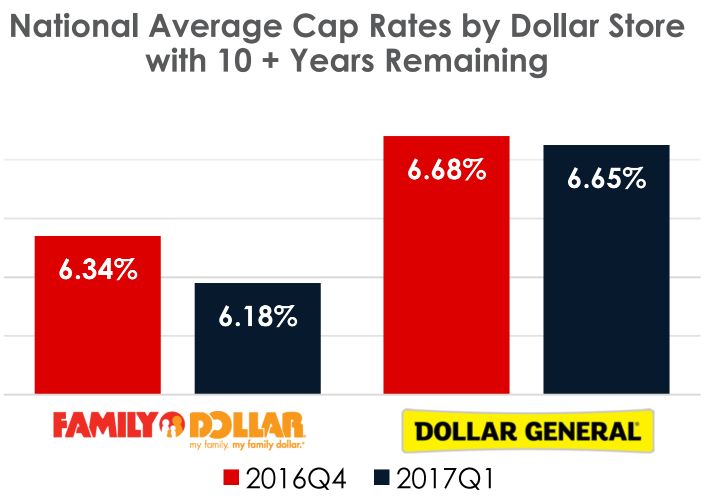
Other explanations flow from worldwide economic dynamics. With bond yields even lower in much of the advanced world, global capital has continued to flow to America in search of a healthier combination of yield and safety. The result has been surging asset prices, including in equity, bond, and real estate markets. This dynamic helps explain falling cap rates across a host of single tenant net lease segments during the initial three months of 2017, including the 56 basis point decline in the c-store sector and the 16 basis point drop in the dollar store segment.



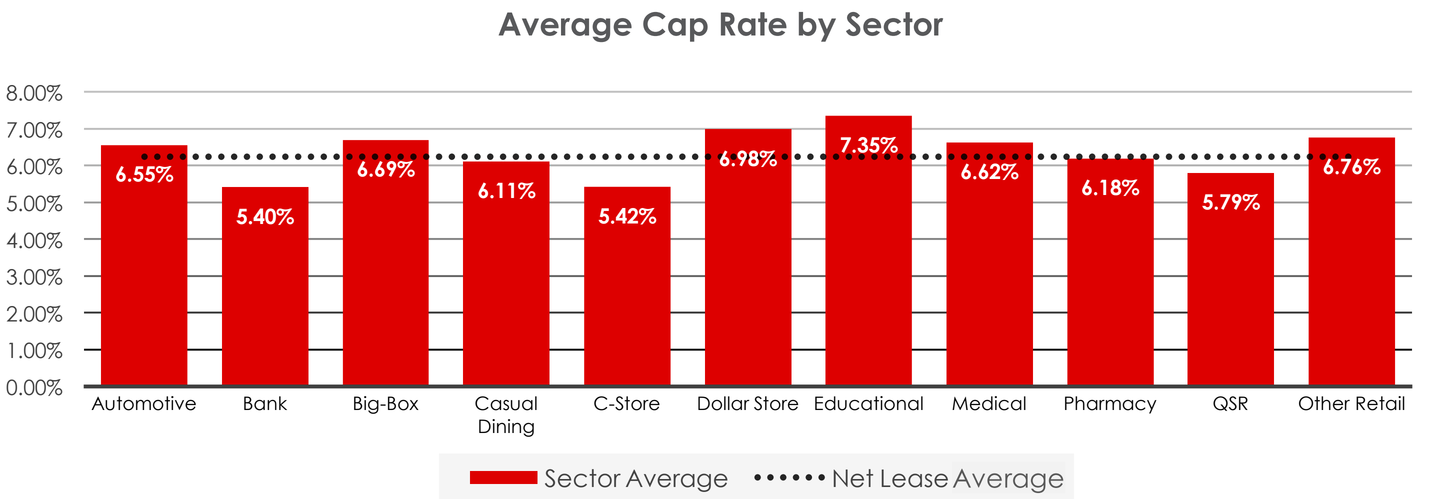
While there may have been large differences in cap rates between 2016 Q4 and 2017 Q1, the 12 month trend shows a stable cap rate, with one month proving to be the exception. The cap rate spike in this month was caused by a drop in the number of lease years remaining.

Deals involving Family Dollar produced a decline of 28 basis point during the quarter while those involving Dollar General produced a 15 basis point decline. Remaining number of years on lease also represents an influential factor. If one focuses on just those deals that were closed during the first quarter with at least 10 years remaining, cap rates were flatter, though still lower at quarter's end.

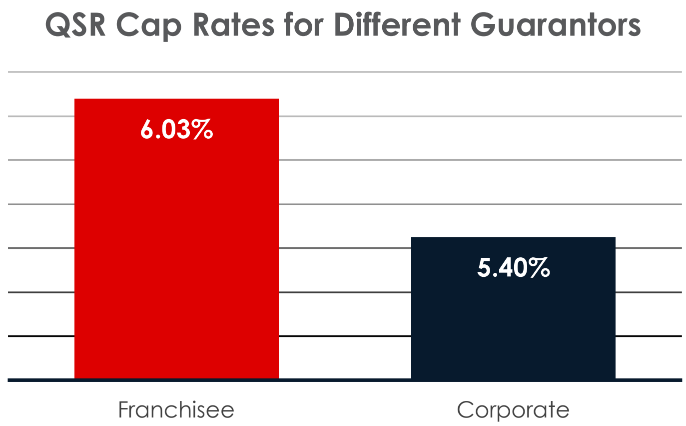




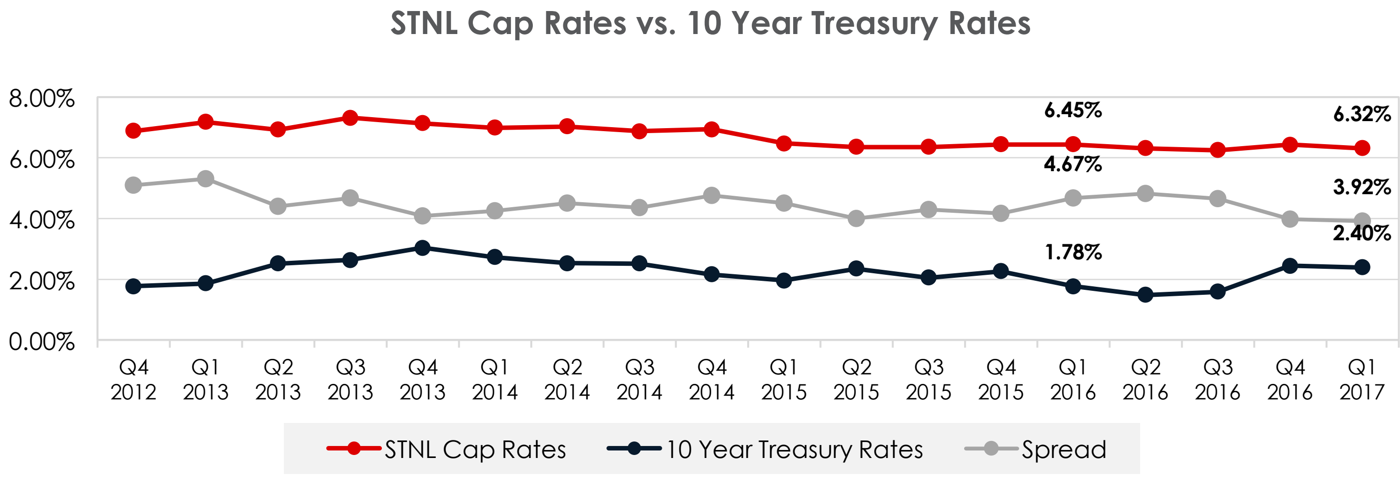
The number of years remaining is a major factor effecting cap rates. With longer durations left on leases, the cap rates are lower than their sector averages. The chart below also demonstrates the differences in cap rates across various sectors.



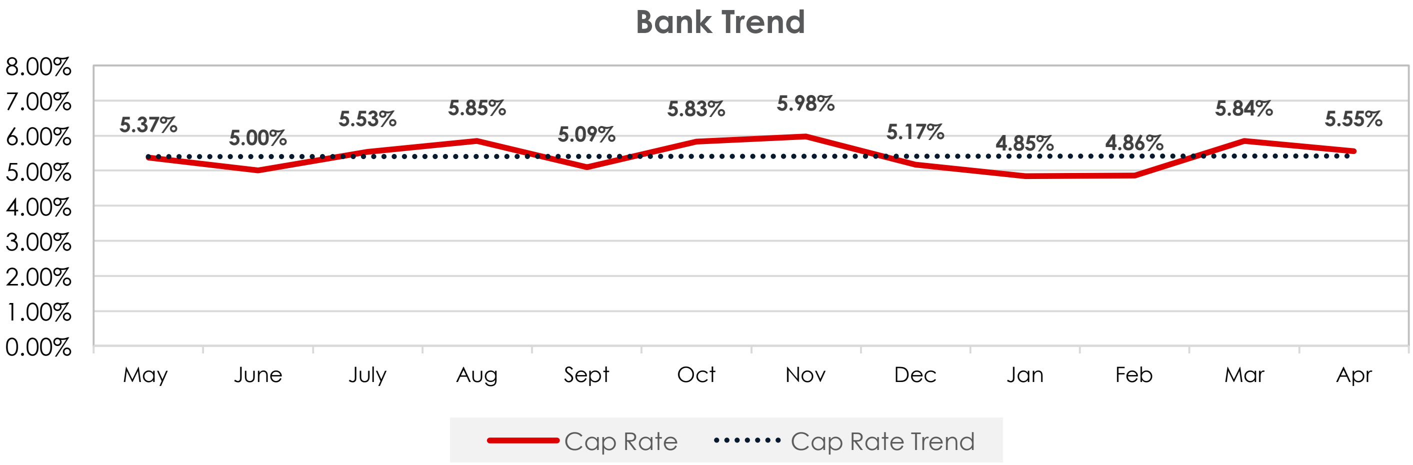
Among quick service restaurants, Arby's experienced one of the steepest compressions in cap rates, falling a sharp 65.2 basis points during Q1 2017. The average number of years remaining on leases increased by nearly two years. There were also more corporate guaranteed leases that closed during the first quarter.



Yet another explanatory factor is the relationship between long-term interest rates and cap rates. During 2017's first quarter, single tenant net lease cap rates virtually mirrored 10-year Treasury rates. However, during the four prior quarters, the spread between single tenant net lease cap rates and 10-year Treasury yields had been narrowing, with the year-over-year spread down by 75 basis points. The first quarter represented the second consecutive quarter with a spread below 4 percent (STNL rates were 6.32 percent while the yield on 10-year Treasury bonds stood at 2.40 percent for a spread of 3.92 percent). This is not altogether surprising. The yield curve has been flattening for several months, with long-term rates in general failing to rise as economists and others had predicted. The combination of narrower spreads and low long-term rates mathematically produces stable to falling single tenant net lease cap rates.

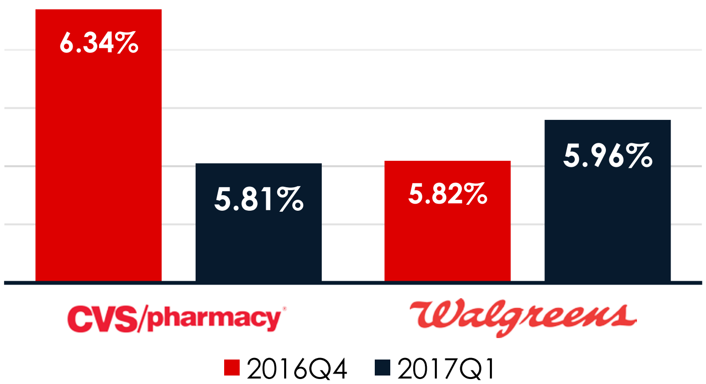


Longer term interest rates such as 15 and 30 year fixed mortgage rates have remained relatively stable even as the Federal Reserve has raised short-term rates and signaled further tightening to come in June and beyond. Stable interest rates coupled with increased economic activity should translate into ongoing home price appreciation as a growing number of workers leverage low rates to buy up still dwindling housing inventory. Resulting positive wealth effects represent one of the reasons that economic forecasts are confident that home sales will pick up during the remainder of 2017. Renewed growth in the nation's homeownership rate also suggests rising sales of furniture, household linens, appliances, and other items that are routinely purchased after the acquisition of a home.



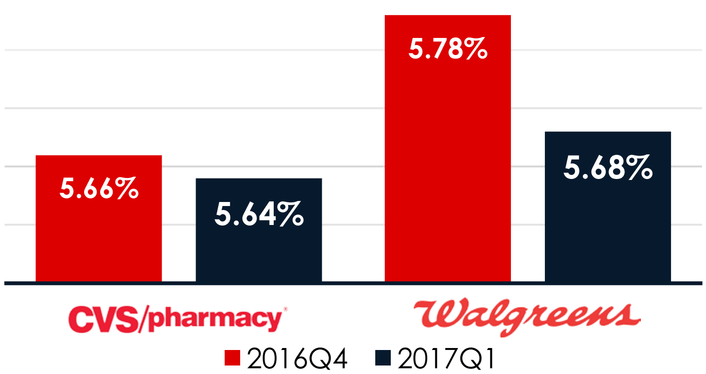
The banking sector experienced a decline in cap rates from Q4 to Q1, even with fewer years remaining on average. Cap rates typically increase with a decline in the average number of years remaining on lease. This appears to have been at least partially attributable to a large number of deals in California, which typically supports much lower cap rates than the balance of the nation.

National Average Cap Rates by Pharmacy



The pharmacy sector had similar dynamics, with cap rates remaining relatively unaltered even though the average years remaining on leases fell by more than two years. CVS experienced the sharpest compression in cap rates, falling by 53 basis points. Perhaps surprisingly, Walgreens, another in-demand tenant, experienced an increase of 14 basis points in its cap rates. This is easily explainable however, since nearly 60 percent of all shorter-term deals in the pharmacy category involved Walgreens. That compares to just 20 percent of sales of pharmacies with fewer than 10 years remaining during the fourth quarter of 2016.

National Average Cap Rates by Pharmacy with 10+ Years Remaining



There were a handful of other instances of rising cap rates. For instance, O'Reilly Auto Parts experienced an increase in cap rates, with older deals trading. For the most part, cap rates compressed slightly during the first quarter.

Looking Ahead

Looking forward, the country should expect a decent level of economic growth for the remainder of the year. Tax cuts, or at least the belief that there will be tax cuts at some point during the next four years, has already boosted confidence in both households and businesses. Consumer spending should pick up again in the latter half of the year, along with business spending. The recent jobs figures indicate that the nation is heading towards full employment.

Though rising wages and more jobs are generally viewed as good news, there is reason to be concerned. Wage pressure is rising alongside other sources of inflation (e.g. healthcare, imports). One would expect this would result in an increase in interest rates, which could bump up against presently elevated property values and lead to a combination of financial and economic turbulence. The accompanying rise in longer-term rates would presumably nudge single tenant net lease cap rates higher. Of course, economists have been predicting that long-term rates will rise for several years, only to find themselves scrambling for explanations for why the inevitable failed to transpire.

The STNL market is also encountering the same forms of uncertainty that other economic factors are with respect to implementation of the president's pro-business agenda. There is evidence that many prospective buyers have embraced a wait-and-see attitude. The implication is that if the administration in Washington, D.C. can get its policy agenda back on track, there could be a flurry of deals in the STNL market.

About This Report

This Net Lease Economic Report was produced by Calkain Companies research department in conjunction with Sage Policy Group, Inc.

CALKAIN
AMERICA'S NET LEASE COMPANY

Calkain Companies is a boutique commercial real estate firm with a passion for the net lease market. In 2005, Jonathan Hipp, President and CEO, took the initiative to build upon his experience and left a large, international brokerage firm to become an independent and innovative leader within the net lease investment community. Armed with a sole employee and a single office, the firm has grown exponentially.

Our services include Asset Management, Research, Advisory and Capital Markets. Solid relationships have been the cornerstone throughout Calkain's decades of experience in the industry. They approach their clients' risk tolerance with foresight and enthusiasm, forging long term partnerships by identifying the right people, investment criteria and innovation. Whether private or institutional investors, Calkain prides itself on providing real estate solutions that maximize client value and build wealth for your future.

Jonathan Hipp | President & CEO

Jon Hipp began his career in real estate over 25 years ago. In his early years as a broker, he ventured into the net lease industry and quickly began leading the US net lease market, closing over $3 billion in transactions. Jon was a Senior Vice President for Grubb & Ellis in Tysons Corner. With his "make it happen" mentality, Jon was honored with the #1 Producer Award for three consecutive years in his local office and was amongst the Top 10 Producers nationwide throughout his tenure at Grubb & Ellis.

In 2005, Jon co-founded Calkain Companies and as President and CEO, Jon has been instrumental in building the firm into one of the leading Net Lease real estate companies, transacting over $11.5 billion of net lease deal volume over the past 11 years.

Sage Policy Group, Inc.

Sage Policy Group, Inc., was established in 2004 by Anirban Basu. Sage is an economic and policy consulting firm specializing in economic, fiscal and legislative analysis, program evaluation, and organizational and strategic development. The firm's clients include public agencies, law firms, developers, money managers and an array of nonprofit organizations. As experts in research methods, their corporate focus is to utilize sound, widely accepted analytical techniques that provide their clients and stakeholders with valid and reliable information to support critical organization requirements.

Sage's clients appreciate the firm's capacity and willingness to go beyond trend forecasts and to envision likely scenarios and their impacts on key variables, including revenues and expenditures. One of their principal strengths is the capacity to predict real estate and construction-related variables, which is important along both economic and fiscal dimensions.

Anirban Basu | Chairman & CEO

Anirban is a study in contradictions. He has been called an economist with a personality, or alternatively, one with a sense of humor. He has twice been recognized as one of Maryland's 50 most influential people. He has also been named one of the Baltimore region's 20 most powerful business leaders.

Anirban serves as Chairman of the Maryland Economic Development Commission, teaches global strategy at Johns Hopkins University, and serves the Chief Economist function for a number of organizations around the country. He has read every one of Agatha Christie's novels, is obsessed with James Bond, English football, Indian cricket, all Baltimore teams, and with his wife and two daughters, Kimaya and Kohena.

Calkain Companies LLC
12930 Worldgate Drive, Suite 150
Herndon, VA 20170
(703) 787-4714
calkain.com

Sage Policy Group, Inc.
575 S. Charles Street, Suite 505
Baltimore, MD 21201
(410) 522-7243
sagepolicygroup.com

DISCLOSURES: As part of our market research, we collect sales price, cap rate, and lease years remaining for all publicly advertised and sold STNL properties. a) We are not able to capture 100% of the off-market transactions that occur; however the nature of off-market typically limits their value as true market comps. b) Sources include public records, sales announcements, Calkain sales, and appraiser obtained sales amongst others. c) Our collection process, while thorough, is not all encompassing and there may be biases in the data as it relates to geography, tenancy, or brokers involved in the transaction. d) Public records often lag behind when transactions actually close, months in some cases. Consequently the data supplied here for any given quarter is likely to miss a material amount of transactions that actually closed in it.