THE OUTLOOK

Marcus & Millichap

SINGLE-TENANT NET-LEASED RETAIL

MIDYEAR 2021

Low Bond Yields and Elevated Inflation Risk Invigorate Buyer Interest in Net-Leased Assets

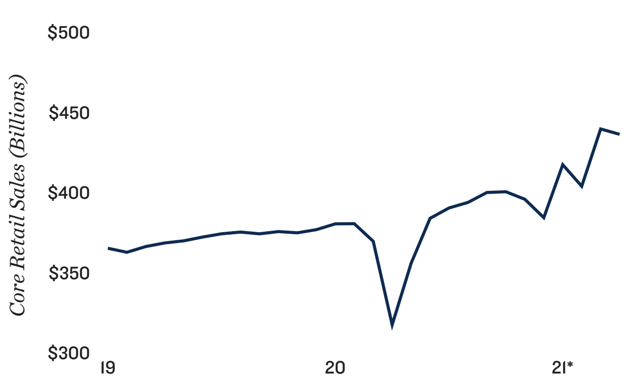
Demand for single-tenant properties to last beyond health crisis. Most of the traditional users of net-leased retail space weathered the pandemic better than many sectors of the real estate market. Nonetheless, vacancy increased as occupancy restrictions and full shutdowns were too much for many concepts to bear. Vacancy in the single-tenant space increased 50 basis points to 5.3 percent between the first quarters of 2020 and 2021. By comparison, multi-tenant retail vacancy jumped 80 basis points to 6.6 percent during the same span. Going forward, vacancy will continue to climb modestly, though most of the rise will be concentrated in dilapidated space or nearby multi-tenant centers that have lost the anchors critical to remaining relevant. Tenants on pads near defunct malls, in particular, will be challenged to survive or forced to relocate.

Retail sales well above pre-pandemic levels. Single-tenant retailers continue to benefit from the influx of stimulus capital pumped into the economy in the wake of the health crisis. Core retail sales climbed 15.7 percent between February of last year and May 2021, while the nation's money supply rose by nearly double that rate. The gap between the rise in money supply and retail sales suggests pent-up demand exists and a return to previous spending levels is unlikely. Americans have accumulated more than $4 trillion in savings deposits since the onset of the pandemic, and now that vaccinations are readily available for every adult that wants one, more visits to retailers are expected in the coming months. Although some of those funds are being directed into services that are not generally reflected in the U.S. Census' measure of retail sales, many single-tenant buildings, such as gyms, will benefit from the rise in in-person spending.

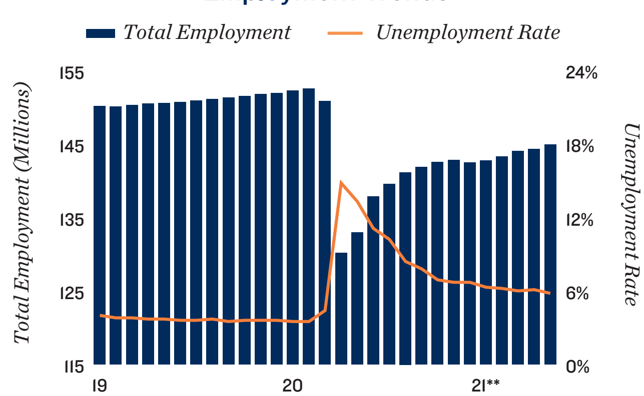
Labor shortage hamstrings some sectors. A few states with stringent lockdowns may see restaurant closures near 33 percent, while others may only experience 10 percent losses. Many of the remaining dining concepts have struggled to find enough workers to fill vacant spots. There were 1.3 million job openings for accommodations and food services in April, up from 800,000 during February 2020, when the unemployment rate was a paltry 3.5 percent. As federal unemployment benefits fade across many states over the summer and conclude on Sept. 6, more individuals will be compelled to fill these vacancies in the coming months. Combined with additional consumers returning to brick-and-mortar stores, many single-tenant locations will post an increase in both customers and sales through the end of the year, including at restaurants where wages are rising. Additional funding from the Small Business Administration, which could be part of a future congressional spending package passed through reconciliation, will help entrepreneurs backfill dark single-tenant space.

Reopening to support single-tenant retailers. As workers return to offices, more visits to single-tenant facilities will aid in retail sales at stores near offices and other establishments that rely on commuters. Restaurants near major office districts, in particular, are poised to benefit from the increase in the number of people returning to those areas. Retailers in urban centers have been particularly hit hard by the global health crisis and long shutdowns focused on easing the spread of the virus. Dense office districts in New York City and San Francisco are positioned to benefit the most from the reopening of offices, though the scope and scale of the return in these areas remains uncertain. Financial firms appear to be more aggressive in bringing staff back into facilities, whereas tech companies are more flexible with schedules.

Core Retail Sales Growth

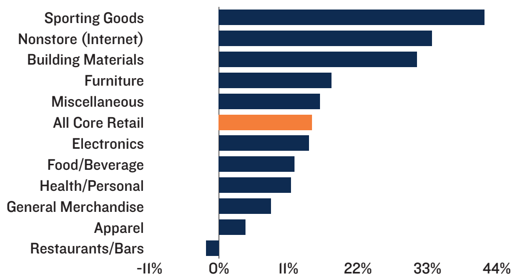


Employment Trends



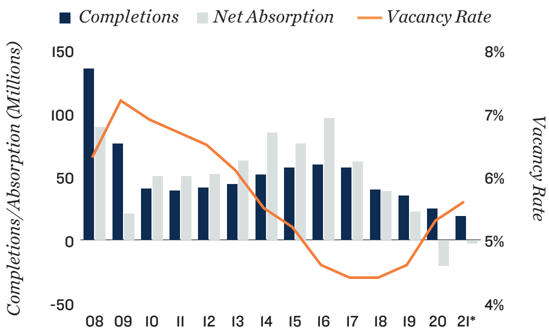
** Through April*
*** Through May*
Sources: BLS; U.S. Census Bureau

Retail Sales Soar Above Pre-Pandemic Levels

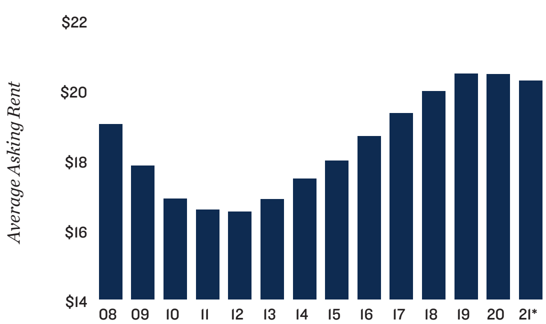


Percent Change Feb. 2020-April 2021

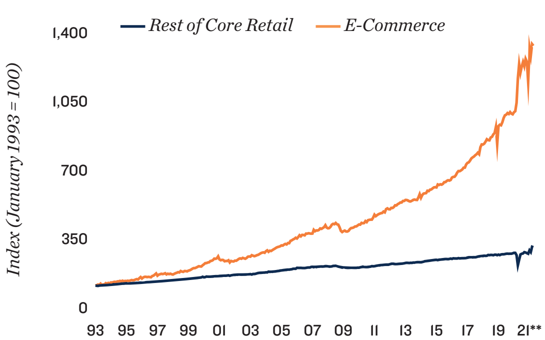
Supply and Demand



Rent Trends



Retail Sales Growth Index



* Forecast

** Through April

Sources: U.S. Census Bureau; CoStar Group, Inc.

Suburban Single-Tenant Retail Poised for Growth

Population spreads out across cities. Americans searched for larger spaces at the onset of the pandemic as office employees worked from home and their children participated in remote learning. Most of those housing units are located in suburban areas, which encouraged people in high-density areas to search for homes with more space. Single-tenant properties in those locations are performing well due to the increase in traffic relative to before the health crisis. Buildings with a drive-thru have performed well and are expected to receive steady traffic in the coming months as many residents remain hesitant to fully resume their activities until a larger percentage of the population is vaccinated. Additionally, more Americans are projected to live in suburbs over the long term as millennials enter the prime age to start families and move to less dense areas.

Developers Follow Varying Demand Drivers

Builders remain active after health crisis pause. Developers have continued to add to inventory over the past year after a short hiatus during the early stages of the COVID-19 outbreak. Concerns about the lethality of the virus and challenges attracting workers caused builders to take a break from working on new construction. Nonetheless, speculative development resumed relatively quickly as demand for single-tenant buildings remained in high demand. Currently, 19.5 million square feet of single-tenant square feet is under construction. Only 23 percent of that space does not have a leasing commitment as retailers flock to suburban assets where they have access to drive-thru portals. Most of the new construction is build-to-suit as national-credit tenants take advantage of healthy demand. Dollar General, for example, is planning over 1,000 new locations this year after sales climbed by over 20 percent in 2020.

Vacancy searches for new balance. Single-tenant vacancy is anticipated to increase this year as many smaller locations succumb to the challenges of the health crisis. California, New York, Michigan and other states that issued extended lockdowns are expected to have the highest level of vacancy rises in the coming months. California currently has an unemployment rate of 7.9 percent, while New York's level is 8.0 percent. Both economies are expected to gain traction over the coming years, though it will take some time for new establishments to materialize and absorb dark single-tenant properties. Other states are performing significantly better due to more lax shutdown laws, mostly in the Sunbelt where outdoor dining was more easily adoptable and capacity restrictions were lifted more quickly. Going forward, the performance of single-tenant properties in various locations will be heavily contingent on the strength of the local economy; some states are expected to outperform over the next few months. Nationally, vacancy is anticipated to increase by just 30 basis points to 5.6 percent before beginning to contract next year.

Rent performance highly dependent on geography. Like other commercial property types, space demand and rents for single-tenant buildings are reflected in migration trends. Over the past year, the average asking rent for available space dipped 0.4 percent to $20.45 per square foot. Rents are projected to rise across the Sunbelt and retreat in some areas where many smaller retailers that occupy single-tenant space have permanently closed. Overall, single-tenant rents are on track to decline approximately 1 percent to $20.25 per square foot, though a bifurcated performance is anticipated. The prevalence of new construction will limit the total decrease despite the challenges presented to the retail market by the health crisis.

Investors Target Single-Tenant Properties as Alternative to Bonds

2021 Forecast

U.S. RETAIL SALES:

12.0% increase Y-O-Y

- The influx of stimulus money and rise in inflation is projected to push retail sales up 12 percent this year relative to 2020. A more normalized level of consumer spending is anticipated next year barring a significant change in the health of the economy.

U.S. CONSTRUCTION

18.7 million square feet completed

- Developers will ease the pace of new development this year as the focus shifts to build-to-suit projects. Following the construction of 24.7 million square feet in 2020, construction will slip nearly 25 percent.

U.S. VACANCY

30 basis point increase Y-O-Y

- Nationwide vacancy is projected to inch up 30 basis points to 5.6 percent in 2021. Most of that increase will occur in the coming months as retailers shutter their doors permanently.

U.S. RENT

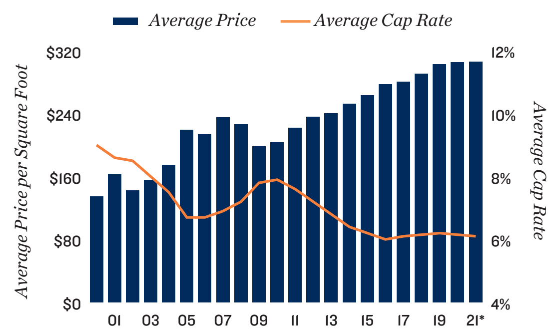
1.0% decrease Y-O-Y

- Available space is projected to be marketed at a 1 percent discount this year at $20.25 per square foot. Many of the properties that become available will be mid-block locations, which will be more challenging to attract tenants.

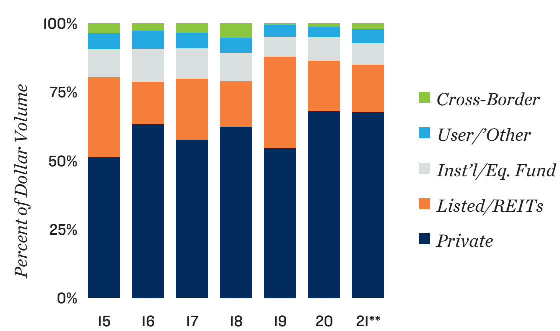
2021 INVESTMENT OUTLOOK

- **Smaller deals move to the forefront.** Due to the health crisis, investors transitioned to a flight to safety and were less likely to target portfolios. The cautionary stance of these investors decreased the number of portfolio sales from 18 percent in the first quarter of 2020 to approximately 14.5 percent in the first quarter of this year. Prospective owners are far more focused on the creditworthiness of the tenant rather than acquiring a larger group of properties to increase their portfolios. That trend is expected to reverse in the coming months, however, as the survivability of retailers becomes clearer as the economy gains traction.
- **Prices inch higher over the past year.** Buyers, with easy access to capital and leveraging low interest rates, were enthusiastic about purchasing single-tenant properties. Over the 12-month period ending in the first quarter, the average price increased 0.7 percent nationwide. At the same time, the average first-year return dipped 10 basis points to 6.1 percent as investors targeted creditworthy tenants. Nonetheless, the spread between interest rates and cap rates remains wide and purchasing a single-tenant property is among the strongest returns available, particularly as the 10-year Treasury rate hovers in the middle-1 percent range. Going forward, single-tenant assets will remain a popular destination for investor capital as a hedge against inflation and an alternative to low-yield bonds.
- **Mom-and-pop retailers attract buyers.** After a year of investors taking a cautious stance, the attractiveness of non-creditworthy tenants should skyrocket this year as buyers realize the vitality of single-tenant retailers that managed to survive the health crisis.

Sales Trends



Buyer Composition Trends



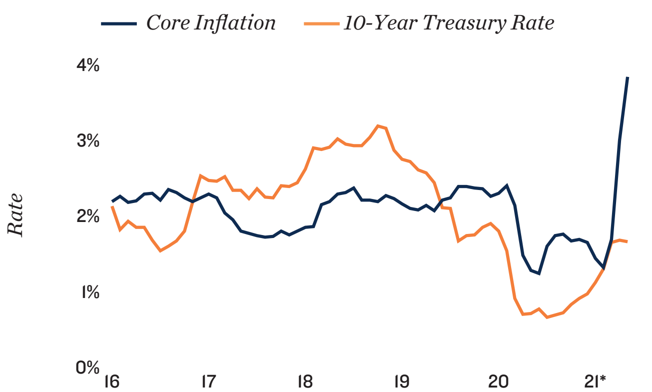
** Through 1Q*
*** Trailing 12 months through 1Q*
Buyer composition for sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

Capital Market Operations Largely Resume; Inflation Concerns Becoming More Apparent

Fed positions for temporary higher inflation period. Applying lessons learned from the global financial crisis, Congress and the Federal Reserve acted swiftly to preserve market liquidity and support borrowers amid the pandemic last year. As U.S. infections recede and the economy reopens, attention is shifting to the potential longer-term ramifications of these actions. The rapid increase in money supply from multiple stimulus provisions paired with low interest rates and disrupted supply chains has led to higher inflation, with core CPI climbing 3.8 percent annually in May. While above earlier expectations, the Federal Open Market Committee (FOMC) still considers this a transitory concern and intends to allow inflation to stay above the traditional 2 percent growth target for longer than it has in the past. The Fed also expects to keep the overnight lending rate low for the near future, citing still-high unemployment as one reason to hold off. More committee members are now open to the prospect of raising rates in 2023, however. Current quantitative easing practices will also remain in effect for the time being. The FOMC will wait for more substantial economic progress before tapering asset purchases, although some pandemic period programs have already expired.

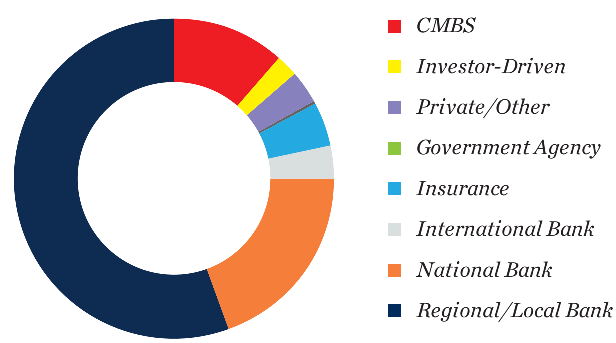
Capital available for properties with pandemic-resilient tenants. Following significant disruptions last year, the majority of lenders are now active and anticipating larger volume after 2020's slowdown. Sentiment is improving, aided by a 10-year Treasury rate in the 1.5 percent range and greater population mobility, which will help properties in commercial and travel hubs that were disproportionately affected by lockdowns. Lenders are nevertheless favoring borrowers with whom they have an established and positive relationship. A borrower's credit worthiness and track record bear considerable weight when accessing capital, as does recent property performance, including rent collections. More opportunities are available for assets that demonstrated durability during the pandemic or are now in a strong recovery position. Capital is readily available for properties tenanted by necessity retailers, especially national chains. The same is generally true for assets that house quick service restaurants that were able to largely maintain business via drive-thru or other features. If a tenant has not performed well over the past year, the borrower may still be able to obtain competitive financing if the building is located in a higher-tier residential area. Overall, while lending volume is not anticipated to recover to 2019 levels, the impact of the health crisis on capital availability is expected to be less severe than that of the global financial crisis. The external nature of the health problem and critical efforts taken by Congress and the Federal Reserve have maintained and are improving liquidity in the market.

Inflation and Interest Rate Trends



* Through May
Sources: BLS; Federal Reserve; Real Capital Analytics

2020 Single-Tenant Retail Lender Composition



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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Placer.ai; Real Capital Analytics; U.S. Census Bureau; Federal Reserve