

After July 15th: What Will the Second Half of 2020 Look Like Without Exchange Investors?

Dear Clients & Colleagues -

Much earlier this year, in what seems a lifetime ago back in February, we had the chance to moderate a panel at Interface West Net Lease Conference entitled “Investment Market Outlook: The NNN Market is Red Hot – Can this Continue?” Perhaps we would have been well-advised to follow Casey Stengel’s quote: “Never make predictions, especially about the future.” While the panel did touch on the topic of COVID-19, which was primarily then confined to Mainland China, no one could have foreseen the outsized influence it would have on every aspect of the financial world in 2020.

One of the more intriguing, hypothetical (at that moment) questions which we posed to the panelists was, “What would the marketplace look like if there were no tax-deferred investors (1031 exchanges) acquiring assets?” What was then purely a thought exercise, is now a very real and relevant question. With the expiration of the IRS’ extended 1031 identification deadline, the net lease market now enters a period in which 1031 activity will likely be at its lowest levels in more than a decade, stretching back to the fallout from the Great Recession in 2008-2009.

The consensus amongst panel members was that the impact of no tax-deferred investors in the marketplace would be somewhere between substantial and catastrophic, and by eliminating one of the predominant buyer segments for the market (particularly for retail assets), cap rates could rise as much as 200 basis points or more. That line of thinking seemed defensible, inasmuch as if 30 to 50 percent of the investors were suddenly absent, it appeared there would need to be a corresponding impact on market pricing.

The counterpoint to that doomsday scenario was the potential that the net lease market possessed a better firewall of pricing than may have been obvious. Lurking behind exchange investors who paid an average 6.27 percent cap rate in 2019 (for retail net lease assets greater than \$2.5 million), were a host of institutional (REITs and funds) and non-exchange private investors who would step up to acquire assets if cap rates started to meaningfully rise. Alas, our once hypothetical is no longer a thought exercise, and far closer to reality! Accordingly, we now consider the cases both for and against the impact that the decade-low exchange activity will have on the market.

The rationale for why low exchange activity would lead to a rise in cap rates is straightforward:

- Exchange investors represented a high portion of overall transaction volume for the last decade, particularly retail net lease
- Exchange investors paid the most aggressive cap rates generally by virtue of their time-sensitivity and capital they would forfeit to the IRS if they did not complete a trade
- Many exchangers were lower leverage investors, and thus less dependent on interest rates to achieve their returns
- Institutional and non-exchange investors generally were 50 to 100 basis points higher in cap rates, and with less competition would be able to achieve even more favorable pricing

So, what counterpoints might exist for the balance of 2020 that would stem a massive rise in prevailing cap rates? Interestingly, some have already emerged in the last three to four months, namely:

Historically Low CRE Financing Costs Spurred by a Sub-1% 10-Year Treasury

- With the Treasury sitting at roughly 0.65 percent, lenders have been able to offer loans to investors around a 4.0 percent interest rate, allowing them to achieve at least 300 basis points, which are both historically low rates for investors, and historically high spreads for lenders
- This win-win has been a boon for banks and life insurance companies, as they've seen CMBS lending at very low levels, allowing them to tighten underwriting standards and achieve better returns

Lack of Confidence in Alternative Investments

- COVID-19 and the multitude of crosswinds buffeting the financial world have made it wildly challenging for investors to assess where to place their capital
- The most secure of investments, including Treasuries, are offering virtually no returns
- This has driven some investors to conclude that although not risk-free in these uncertain times, the net lease sector provides an interesting risk-adjusted return option

Sporadically Strong REIT Cost of Capital & Fundraising

- Net lease REITs have shown a good degree of resilience during the pandemic - while many have had “fires to put out” via asset management in their existing portfolios, their stocks have generally rebounded off of the April 2020 lows
- For instance, Agree Realty, (NYSE: ADC) since the start of 2020, has raised its acquisition guidance from \$600 million to \$1.1 billion, after acquiring \$275 million in second quarter 2020

Increasing Bifurcation of the Net Lease Market

- We continue to see a “tale of two worlds” in which certain asset segments are seeing heavy investor engagement (e.g., essential retail, medical, industrial) while other segments are sluggish at best (e.g., non-essential retail, office, short-term leases, high rent assets)
- Such a dynamic could lead to further spread widening between the “haves and have-nots” without impacting overall market pricing on as substantial a basis

Ultimately, anything could still transpire for the balance of 2020, particularly with the Presidential and Congressional elections just months away. However, one key storyline we will be monitoring is what the net lease market will look like with far fewer exchange investors in the mix.

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