

# The Great Net Lease Trifurcation

Dear Clients & Colleagues -

The upheaval inflicted by COVID-19 upon the commercial real estate market has been unprecedented, far reaching, and fast moving. Investors are evaluating dynamics and situations that most considered largely impossible only months ago. The pace of this disruption has caused investors to quickly pivot their thinking and behavior, shifting their investment parameters and risk underwriting.

For the Net Lease Market, this has led to a **“Trifurcation”** of the industry into three clear tranches:



In the below chart, we breakdown each category in detail. It is a triage, where investors have collectively analyzed each segment of net lease based upon the intersection of public health, economic, and financial markets.

	Essential Net Lease	Impacted Net Lease	Obliterated Net Lease
Overview	Composed largely of the tenants who have been net beneficiaries of COVID-19, or have been able to maintain their businesses	Composed of tenants who have been able to operate to some degree, but have been majorly impacted in a manner that stops them from driving revenues anywhere near where they once were	Composed of Tenants whose businesses cannot operate during the pandemic, and don't have an easy path to understanding how the future looks
Tenant Types	Grocery, Pharmacy, Home Supply, Paint, Coffee, Industrial, Medical	QSR Restaurants & Casual Dining with carryout/drive-thru, Electronics, Fashion and traditional Retailers with brick & mortar and online presence	Gyms, Fitness, Theaters, Entertainment, Bars & Restaurants with no carryout/drive-thru, traditional retail with brick & mortar only
COVID-19 Impact	Although the crisis has caused severe shifts in the business model, these tenants have continued to operate and drive significant business	These segments have seen their business greatly hobbled by the outbreak, and have sought to shift their business models to maintain some degree of business revenues	This segment has seen the greatest brunt of COVID-19, with full shutdowns of their business, and a very uncertain timeframe for their resumption
Debt Capital Availability	Although CMBS is absent from the market, there remains decent lending from banks and life insurance companies	Greatly diminished, with lending sources likely to be only commercial banks on recourse loans, with much tighter underwriting	Virtually unavailable, with the exception being private-client lending relationships, in which banks are lending based on a sponsor and not the property
Pricing Dynamics	Pricing has remained largely unchanged from 2019, and in some cases may have seen some tightening in Cap Rates	Pricing is significantly elevated on a Cap Rate basis. The full impact likely is not being seen yet, because of limited liquidity, but our view is that the segment will experience Cap Rates 75-150bps higher	For all intents and purposes, this segment has no liquidity currently. Forced sales would likely see Cap Rates that would be 200+ basis points higher than 2019
Outlook	The outlook for this segment is very favorable, with a growing view that the segment will see a sustained uptick in business as behaviors of customers are altered from this crisis	The outlook for this segment is more uncertain. With shifts to business models, and recovery from this crisis, it's possible that the segment could see a relative return to normalcy in 12 months, but that return likely includes sales that will be 10-20% lower than 2019	The outlook is very bleak, owing largely to the fact that customer perception for going back to these businesses will be stubbornly pessimistic in an attempt to shield themselves from infection. Even a return to business will be at levels far lower than last year, and likely to be so for quite some time

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