



## **The value of single tenant net lease in an inflationary environment - by Michael Packman**

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Despite rising interest rates and an inflationary environment, the U.S. economy continues to defy expectations. Consumer spending is fueling GDP growth, and jobless rates, while still climbing, are by historical standards low and reflective of a labor shortage sparked by the COVID-19 pandemic. As borrowing costs continue to rise, those of us in the real estate industry have had to adjust our acquisition approach to find value for ourselves and our investors. In an inflationary environment teetering on recession, net lease assets can potentially be of benefit to exchange investors.

### Reset and Refocus

At Keystone, our real estate team, like real estate teams across the country, has spent a good deal of time reviewing opportunities that fit our investment criteria and will make suitable and accretive investments for exchangers. We started 2022 buying retail assets with nationally recognized brands, credit tenants, in top markets. At the prices these types of single tenant net lease properties had been selling at—coupled with the low cost of debt, we were able to package them into DST exchange portfolios and still offer competitive yields. When interest rates began to rise, net lease retail cap rates did not see much compression. As a result, we navigated away from retail portfolios. We are keeping an open mind regarding the sector though, and recently purchased two larger buildings with the same credit rating but non-retail. An example would be a FedEx distribution facility with a 10-year NN lease that we acquired in early February.

According to The Boulder Group, borrowing costs for both private and institutional investors continued to rise over the course of 2022; referencing the 10-year treasury yield ending 2022 at 3.87% after beginning the year at 1.53%. Cap rates for retail, office and industrial were all near historic lows in the first quarter of 2022 but rose for retail and office throughout the year as borrowing costs increased. Single tenant retail cap rates rose by 20 basis points while office cap rates expanded by 25 basis points from Q1 to Q4. Industrial cap rates widened by just five basis points.

### Slowing Deal Volume

The increase in borrowing costs and decreasing number of Exchange investors have caused deal volume to slow and gave a longer shelf life to equity in DST exchange offerings vs. flying off the shelves like in 2021 and early 2022. This provides exchangers with more time to review investment options and opportunity to diversify their exchange dollars. In 2022, despite the rising cost of debt, DST exchangers invested some \$9 billion into DST offerings—an increase from \$8 billion in 2021.

### Why Net Lease Assets

While multifamily assets, which comprise 44% of the DST exchange equity available, are the popular choice due to the ability to increase rents and potentially investor cash flow, we believe non-retail, high-credit net lease assets may offer an interesting diversification tool for exchangers.

Broadly, the multifamily asset class may deliver value based on their ability to frequently increase rents. Net lease properties, especially those with nationally recognized credit tenant brands often have flat or minimal increases over the projected 10-year hold of a DST exchange. However, unlike

multifamily which may be impacted by rising operating costs that outpace the ability of an owner to raise rents, for net lease portfolio owners, the increases in operating costs are absorbed by the tenant.

Assets leased on a long-term basis by nationally recognized credit tenants that have weathered a variety of economic conditions may provide stable, predictable rent regardless of inflationary pressures as well as during periods of economic contraction. An additional potential layer of protection comes at the end of the term of a long-term lease. In the event market rental rates have increased significantly, there may be an opportunity to “mark to market” the lease rate on renewal and experience an increase in rent, and thereby an increase in value.

### Summary

Given the continued uncertainty of economic conditions, exchangers may want to consider diversifying their investment with net lease assets. Those assets with corporate backed leases from companies that have withstood a variety of economic conditions may provide an additional layer of comfort knowing that the likelihood of those companies weathering a recession and continued inflationary environment is high. Even with a slowdown in exchange equity, there are still a significant volume of exchanges taking place. Companies like ours will continue to monitor conditions and adjust to find value for exchange investors.

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