BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT NET LEASE RETAIL

THIRD QUARTER 2020

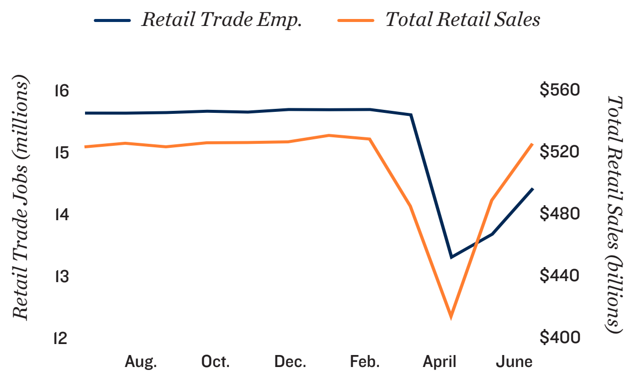
Market Looks Toward Recovery as Consumption Strengthens; Scale of Damage to Retailers Still Evolving

Spending recovers as economy reopens. Stimulus and fewer business restrictions propelled the retail market during the past few months. As the central bank and federal government flooded the economy with liquidity, personal income soared by $1.4 trillion in the second quarter, more than seven times the rise in the first quarter. As a result, retail sales had nearly returned to pre-health crisis levels by midyear. However, several states slowed their reopening due to a spike in positive COVID-19 tests, which could restrain consumer spending in the final six months of 2020. Meanwhile, less than half of retail trade jobs have been recovered, indicating there may be some potential upside on the employment front.

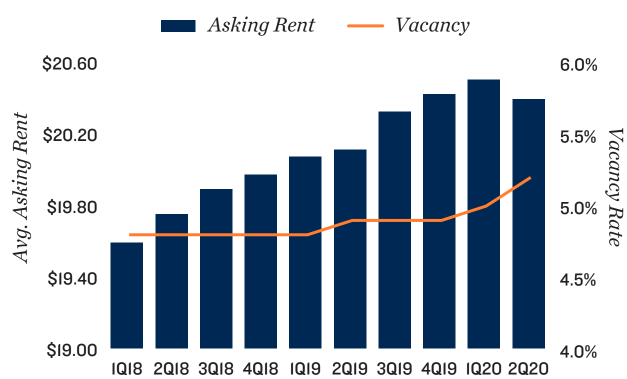
Retail property fundamentals soften. In the second quarter, retail vacancy ticked up 20 basis points to 5.2 percent while asking rents dipped 0.5 percent to $20.39 per square foot. Although still tight by historical standards, the true impact of a partial economic shutdown may not be reflected in vacancy for several quarters. While property owners have been accommodative through the crisis and Paycheck Protection Program (PPP) loans prevented many shuttered tenants from becoming delinquent, the ramifications of this recession will be pronounced in the second half of the year. Unlike during the global financial crisis when many retailers slowly withered over a six-quarter downturn, an abrupt recession will condense business failure timelines. Consequently, some retailers may be spared due to reduced competition.

Investment market fragmented. Single-tenant properties occupied by an essential business will attract buyers, often at prices near or above those paid prior to the recession. Investors are also searching for distressed assets when available. Dispersed working conditions and uncertainty weighed on sales velocity in the early stages of the pandemic. Although limited relief in the sales market was reported in late June and early July as the extended 1031-exchange deadline approached, challenges with closing deals have persisted into the third quarter. Underwriting assets for a post-pandemic economy is hampering decision making for buyers and sellers. Other barriers are abating, such as showing properties or obtaining financing from banks tasked with distributing a significant share of CARES Act funds.

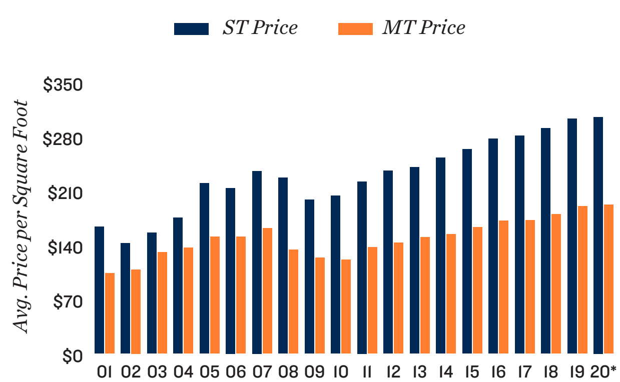
Retail Sales Return Ahead of Jobs



Fundamentals Weaken in 2Q



More Price Discovery Expected in Second Half



* Trailing 12-month period through second quarter

Sources: Bureau of Economic Development; Bureau of Labor Statistics; CoStar Group, Inc.; Real Capital Analytics

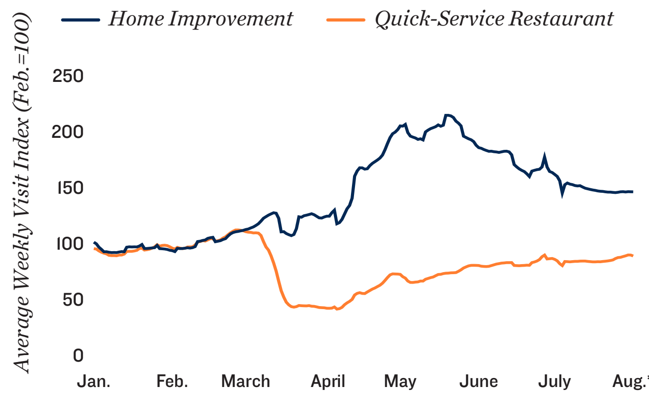
Single-Tenant Sector Features Several Healthy Concepts; Investors Anticipated to Favor Net Lease Deals During Health Crisis

Essential retailers boost single-tenant sector. Many stores that were allowed to operate during broad government shutdowns occupy their own buildings, supporting a perception of safety. Quick-service restaurants, auto parts, convenience stores, home improvement retailers and drugstores have survived and, in some cases, thrived during the pandemic. Shuttering full-service restaurants drove diners to quick-service establishments, though traffic to these locations has also decreased due to closed dining rooms. Nonetheless, numerous national chains should remain profitable, aided by drive-thru, delivery and carryout. Drugstores posted a 20 percent decline in visits while earnings soared year over year as shoppers increased the size of their receipts. Home improvement stores, particularly Lowe's and The Home Depot, posted gains in both visits and sales as furloughed workers tackled household projects.

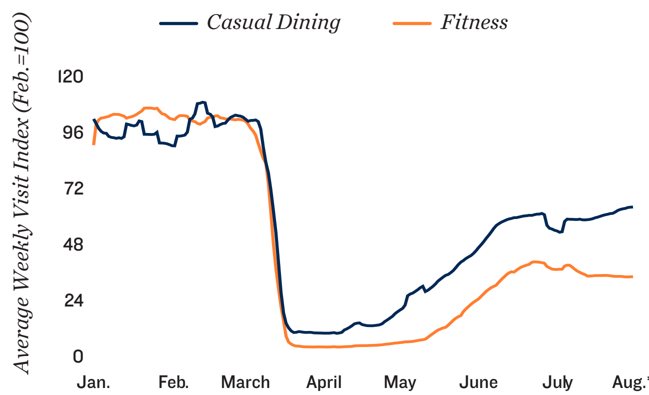
Experience-based concepts have murky outlook. Gyms, theaters and full-service restaurants will struggle until a medical solution is identified. Visits to gyms are down approximately 67 percent from pre-pandemic levels and several regions of the country have kept fitness centers closed despite opening other retailers. Gold's Gym and 24 Hour Fitness have both filed for bankruptcy protection and will permanently lock the doors on dozens of locations. Few theaters have reopened and returning to operations as normal is unlikely for some time after the end of the crisis. Viewing options will be limited when projectors resume operations. Most major studios have suspended production of movies and are releasing their current catalogs on streaming platforms. Traffic at full-service restaurants has declined by an average of 38 percent between February and July. Concepts typically not attached to malls, such as Applebee's, Chili's and Olive Garden, have fared better than the Cheesecake Factory and Panera Bread.

Single-tenant will be among first investment classes to recover. Net-leased properties are far easier to underwrite during a period of uncertainty and will continue to attract capital. Lenders and investors should be able to reach a consensus on pricing expectations, while low interest rates make the asset class a favorable alternative to bonds. There will be some challenges, however, as a sizable share of these deals typically involve a 1031 exchange. Most of those buyers come from the multifamily market, and it will take longer for buyers, sellers and lenders to reach an agreement on valuation. This may open the door for more traditional buyers to enter the single-tenant sector in the second half of this year. Another challenge is a potential change to tax law. The Democratic platform has a proposal to eliminate the 1031 exchange to raise revenue.

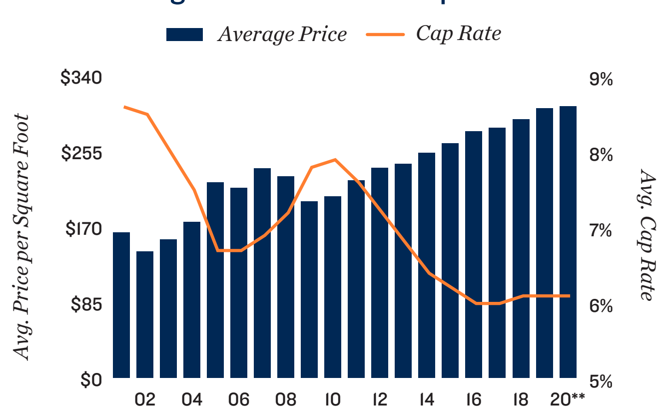
Disparity Between Healthy Single-Tenant Concepts



Shutdowns Hurt Experience Retailers



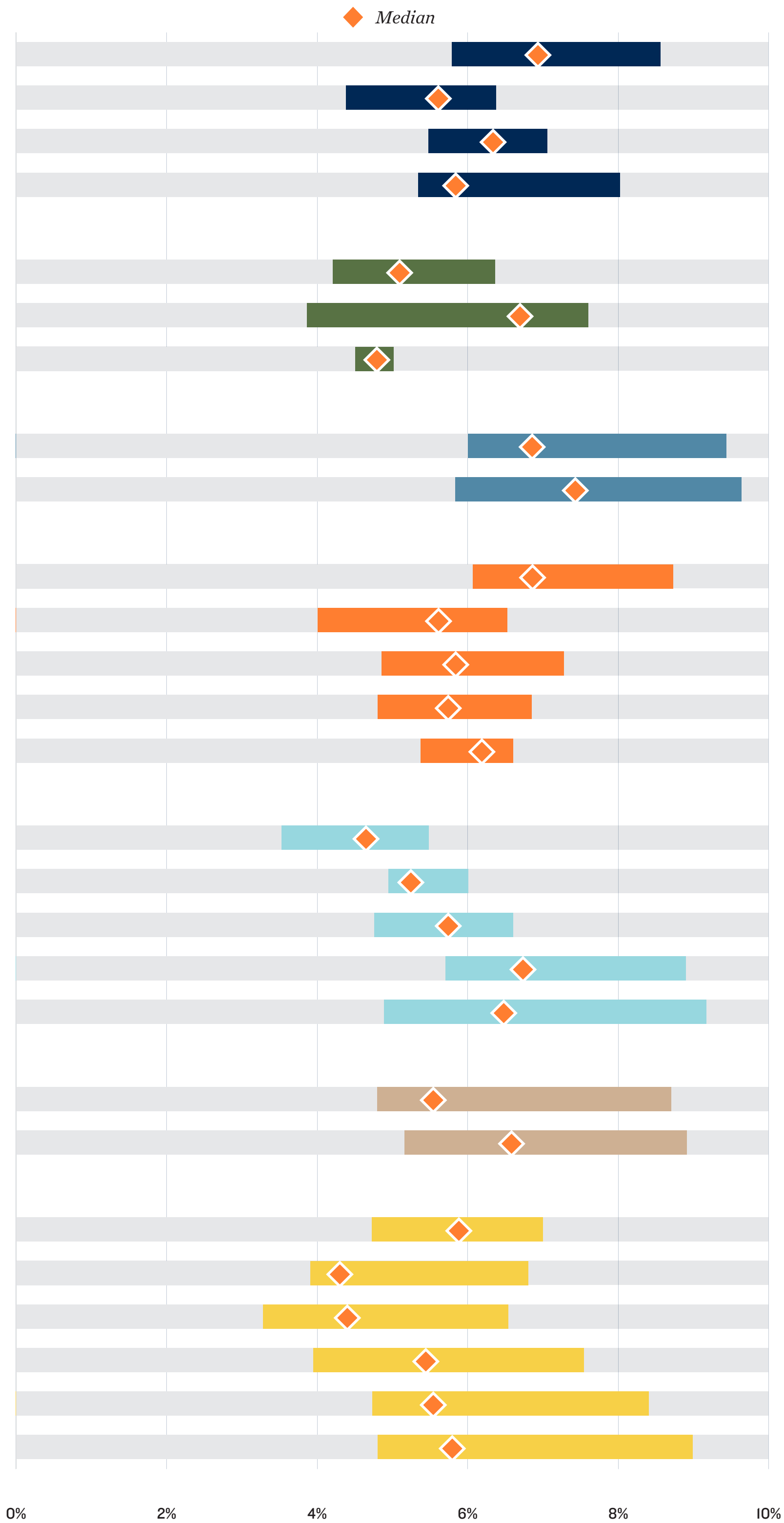
Single-Tenant Could Outperform



* Through Aug. 7 ** Trailing 12-month period through second quarter
Sources: CoStar Group, Inc.; Placer.ai; Real Capital Analytics

Brand	Locations*
Auto Parts	
Advance Auto Parts	4,276
AutoZone	5,815
Caliber Collision	1,062
O'Reilly Auto Parts	5,477
Convenience Stores	
7-Eleven	8,707
Circle K	6,250
Wawa	815
Dollar Stores	
Dollar General	16,278
Dollar Tree/Family Dollar	15,288
Fast Casual Restaurants	
Applebee's	1,682
Bloomin' Brands	1,214
Chili's	1,238
Darden Restaurants	1,812
Red Lobster	749
Grocery and General Retail	
Aldi	1,987
Safeway	895
Sherwin-Williams	4,415
Verizon Wireless	1,703
Walmart	5,078
Pharmacies	
CVS	8,131
Walgreens	8,916
Quick Service Restaurants	
Burger King	7,566
Chick-fil-A	2,497
McDonald's	15,338
Starbucks	16,752
Wendy's	6,289
Yum! Brands	18,841

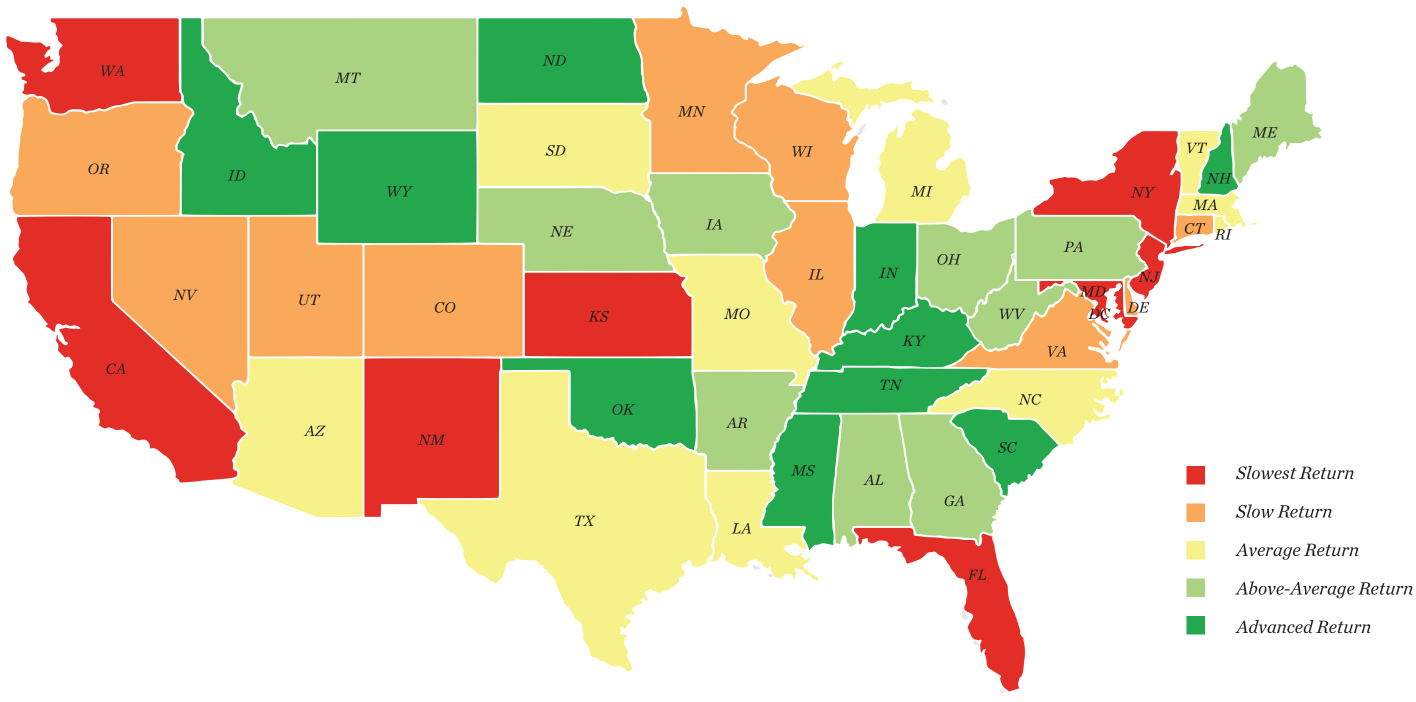
STNL CAP RATE RANGE BY BRAND**



Cap rates shown above are representative of transactions that closed in the trailing 12 months ending in September. Actual yields will vary by locations, tenant, lease terms and other considerations.
Locations sourced from Creditntell for public companies and company websites for private companies.
** U.S. and Canadian locations ** For transactions closed in the trailing 12 months ending in September*
Sources: Marcus & Millichap MNET; CoStar Group, Inc.; Creditntell

Uneven Return of Shoppers to Nonessential Retailers Impacting Recovery

States at Various Stages of Recouping Foot Traffic



Based on year-over-year foot traffic through Oct. 12, 2020

Shoppers returning to nonessential retailers. The flow of traffic to five nonessential retail sectors is contingent on consumer behavior and public policy. Apparel, casual dining, fitness, leisure, shopping centers, and spa and beauty establishments were mostly closed during shelter-in-place orders. Although all sectors showed a year-over-year decline as a whole, many states are significantly closer to returning to visit levels on a year-over-year basis. Shopper preference is the driving factor in some locations. Florida, for example, has some of the most relaxed restrictions, though the state's older population is shying away from nonessential retailers. States with more strict restrictions, such as California and New York, meanwhile, are also lagging as consumers do not have the option to return to nonessential retailers in large numbers. Less densely populated areas tend to be further along, while the Sunbelt as a whole is outperforming.

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

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