

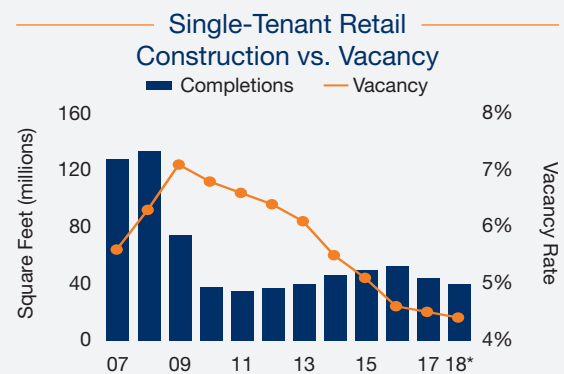
New Tax Rules Could Inspire Strategy Change for Owner-Users; Additional Sale-Leaseback Investments Could Surface

New tax rules motivate restaurant and retail owners to pursue sale-leaseback. The convergence of several factors has increased the appeal of sale-leaseback options for companies that own and occupy retail space. The evolving retail climate has pressured many retailers to adopt creative strategies to increase their profitability. Under the old tax rules, some business owners preferred to lock in their costs by purchasing the real estate in which they operate, but this could change under the new tax law. Previously, companies could deduct all of their interest expenses on their taxes, but the new provisions restrict the deductibility of business interest for companies with gross receipts in excess of \$25 million. Now interest totaling just 30 percent of earnings before taxes, depreciation and amortization can be deducted on taxes. As a result, businesses may shift strategies and sell the real estate in which they operate to investors and lease it back from them. This eliminates the interest expense of the mortgage tied to the real estate and transforms that cost into a lease, which is generally fully deductible. Because sale-leasebacks often have extended lease terms and allow the seller-turned-tenant to maintain the property, there are few operational differences. As an added benefit for the seller, this process also unlocks the equity of the property, providing additional capital to grow operations.

Retail metrics continue to strengthen, attracting a diverse pool of investors. Last year, the U.S. single-tenant vacancy rate decreased 10 basis points to 4.5 percent, the lowest rate in more than a decade and down 260 basis points from the high recorded in 2009. Tempered development compared to the prior business cycle has contributed to single-tenant retail's tight market conditions. Rents have moved in accordance by increasing steadily in the past five years, posting cycle-high growth of 4.6 percent in 2017 and placing the average asking rent at \$20.35 per square foot. Looking ahead, fundamentals in the single-tenant retail sector appear favorable through this year, as the national vacancy rate is forecast to decline 10 basis points in 2018, supporting an anticipated 3.7 percent increase to the average asking rent.

Executive Summary

- Investors' desire to own stabilized assets with long-term tenants, and the ability of owners to unlock equity for reinvestment into operations keep retail sale-leaseback transactions steady.
- Encouraging single-tenant trends persisted last year, as vacancy continued to fall and rents remained on their upward trend. Limited development will support the current trends throughout 2018, reinforcing the demand of these generally stable assets.
- Changes to the tax code have limited the benefits of owning the real estate in which businesses operate. This could encourage added sale-leaseback activity.
- Retail owner/users are most prevalent in the 1,000-square-foot to 5,000-square-foot range, occupying roughly 30 percent of properties traded in this tranche last year.



* Forecast

Source: CoStar Group, Inc.

Stable retailers fuel interest in sale-leasebacks. The single-tenant retail sector has drawn considerable interest from investors seeking sale-leaseback opportunities. Quick-service restaurants, in particular, continue to attract buyers because of their brand visibility and typically national credit status, providing investors increased stability. At the same time, these assets have proved to be resistant to weaker economic conditions, as well as e-commerce. Investors also seek grocery stores, discount stores, fast and casual dining, pharmacies and a range of other business types.

Sub-\$5 million assets dominate deal flow. Sale-leaseback transactions of single-tenant retail buildings last year were greatest in the 1,000-to-5,000-square-foot range. For properties traded in this tranche last year, the average price was \$306 per square foot, providing private investors with a wide span of assets for less than \$5 million. While deal flow slowed modestly in 2017, following the surge of bulk portfolio deals in previous years, sales volume surpassed \$3.5 billion. The first-year yield on assets in this segment varied greatly in 2017 and was largely dependent on location, lease term and tenant creditworthiness. Cap rates for single-tenant retail sale-leaseback transactions generally ranged from 5 to 7 percent during 2017.

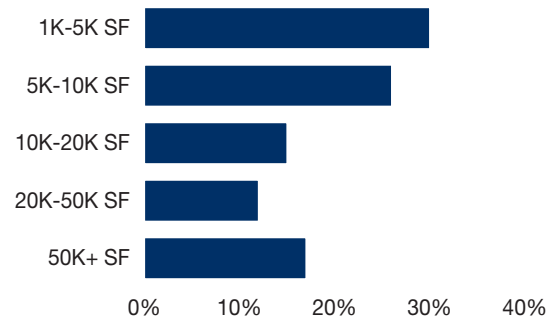
Private investors motivated by ease of operations, stable cash flows. Though institutional investors and REITs are active buyers of sale-leaseback properties, private investor activity accelerated for this segment last year. Investors find these assets particularly appealing because of their very limited management needs and their steady income stream. Also, vacancies are minimized due to the typical long-term nature of sale-leaseback terms, adding another layer of security for investors.

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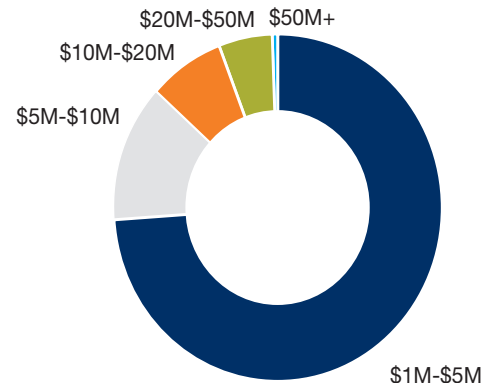
This report is not intended and should not be considered tax or investment advice. It provides an interpretation of the potential effects of the new tax law on the commercial real estate market. A tax accountant should be consulted for guidance on specific tax rules.

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Moody's Analytics; Real Capital Analytics.

— Owner/User Percentage of Single-Tenant Retail Property Sales By Size Tranche in 2017 —



— 2017 Single-Tenant Retail Property Sales by Price Tranche —



Source: CoStar Group, Inc, Transactions over \$1M+

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