RetailResearch

SINGLE-TENANT OUTLOOK

Marcus & Millichap

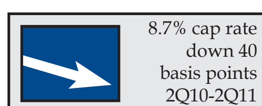
Second Half 2011

Shortage of Investment-Grade Assets Prompts Buyers to Acquire Less-Conservative Deals in Previously Overlooked Markets

Despite a slow and uneven U.S. economic recovery, nationally branded retailers stand ready to execute revised expansion models to fill coverage gaps in markets left under-served in the wake of the recession. Many national retailers pursuing new locations are deviating from pre-recession expansion models that centered on building sites in the path of suburban growth and, instead, are leasing vacant spaces in untapped urban and rural markets. This trend is particularly evident among major value- and necessity-based chains, such as Walmart, Target and dollar stores. Walmart, for instance, has reconfigured its strategy to focus on introducing small "convenience" store formats to urban markets such as Chicago, as well as rural pockets where consumers have limited access to major chains. Rival Target has employed a similar plan, and recently secured leases in supply-constrained metros such as San Francisco. Dollar stores, which remain among the fastest growing retail category, have followed suit and are capitalizing on the abundance of dark space to enter new markets. Family Dollar, in particular, will make its California debut by year end, providing the retailer with a coast-to-coast presence.

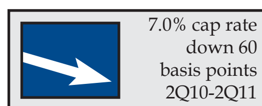
Strong buyer demand and the limited pipeline of investment-grade assets are pushing investors into second-tier markets, which will support deal flow leading into 2012. The combined influence of low interest rates and a steady stream of investors cycling capital back into net-leased properties have steadily compressed cap rates since mid-year 2010. Best-in-class properties are now generally trading on par with pre-recession norms, with cap rates 150 basis points to 200 basis points over interest rates. Moreover, a shortage of top-tier assets has prompted buyers to pursue listings with shorter lease terms if in-place rents are replaceable. Subsequently, spreads between corporate-backed leases with 10 years remaining and those with lengthier terms have narrowed to roughly 100 basis points. While buyers will continue to pursue top-tier assets with shorter leases, these spreads should hold relatively steady going forward.

Single-Tenant Retail Market Overview



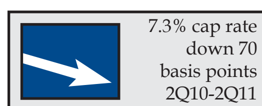
8.7% cap rate down 40 basis points 2Q10-2Q11

Dollar Stores: The choppy economic recovery, combined with the impact of elevated unemployment, will preserve bargain-hunting shopping patterns, as thrifty consumers seek expense relief at discount chains.



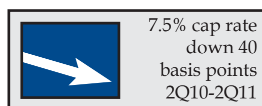
7.0% cap rate down 60 basis points 2Q10-2Q11

Quick-Service Restaurants: A broadened consumer-base preferring affordable alternatives to traditional sit-in restaurants will support solid operations at national quick-service restaurants.



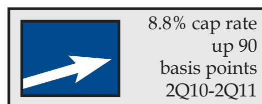
7.3% cap rate down 70 basis points 2Q10-2Q11

Auto-Part Retailers: A general reluctance to obtain substantive debt obligations will lead both business owners and individual consumers to retain vehicles for longer stretches of time, necessitating routine maintenance work.



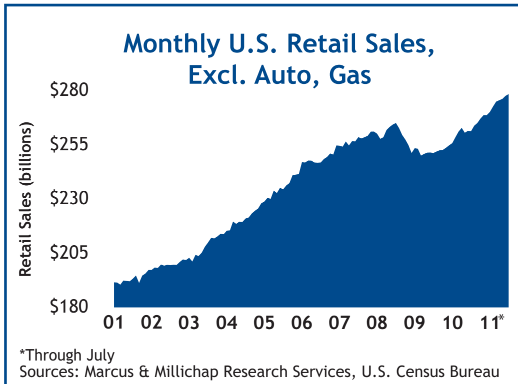
7.5% cap rate down 40 basis points 2Q10-2Q11

Drugstores: Drugstore openings will ease in 2011 as major chains revamp existing sites. The growing popularity of e-commerce sales, meanwhile, led to Walgreen's recent acquisition of drugstore.com, shifting from the company's aggressive "bricks-and-mortar" expansion recorded in prior years.



8.8% cap rate up 90 basis points 2Q10-2Q11

Big-Box Retailers: Major big-box retailers will focus on rolling out small, urban outposts in the coming years. This marks an about-face from the housing run-up when new-store openings involved warehouse-sized formats in suburban areas.

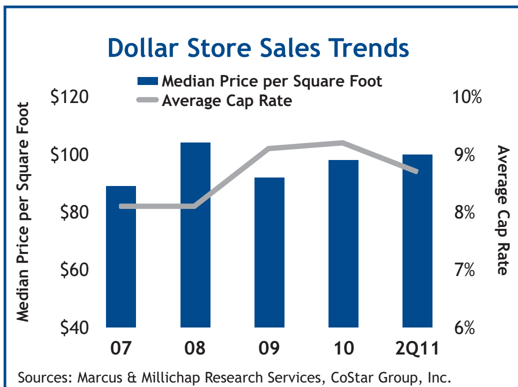


Dollar Stores

Extreme-Value Retailers at the Forefront of Retail Expansions

The choppy economic recovery, combined with the impact of elevated unemployment, will preserve bargain-hunting shopping patterns, as thrifty consumers seek expense relief at discount chains. Extreme-value retailers have outperformed most retail segments in recent years, and despite the official end of the recession, many households still face financial insecurity and diminished savings. With a sizable share of households underemployed, more shoppers are turning to dollar stores for more affordable daily items, which has deepened the sector's customer base. Softened real estate conditions, meanwhile, are presenting expansion opportunities, driving national chains to pursue store openings and enter new markets. Family Dollar, for instance, is set to open 300 new stores in 2011, including the chain's first California location. The company has also launched a multi-year plan to renovate existing sites and strengthen its "all-in-one" appeal by expanding its food offerings. With other leading value-based merchants employing similar strategies, national dollar-store chains will remain among the fastest growing retail segments in 2011 and 2012.

Dollar stores' above-average cap rates continue to attract the attention of yield-seeking buyers. Year over year, deal flow involving discount retailers spiked roughly 70 percent, driving a 3 percent rise in the median price to $100 per square foot. Cap rates for assets with at least 15-year, triple-net leases are in the low-8-percent range, which is 100 basis points lower than those with double-net, 10-year terms.

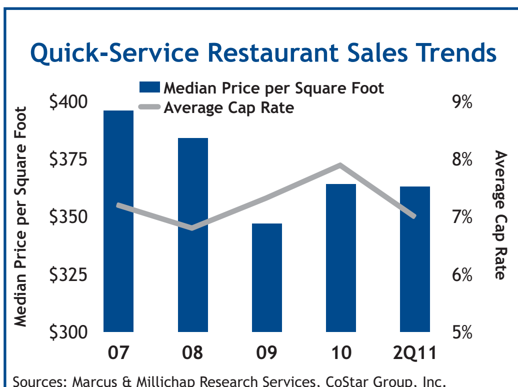


Quick-Service Restaurants

Fast-Food Chains Attracting Broad Spectrum of Restaurant-Goers

A broadened consumer-base preferring affordable alternatives to traditional sit-in restaurants will support solid operations at national quick-service restaurants (QSRs). Pricing wars and increased menu options, such as health-conscious and "value" items, are attracting cash-strapped restaurant-goers and households cutting dining-out expenses. As fast-food traffic increases, national chains will ramp up expansion efforts. Five Guys Burgers, for instance, posted a 35 percent increase in units last year and will open nearly 200 new locations in 2011. Similarly, Chipotle Mexican Grill is slated to open 140 sites this year, with growth expected to persist over the next few years. Rising commodity prices will present challenges by squeezing margins, but many national chains will avoid across-the-board price hikes, which independent eateries may be unable to evade.

Although fast-food assets remain one of the more sought-after product types, a shortage of available listings with national-credit tenants curtailed sales velocity 3 percent over the past year. The median price for QSRs traded in the last year ticked up 3 percent to $362 per square foot. Yields expectations vary considerably by tenant creditworthiness and location, but, in general, cap rates for assets with national-credit tenants averaged in the low-6-percent to low-7-percent range year over year, decreasing 60 basis points from one year earlier.



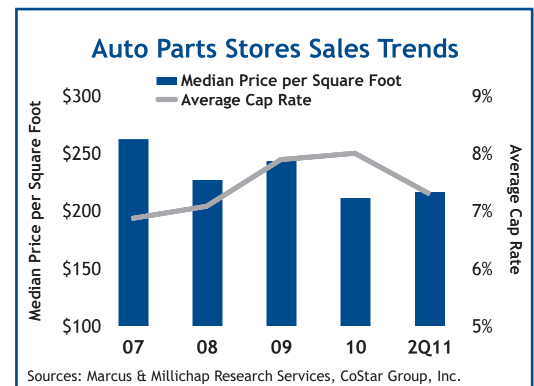
Auto-Part Retailers

Auto-Part Merchants Perform Well Due to Pent-Up Deferred Maintenance Needs

Industry-leading auto-part retailers will record another year of healthy sales as many Americans and businesses extend the life of their vehicles. A general reluctance to obtain substantive debt obligations has led to both business owners and individual consumers to retain vehicles for longer stretches of time. This trend, in addition to many consumers' and business' tarnished credit, is compounding the need for deferred maintenance work and preventing a large share of consumers from buying new vehicles. As such, demand for repairs and routine maintenance work on aging vehicles continues to build, supporting respectable sales increases for top auto-part chains. Advanced Autoparts, for instance, logged

a 4.4 percent rise total sales over the past year, aided by improving comparable store sales. Going forward, commuters performing maintenance work out of necessity will counter balance current economic obstacles and offset new car sales, driving steady operations in the coming quarters.

In the investment arena, sales velocity increased nearly 20 during the most recent 12 months. The median price for assets occupied by auto-part retailers advanced 6 percent in that time to $216 per square foot. For the most part, assets with a corporate tenant traded with cap rates in the mid-6 percent to mid-8 percent range, depending on location and lease duration.



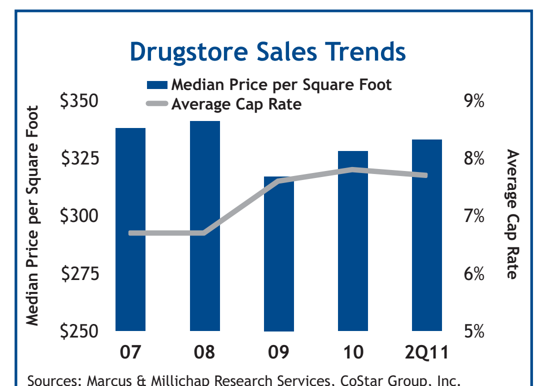
Sources: Marcus & Millichap Research Services, CoStar Group, Inc.

Drugstore

"Bricks-and-Mortar" Expansion Eases to Strengthen Existing Operations

Drugstore openings will ease in 2011 as major chains revamp existing sites. Following years of rapid growth, including the acquisition of 258 Duane Reade drugstores last year, Walgreens' pace of expansion will slow to between 2.5 percent and 3 percent, or approximately 200 new sites, in 2011. The drop off in store openings stems from the chain's renewed focus on existing store operations, which entails site renovations and new products. In addition, Walgreens is pushing to capture a greater share of online sales, spotlighted by the company's recent purchase of drugstore.com, which gave the retailer access to more than 3 million online customers. Similarly, rival CVS Caremark is also tempering store openings this year to roughly 150 units.

Risk-averse investors continue to favor the predictable income stream of drugstore assets. As more investors transferred capital from low-yielding bond markets into well-located drugstores, sales velocity climbed 14 percent year over year, supporting a near 8 percent increase in the median price to $333 per square foot. Direct cap rates for the product type fell 40 basis points in that time to the high-6-percent to mid-7-percent range. With the sector's development pipeline to remain light in the coming year, well-located properties will garner considerable buyer interest when brought to market.



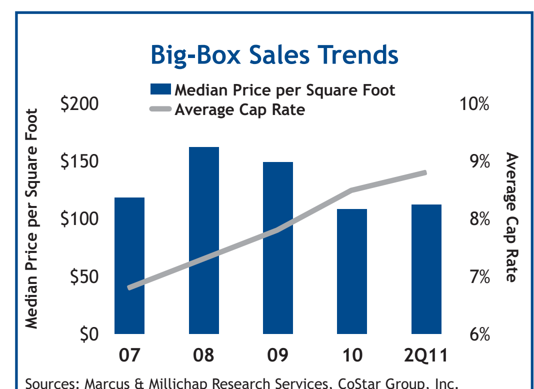
Sources: Marcus & Millichap Research Services, CoStar Group, Inc.

Big-Box Retail

Traditional Big-Box Retailers Begin to Lean Towards Smaller Formats

Major big-box retailers will focus on rolling out small, urban outposts in the coming years. This marks an about-face from the housing run-up when new-store openings involved warehouse-sized formats in suburban areas. In 2011, Walmart will open 15 to 20 Neighborhood Markets and introduce a similar number of new Express stores with formats that require a fraction of the typical 185,000-square-foot supercenters. Merchandise offerings at the stores focus on daily necessities, particularly grocery items, which have become a focal point for the retail giant. Target, meanwhile, plans to open a handful of scaled-down CityTargets in major markets including Seattle, Chicago, Los Angeles and San Francisco, requiring the retailer to lease existing urban retail sites. This push toward urban growth by traditional big-box retailers overturns a long history of targeting revenue from new homeowners in suburban outskirts, which now are undergoing demographic shifts and housing turmoil. Despite this shift to smaller floor plans, some discount and health and fitness retailers are re-absorbing block sites. Looking ahead, however, the growing popularity of e-commerce sales will drive lasting changes to the large "bricks-and-mortar" model. As such, retailer Best Buy plans to cut its U.S. footprint by 10 percent, and already has launched smaller Best Buy Mobile stores.

Emboldened by national chains circling for locations, which is presenting repositioning opportunities, more big-box assets are clearing the market. In the last year, big-box deal flow jumped 45 percent from recessionary lows, with steeper increases in California and Florida. Nonetheless, overall closings remained roughly 40 percent below the number of transactions performed in the years leading up to the recession. With a sizable share of deals involving vacant sites, the median price fell 18 percent year over year to $112 per square foot. Cap rates rose 90 basis points in that time to the mid- to high-8-percent range.



Sources: Marcus & Millichap Research Services, CoStar Group, Inc.

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The yield on the 10-year Treasury slipped to the low-2 percent range following S&P's downgrading of U.S. debt, as investors flocked to safety amid extreme stock market volatility. In response to recent events, lenders have pushed out loan spreads by an average of 30 basis points to 50 basis points, with CMBS lenders pushing significantly wider. Nonetheless, borrowing costs remain low by historical standards, enhancing property returns and supporting values.

- During the first half of 2011, retail mortgage originations were up 60 percent when compared to the same period last year, driven by increased activity among national banks and CMBS lenders. The CMBS sector may lose momentum in the coming months, however, as elevated credit spreads translate into less competitive lending rates.

- Funding for single-tenant assets with credit tenants will remain plentiful this year. All-in lending rates for drugstore assets currently fall in the high-4 percent to mid-5 percent range, while loans for fast food and restaurant properties typically price 125 basis points to 175 basis points higher.

- Deals under $10 million will be dominated by local and regional banks, which typically offer three- to seven-year, fixed rate recourse loans. CMBS lenders and finance companies will step into the $10 million to $20 million arena, while deals over $20 million will have access to a full range of sources. On average, debt yields will hover between 9 percent and 11 percent, translating into LTVs of 60 percent to 75 percent.

Recent Sales Highlights

Property Name	City, State	Sales Price	Price per Sq. Ft.	Cap Rate
Walgreens	Leitchfield, KY	$4,830,000	$333	7.25%
CVS	Edinboro, PA	$3,878,000	$386	6.75%
Comerica Bank	Austin, TX	$3,167,000	$880	6.00%
Carl's Jr.	Harbor City, CA	$3,070,000	$1,444	5.51%
Buffalo Wild Wings	Tyler, TX	$2,500,000	$417	8.45%
Wells Fargo	Houston, TX	$2,150,000	$866	6.40%
AutoZone	Pomona, CA	$1,700,000	$281	7.51%
Applebee's	Cloquet, MN	$1,591,000	$235	9.00%
Rite Aid	Vandalia, OH	$1,575,000	$139	14.03%
Jack in the Box	Rosemead, CA	$1,545,000	$820	5.50%
Hardee's	St. Petersburg, FL	$1,440,448	$543	7.50%
Dollar General	Dayton, OH	$1,275,000	$114	12.63%
Dollar General	Westport, IN	$915,000	$102	8.54%
O'Reilly Auto Parts	Fort Stockton, TX	$850,529	$133	7.75%
Advanced Auto	Jackson, MI	$490,000	$70	11.43%
Burger King	Palm Springs, CA	$415,500	$99	10.86%

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