NNN PROPERTIES REPORT

Investment Grade Yield Spreads

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The NNN Properties sector faces pivotal shifts due to rising interest rates and economic adjustments as we head into 2024. This report provides a deep dive into the impact of these changes on the relationship between corporate bond yields and NNN lease cap rates. It explores the importance of accurately assessing cap rates amidst evolving market conditions, focusing on tenant credit strength and market liquidity. Through examining lease terms, credit ratings, and real estate-specific factors, we offer investors critical insights into cap rate determinations. Read on for a concise analysis that equips investors and real estate professionals to navigate the complexities of the NNN properties market with confidence.

As 2023 comes to a close, market participants are reflecting on the major market transitions that have taken place and looking forward to 2024. Undoubtedly, the past year will be remembered for significant shifts in interest rates, a reaction to the Federal Reserve's monetary policy. Investors –– in real estate and securities alike –– have been impacted by the rising rates and the implications throughout the capital stack. As lenders caution exposure and leveraged investors struggle to pencil deals, cash buyers of credit properties will be more influenced by yield spreads than leverage over lending rates. Accurately assessing capitalization rates through these changing conditions will continue to be a critical factor in real property valuation. To assist with the analysis of investment grade capitalization rates secured by credit tenants, we consider the differences between tenants' bonds yields and their corresponding capitalization rates for net leased properties.

Market participants use a variety of methods and techniques to derive capitalization rates, often looking to the returns found in the bond market as a basis for analysis. The buyers of credit properties have investment options; including secured real estate, corporate bonds, and other vehicles; for investing their cash. Investors turn to secured real estate, but only when there is sufficient margin to offset illiquidity of real estate over investing in corporate bonds. As such, the corporate bond rate is a basis for developing the appropriate capitalization rate for similar grade real estate.

The bonds issued by a credit tenant provide an indication of the tenant's credit strength and a starting point for capitalization rate derivation. While bonds are typically analyzed on yield to maturity and investment grade real estate on capitalization rate, steps can be taken to quantify and adjust for the individual components that make up a net leased capitalization rate. In a market of equilibrium influences, three components broadly contribute to the spread between net lease capitalization rates and bond yields; these include lease term, credit rating and strength, and real estate-specific factors such as illiquidity premium.

First, let's consider the remaining term, which significantly impacts the life of the investment. Most bond or credit tenant investors look for longer term investment horizons. As such, newly leased properties with 10-20-year terms are generally more attractive with a premium for the length of term. Adjustments for the term are primarily concerned with the remaining base term; however, you should also consider tenant renewal options. These offer potential for an extended holding period. Second, consider the credit risk and the financial strength of the tenant or the guarantor as a factor of adjustment. When selecting traded bond yields, it's essential to select companies with similar credit profiles for comparison to the tenant of the property in question. Last, consider a broader adjustment, one that encompasses real estate-specific factors and illiquidity premium, which is also impacted by appreciation, tax benefits, and other unique variables. This last factor encompasses a variety of elements, including the sequence of lease rate steps, the illiquidity of the real estate, and the micro market trends of the real estate. Each is a core component in analyzing capitalization rates and accurately adjusting for yield. Together, these factors create the spread between the efficiently traded bond markets and the investment real estate market.

For this analysis, let's consider data from "A" and "B" credit rated companies that have actively traded bonds and also have a presence in the net lease real estate market. The bond data and the real estate sales of properties occupied by these companies were aggregated and measured using a variety of methodologies, including multiple linear regression and paired sales analysis. The isolation of these factors allowed us to measure the impacts between the variables. The results were used in conjunction with market survey data. By analyzing specific companies who have publicly traded both debt (bonds) and net lease real estate, we're able to derive adjustments for the factors noted above.

Lease Term

When it comes to leases, shorter terms carry greater uncertainty for investors and longer lease terms offer stronger yield protection. It's prudent to consider adjustments to the remaining term for both bonds and real estate. For analysis, net leased properties are often categorized in three segments: 0–5-year terms, 5-9 year terms, and 10+ year terms, with each segment having a diminishing adjustment. In general, shorter lease terms carry greater uncertainty for investors, while longer lease terms provide reasonable certainty and security to those seeking long-term cash flow.

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To derive an adjustment for term length, we consider both corporate bond data and a variety of sales data for investment grade tenants with both an active net lease market and an active bond market. Through statistical analysis of this data, we see a remaining term coefficient ranging from 5 basis points to 10 basis points, with an average of 7 basis points per year of remaining term. Essentially, for each additional year of term on an investment grade credit, we see an average of 7 basis points added to the capitalization rate.

Term Adj Range	Term Adj Avg
0.05%-0.10%	0.07%

Please note that the yield curve of both corporate debt and real estate is rarely linear. There's often a diminishing return noted near year 10 which peaks around year 20 due to the marginal impacts of present value at those points. Considering this, an adjustment near the lower end of the range should be used for longer remaining terms, while an adjustment at or above the average should be used for shorter remaining terms.

Credit Rating and Strength

In considering the credit rating spread, we have analyzed bond data based on the Moody's rating scale. For purposes of this analysis, we have bracketed corporate debt into two categories: "A" rated credits and "B" rated credits.

Based on the spreads between these bond categories after adjusting for term length, we see a concentrated spread of 25 basis points to 75 basis points, with a median of 50 basis points between the "A" rated credits and the "B" rated credits. Again, the rating scales include a variety of tiers within each of these brackets, with the lower end of the range pertaining to higher rated credits and the higher end of the range representing lower credit ratings.

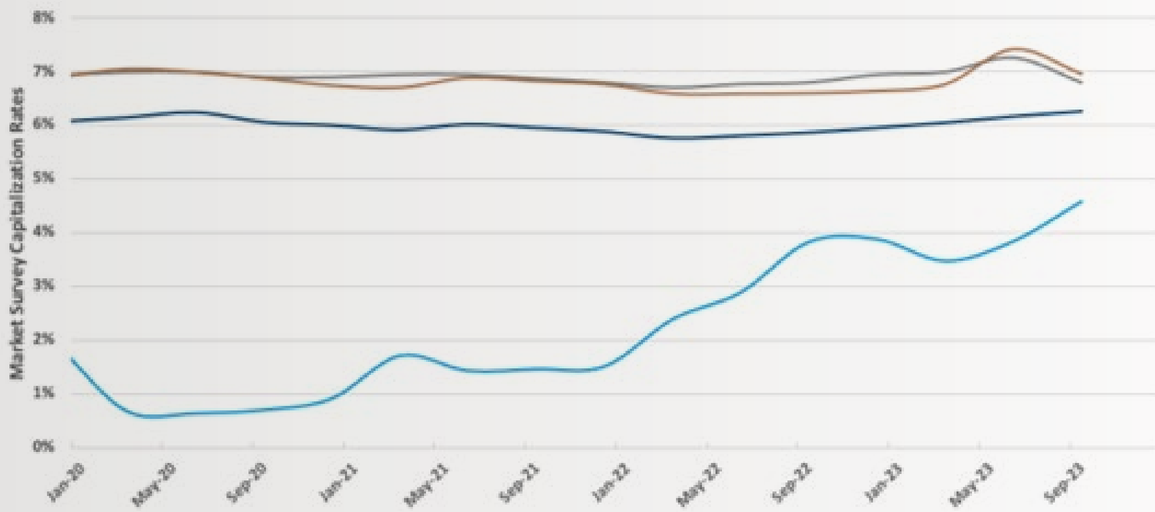
Rating Bracket	Base Rate Range	Base Rate Avg
A	5.25% - 5.75%	5.50%
B	5.25% - 7.00%	5.75%
Spread		0.25%

In addition to considering the spreads between capitalization rates and corporate debt, we also consider the spreads compared to treasury yields. These yields, backed by the United States Treasury, are often referred to as the risk-free or safe rates and represent the benchmark for returns and risk to be measured against. Market data from the past year shows a 200-basis point to 250-basis point spread between across-the-board average net lease capitalization rates and the 10-year treasury yield, with a significant compression between 2022 and 2023. This data further supports the yield spread between investment grade real estate and bond securities.

As yields compress, upward pressure is applied throughout the debt stack with investors requiring greater returns per unit of risk. This lag between yields in the efficient securities markets is pronounced when applied to the real estate market; during the lag, investors recalibrate the required returns of net leased investments and challenges in financing impact the market. As of Q3 2023, spreads between the US 10-year treasury and broad net leased properties have compressed to some of the lowest levels in the past 20 years, indicating continued upward pressure on capitalization rates.

US 10-Year Treasury Rate

Capitalization Rate & Treasure Yield Compression



Real Estate Specific Factors

The third elements of comparison, real estate, and illiquidity factors are inherently qualitative in nature. When considering the bond market, securities are easily traded with adequate market participants providing liquidity. Real estate is less liquid and requires greater marketing times due to the need to find a buyer. When it comes to the spreads between bonds and real estate, you must consider an adjustment for illiquidity. While an illiquidity discount can be established for real estate, lease-specific details such as renewal options, rental rate steps, and location vary between individual properties and even markets. These factors can further impact yield beyond liquidity. In line with broad factors, we observed an array of discounts related to real estate characteristics and illiquidity. These ranged from 0 basis points in top national metros and prime locations to 150 basis points in non-metro areas, with like-term real estate deals in active secondary markets appearing to trade at a more moderate discount range of 25 basis points to 75 basis points. Generally, properties trading at a spread of less than 25 bps compared to comparable corporate debt were in high-growth areas or markets with high barriers to entry, where the appreciation of the specific property is expected to be a significant factor in determining overall yield, despite the remaining lease term.

Final Thoughts

In analyzing net leased real estate, it's critical to consider the bond market and alternative uses of capital as investors weigh the risks and returns associated with fixed income products. Real estate provides an alternative to traditional bond market investing with term, credit rating, and real estate specific factors creating a spread between bond yields and capitalization rates that are needed to attract investors across markets.

In 2024, investors will continue to question how much rising interest rates will impact the market and the degree to which capitalization rates will adjust to meet expectations. As yield spreads continue to compress, it's essential to quantify appropriate real estate capitalization rates accurately and reliably, with seemingly minor factors often having great impacts on real property valuation through capitalization rate selection.

SOURCES & REFERENCES

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US 10-Year Treasury Rate
Source: U.S. Department of the Treasury

Capitalization Rate & Treasury Yield Compression
Source: 10-year Treasury Rates: U.S. Department of the Treasury; Cap Rates: The Boulder Group. The Net Lease Market Report (Q4 2019 - Q3 2023)

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ABOUT IRR

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