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Cap rates show investors are sticking to top-notch properties

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Analysts agree a sign that recovery is underway in the commercial real estate markets is when investors start spreading their dollars out from sure-fire properties that everyone acknowledges are top-of-the-line to more risky assets. When that happens, they say, it signals that the markets are truly back.

Unfortunately, applying that criterion to the latest numbers from the net lease market shows we've got some way to go before we get there.

Those figures indicate investors are still chasing after a handful of prime retail properties in the best locations and aren't much interested in anything else, disappointing those who had hoped there would be more of a broad-based recovery in the first quarter of 2011.

The net lease market attracts passive investors looking for income property, frequently wealthy individuals, who see it as a n alternative to the stock and money markets. Under "triple-net" lease deals, they use their capital to buy small retail buildings that are leased on a long-term basis (sometimes up to 75 years) to a single tenant, usually pharmacies such as Walgreens and CVS, chain restaurants like McDonald's and bank branches.

The tenants are responsible for all the upkeep and repairs to the property while the owners sit back and collect the rent every month, with returns (capitalization or "cap" rates) on the most secure, "investment grade" properties averaging around 7 percent.

Cap rates usually reflect the risk of the venture -- the higher the cap rate, the better the return but also the bigger the chance the tenant's business will fail before the lease expires or that, once it does, they will leave and the property will remain vacant due to a poor location or some other reason.

Some cap rates can be as high as 11 percent on especially risky properties.

When average cap rates expand, it usually

means the fundamentals of the real estate economy are improving. When they compress, it indicates buyers are in a "flight-to-quality" mode and market uncertainty is the rule.

National net lease cap rates stubbornly continued their compression in the first quarter, according to the Boulder Group, a Chicago-based boutique investment firm that tracks the market.

The firm said cap rates for retail properties fell 17 basis points from the fourth quarter of 2010 to 7.83 percent, indicating that prices for investment grade properties such as Walgreens pharmacies and banks are being pushed higher because of competition among investors, and thus the returns they can expect from them are being trimmed.

Meanwhile the rest of the market -- buildings with tenants such as day care centers or local restaurateurs, or in less-than-trendy parts of town -- is languishing f or lack of buyer interest. Investors, it seems, are far from convinced the recovery is strong enough to lift all boats.

"Industry insiders expected this quarter would be the start of investors branching out from their limited focus on prime assets and seek opportunistic yields in secondary markets," the Boulder Group said in a recent report. "However, with the exception of shorter term leases for investment-grade tenants, this has failed to materialize."

"What's happening is that higher-quality tenants and properties are very popular," said Sean Doyle of Marcus & Millichap, a national commercial real estate firm that specializes in such deals. "It's still a flight to quality, and because of that, we're seeing compression on cap rates."

Doyle said buildings with tenants that aren't pharmacies or well-known purveyors of fast food still aren't finding takers despite the potential for higher returns.

"People are still scared of some retail industries -- they're shying away," he said. "They're not risking it for a higher cap rate. It's easier to sell a Walgreens with a 7 cap rate than a not-great tenant with a 9."

That wasn't always the case, Doyle said. Before the recession, investors would jump i nto net lease properties as tax shelters, regardless of their cap rates.

Apartment owners, for instance, would sell their buildings and plow the proceeds into

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net lease properties. And while that still happens with property owners who are l ooking to shed management responsibilities, the days of grabbing them without regard to underlying fundamentals such as the creditworthiness of the tenant or the location of the buildings are over.

"Many people are looking at net lease properties of under $2 million for their alternative investments," added Keith Sturm, a principal with Minneapolis-based Upland Real Estate Group. "I think people are still sick of the stock market and the money they lost there, and they're looking for high-quality, well-located real estate."

He cited a recent all-cash sale of a McDonald's restaurant at a 5 1/2 cap rate, which he said likely "broke the low-water mark" in the Twin Cities market, but was still better than what the buyer was earning in his money maret account.

More people are getting into the net lease market for the first time as bank financing becomes more available, but, he added, competition for the best assets is tough in part because there has been so little new construction during the recession, pinching the supply.

Part of his job, Sturm said, is to scout out potential investment-grade net lease deals for his clients, but it's difficult because there are just not many of them around.

"We're looking under every stone."

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