Investors chase net lease properties

by Beth Mattson-Teig

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Forget location. Credit is king with net lease property investors, and buyers are exhibiting a voracious appetite for Twin Cities real estate ranging from Applebee's restaurants to Walgreens pharmacies and grocery stores.

An investment group from California paid $14.1 million or a cap rate of 6.4 percent for a net-leased Lunds at 25 University Ave. SE in Minneapolis. (File photo: Bill Klotz)

Both local and out-of-state investors are scouring the Twin Cities for net lease investments in a market where the demand is increasingly surpassing the available supply of for-sale properties on the market.

"There is an influx of outside investors. People on the coasts in particular think that Midwest real estate is bargain-priced compared to the rest of the country," said Keith Sturm, CCIM, a principal at Upland Real Estate Group Inc. in Minneapolis. Upland specializes in selling single- tenant net lease properties throughout the United States.

For example, Upland brokered the sale of a Walgreens in Mound that attracted multiple bidders. The property ultimately sold to a California-based investor for $11.3 million or a capitalization rate of 6 percent. The property was attractive to investors because of Walgreens' investment-grade credit rating and its 25-year lease on the property.

"Investors are looking at major Midwestern cities, and they are seeing a bit of a discount," said Randy Blankstein, president of The Boulder Group, a national net lease advisory firm based in Chicago.

Properties in cities such as Minneapolis, St. Louis and Indianapolis do have a slightly higher yield — about 25 to 50 basis points — compared with buying properties on the East and West Coasts, noted Blankstein. Buying a Walgreens in Miami or San Diego might be a 5.5 cap rate compared with Minneapolis where pricing is more likely to be 5.7 to 6 percent, he added.

The cap rate, which is used as a benchmark to discuss the acquisition price of an income-producing property, refers to the annual net income divided by the sales price of a property.

A Walgreens in Mound, which attracted multiple bidders, sold to a California-based investor for $11.3

California investors in particular have been snapping up local properties in recent months. California buyers are paying less of a premium here compared with what they can buy in their home state, said Bob Pounds, senior vice president, investment services at Welsh & Colliers International in Minnetonka.

Pounds recently brokered the sale of a net-leased Lunds at 25 University Ave. SE in Minneapolis to an investment group from California that bought the property for $14.1 million or a cap rate of 6.4 percent. "So, for those investors, it is a good deal. For us, it is a pretty aggressive cap rate," he said.

million or a capitalization rate of 6 percent. (File photo: Bill Klotz)

Twin Cities offers higher yields

Single-tenant net lease properties have long been a favorite for investors who like the low maintenance and relative "safety" of buying a property with a strong credit rating.

Part of the appeal of such properties for investors is that there is no management, noted Pounds. The tenant takes care of — and pays for — most everything including rent, taxes, insurance, maintenance and utilities. The landlord is usually responsible only for major structural issues, such as a roof repair.

Net lease sales activity began rebounding in late 2011 and has remained steady in 2012 and year-to-date through 2013. "The demand seems to be ever increasing, while the supply of properties has not increased along with that demand," said Sturm.

In part, investors have been stymied by a slowdown in retail and restaurant expansion since the recession, which has created a more limited supply of new deals coming to the sale market. "So, what we're finding is that the cap rates are very low, maybe even at historical lows based on even pre-recession levels," said Sturm.

The Twin Cities net lease investment market is mirroring a larger national trend where strong investor demand — and limited supply of properties is pushing prices higher. One of the key drivers behind the demand is the "flight to safety" as investors are getting back into the commercial real estate market, noted Blankstein. There is less risk in buying properties that are occupied by investment grade tenants such as McDonald's and Starbucks, and those types of properties also are easier to finance, he said.

Cap rates for single-tenant properties in the U.S. are at near record lows for retail, office and industrial properties. Nationally, cap rates based on asking sale prices are averaging 7 percent for retail, 7.5 percent for office, and 8 percent for industrial properties, according to a second quarter net lease report issued by The Boulder Group.

However, newer properties that have the backing of top-credit tenants are selling for even lower rates. McDonald's ground leases, for example, are selling for cap rates of 4.0 to 4.5 percent, while drugstores occupied by Walgreens and CVS are trading at cap rates of about 5.7 percent. If interest rates remain relatively low, pricing on net lease pricing will likely remain aggressive through the end of the year — if not well into 2014, added Blankstein.