'Folks Doing Nothing': Net Lease Transactions Have Screeched To A Stop

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Net lease investment is stuck on pause after a plunge in investment volume in 2023 that the market just can't shake.

Investment volumes in net lease properties dropped 51% year-over-year in 2023 to $38B, according to CBRE, and remained depressed in first-quarter 2024, clocking just $1.3B, according to CoStar data, an 88% annual drop. At the same time, eager potential investors are sitting on billions in dry powder.

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“There's a huge swath of folks doing nothing,” B+E CEO Camille Renshaw said. “They're waiting, and we hear it all day long, they're on the fence, and they're waiting on interest rates. Obviously, if they get up against that maturity date on their debt or something, they'll have to do something. But mostly there are tons of buyers but not many sellers.”

Under a net lease agreement, tenants typically agree to pay rent plus another portion of a property's operating expenses, such as insurance, taxes and maintenance, and often all of the above. Net lease tenants tend to be retail chains or major users of office or industrial space who are prepared to factor those costs into the cost of doing business.

From an investor's point of view, a net lease represents a bond-like investment, since the owner bears little of the cost or effort of running the property. Net lease investments are popular with high-net-worth individuals, families or partnerships.

“We're preparing for ICSC [RECon] right now,” Renshaw said.” I'm revisiting the largest buyers in our space right now. Most of them have a $1B or so to put out this year, and some of them have more than that.”

As with most of the investment market, the misalignment in expectations between buyers and sellers is weighing on deal flow.

“Buyers believe that cap rates are coming up for them,” Boulder Group President Randy Blankstein said. “Sellers believe that rates will come down and it'd be better for them next year. Everyone's wanting to believe in their own story, so we're at a standoff, which drops volume down fairly dramatically.”

“It's not an issue of fundamentals, and it isn't an issue of capital, that's for sure,” CBRE Vice Chairman and net lease specialist Will Pike said. “It's rate-driven. Outside of the office sector, that's probably the case for every asset class of commercial real estate, right? In retail real estate, the fundamentals are probably as good as they've been in a very long time.”

Now it looks like rates will be elevated rates for quite some time, Pike said, keeping deal volume flat.

“Lower rates would undoubtedly ease underwriting hurdles and, more importantly, improve investor sentiment,” Pike said. “If you'd have asked me a month ago, I would have told you probably 5% to 10% increase by the end of the year. I would say now it's more flat to 5%.”

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The fact that rates are high is important in keeping deal volume down, but so is the uncertainty about when rates might change, according to StarPoint Properties CEO Paul Daneshrad.

“The year started with most economists expecting a Fed decrease of about six times, but by February or March, that was down to a projection of three decreases, and now it's down to one,” Daneshrad said. “That uncertainty has created a dislocation in the marketplace, where buyers and sellers aren't connecting, especially sellers, who keep expecting a reduction in interest rates, which would increase their values.”

The Federal Open Market Committee once again declined to move interest rates at its meeting May 1. Fixed income markets imply that rate cuts could begin in July or September, Forbes reports, which would mean that the first rate cut would come at least a year after the most recent rate hike in July 2023.

Even if rates start moving down, that wouldn't spur the net lease market into high gear right away, according to Blankstein.

When interest rates finally go down, there will still be a backlog of net lease property supply that will have to work its way through, Blankstein said. And the longer interest rates remain high, the longer it will take to deal with the backlog.

“If we're nine months away from interest rate cuts, we may be a year and a quarter away from clearing to an equilibrium standpoint,” Blankstein said. “Everyone's looking at everybody else to break the logjam. Buyers and sellers are disconnected, and where pricing shouldn't be, there's not enough comps to get a real sense of the market."

At the highest level, the net lease business may be about interest rates and the change in them, Renshaw said, but on a more detailed level, there are other changes in the natural evolution of competitors affecting the marketplace. Some properties are seeing demand fall off for reasons specific to their tenants.

"Walgreens is a really good example," Renshaw said. "They've had their credit rating with Moody's changed to sub-investment grade, and there are a lot of things going on as a pharmacy business. We've already seen a couple of examples of no more cash flow going to owners due to what's going on with Walgreens."

By contrast, some kinds of net lease properties are more likely to sell, even in the current environment, simply because of their high quality, which inspires intense demand, Daneshrad said, such as highly successful fast-food properties.

"You get an In-N-Out in California and it's going to sell at a very low cap rate, maybe 100 to 150 basis points lower than the rest of the market," Daneshrad said.

Another bright spot in the market has been deals under about $4M, Blankstein said.

"Properties under $4M have been dominated by cash buyers. And if you're a cash buyer you're a lot less concerned with what goes on in the financing market," Blankstein said. "The more you leverage, the worse it gets. You can actually get a 6% yield at a 6% cap rate in a cash deal, which is better than money markets and better than most bonds."

Though the market is stuck in a kind of neutral, Renshaw said, she doesn't expect volume to get any lower, especially if the cost of debt doesn't get any higher, since net lease investment is still perceived as a safe, if not exciting, place to put capital.

"The drop has been dramatic," Renshaw said. "I don't want to understate it, but it is a more balanced picture than that. This isn't the Great Recession. Transactions are occurring, and there's still a lot of arbitrage available in the market."

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