RetailResearch

SINGLE-TENANT OUTLOOK

Marcus & Millichap

Second Half 2009

Opportunities Emerge as Cap Rates and Inventory Rise

After several years of cap rate compression, escalating prices and eroding risk premiums, the single-tenant retail market is recording some correction. During post-boom periods, an overcorrection is common before conditions normalize, a trend that will likely unfold over the next six to 12 months, resulting in strong acquisition opportunities for well-capitalized investors. While risks have increased across the board, top-quality single-tenant properties — those occupied by strong-credit tenants and secured by long-term leases — are likely to remain among the safest alternatives in the commercial real estate marketplace. Furthermore, single-tenant assets are generally priced at less than $10 million; this price group has accounted for more than 90 percent of all retail transactions closed over the past year. Nonetheless, there are fewer buyers competing for these deals, due in part to a considerable reduction in 1031-exchange capital coming from apartments. Investors and lenders also are underwriting deals much more conservatively in light of the weak economy, even for properties occupied by top national-credit tenants. Overall, lenders have become cautious, closely scrutinizing buyer and tenant credit quality and requiring higher equity contributions from borrowers. On average, debt-service ratios have increased from 1.1x to 1.3x, even for high-quality assets with major credit tenants, and many lenders are requiring recourse on new loans.

Given the weak economy, investors would be wise to monitor expansion plans and potential store closures by even the stronger national chains. The recession has taken a toll on the retail sector, leading to several high-profile retailer bankruptcies over the past year. Necessity-based retailers have fared best during the downturn, while home furnishings, electronics, jewelry and apparel retailers have taken the hardest hits, accounting for more than half of all closure announcements since the beginning of 2008. As consumers look to trim costs, deep discounters will continue to outperform, while specialty retailers and restaurants will adapt their strategies to attract today's more value-oriented consumers. Several major chains already are shifting their strategies and taking steps to pare down operating costs, which should position them for expansion when an economic recovery ultimately takes shape.

Single-Tenant Retail Market Overview

7.4% cap rate up 60 basis points 1Q08-1Q09

Drugstores: CVS and Walgreens continue to dominate the drugstore industry, while Rite Aid has experienced some troubles, leading to significant cost-cutting measures and the closure of more than 200 stores. While top-quality drugstores are still considered some of the safest single-tenant assets in the marketplace, buyer demand has softened, and cap rates are up from record lows.

7.5% cap rate up 70 basis points 1Q08-1Q09

Quick-Service Restaurants: Rising unemployment and tight household budgets have led many major chains to introduce or expand their value menu selections to increase market share. The weak economy continues to weigh on Starbucks, which recently announced plans to shutter 300 stores in addition to the 600 locations the company already has closed.

7.6% cap rate up 80 basis points 1Q08-1Q09

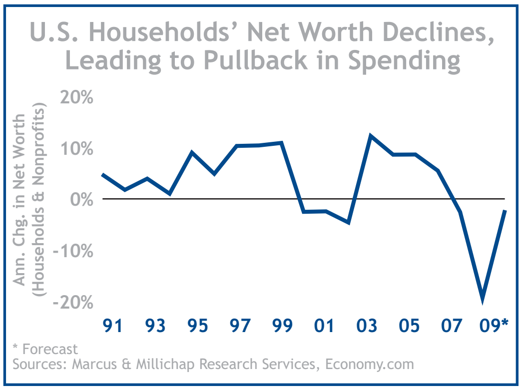
Casual Dining: Reduced consumer spending has served as a drag on casual dining restaurants. Similar to the fast-food segment, major chains are heavily promoting lower-priced menu options to draw budget-minded diners. Recent closures are creating strong opportunities for expanding chains to secure already equipped properties at discounted rates.

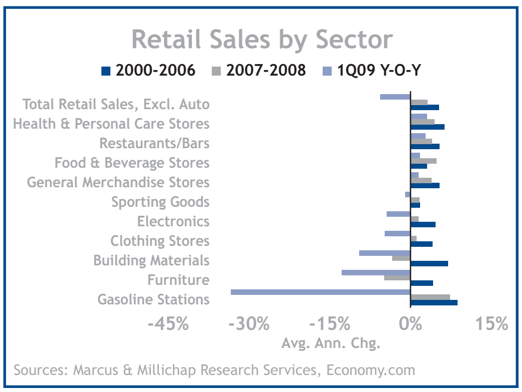
7.5% cap rate up 20 basis points 1Q08-1Q09

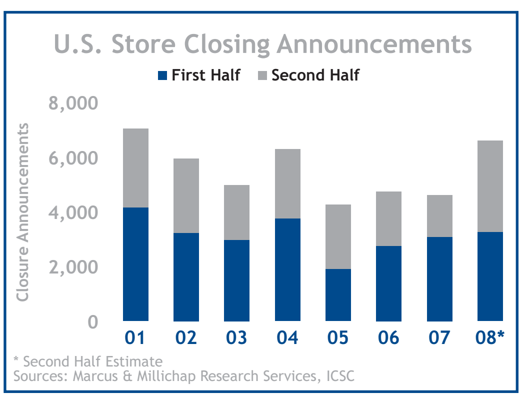
Discount Stores: Dollar stores are outperforming in the current economic climate, a trend anticipated to persist through the next several quarters. Among the major discount chains, Target has recorded softening sales in recent months, while Wal-Mart continues to post growth, due in part to its strong market share in the grocery sector.

8.25% cap rate up 45 basis points 1Q08-1Q09

Big Box: The housing downturn has weighed on home furnishings, construction materials and electronics retailers, leading to bankruptcies and a rapid increase in big-box vacancy. Many investors and lenders are likely to remain wary of big-box properties, as major chains will continue to shutter underperforming stores, and the long-term viability of other chains is still in question.







Drugstores

For-Sale Inventory and Cap Rates Rising, Even for Sought-After Drugstore Assets

The drugstore industry continues to consolidate. Late last year, CVS Caremark acquired Longs Drug Stores, as well as the company's pharmacy benefits management service, RxAmerica. The move made CVS the largest drugstore chain in the United States, with 6,800 stores, followed by Walgreens, with nearly 6,500 locations. Rapid expansion of drugstore chains in recent years and added pressure from Wal-Mart for pharmacy business have created an increasingly competitive environment. Rite Aid has seen its share of troubles over the past several quarters, leading to significant cost-cutting measures and the closure of more than 200 stores.

The reduction of 1031-exchange buyers has led to a decline in drugstore property sales, as this segment once captured the attention of many smaller, private apartment owners who were approaching retirement. While assets occupied by top drugstore chains are still considered among the safest in the marketplace, buyer demand has softened, and cap rates have increased from record-low levels. Since the start of the year, cap rates for sold drugstore properties have averaged 7.4 percent, compared with 6.8 percent one year ago. Since the market is changing rapidly, year-to-date trends do not necessarily represent current averages. Cap rates on some of the the most recent drugstore sales, for example, have been in the low-8 percent range and could deteriorate further during the next three to six months.

Quick-Service Restaurants

Consumers Focused on Value; Fast-Food Chains Adapt

The prevailing theme for the fast-food industry is offering value. McDonald's, with its longstanding Dollar Menu, was one of the few chains to post a sales gain in the first quarter. Tough economic times also have helped to shore up sales for its premium coffee beverages, as more consumers are opting for lower-cost alternatives. Not surprisingly, several other chains have expanded their value-oriented selections, including Subway, Church's Chicken, Burger King and Taco Bell. The increasingly cost-conscious climate has taken a toll on previous top performers, such as Starbucks. The coffee chain announced 300 closures in early 2009, on top of the 600-plus locations it began to shutter last year. Closures are creating opportunities for expanding chains to pick up quality properties at discounted rates; Burger King, for example, is reportedly leasing a handful of former Starbucks locations.

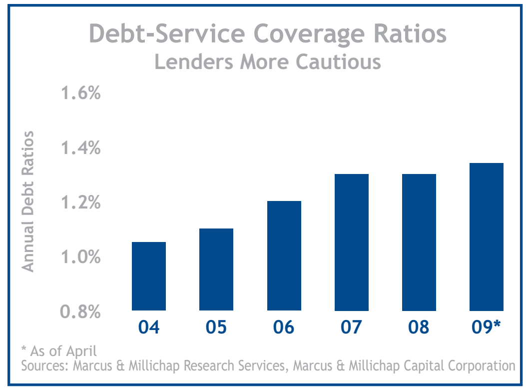
Investors have become increasingly cautious of fast-food properties, leading to a significant increase in for-sale inventory and placing upward pressure on cap rates. The gap between buyers' and sellers' price expectations remains relatively wide, but it appears to be narrowing as cap rates rise. On average, cap rates on closed transactions this year have been in the mid-7 percent range, up from 6.8 percent one year earlier; however, some of the most recent transactions have sold in the 8 percent area. There is a growing divergence in prices and cap rates by property and tenant credit quality, with corporate-owned assets in strong locations faring best. The tight financing climate has made it increasingly difficult to sell lower-quality, franchisee-owned properties, particularly those in secondary or tertiary markets.

Casual Dining Restaurants

Menus Reflect Leaner Times; Vacancies Offer Opportunities for Expanding Chains

Extreme job losses in recent months have weighed on restaurants. To attract more budget-minded diners, many chains have added lower-cost meals to their menus. Chili's, The Cheesecake Factory and T.G.I. Friday's are among the restaurants now offering value-oriented meals, which, in some cases, are simply smaller portions of popular menu items. The recession has claimed its share of restaurants, however, including 150 corporate-owned Bennigan's locations and more than 40 Ruby Tuesdays. Expanding chains are in an opportune position, both in terms of negotiating discounted rents on vacant restaurant properties and lowering construction costs by leasing locations previously occupied by another chain.

Investors and lenders are scrutinizing the credit of restaurant tenants, franchisees and parent companies. Despite relatively attractive cap rates and price points, properties occupied by even the strongest local or regional chains have become challenging to finance. Average cap rates for single-tenant restaurant properties sold during the first quarter were in the mid-7 percent range, up approximately 80 basis points from one year earlier.

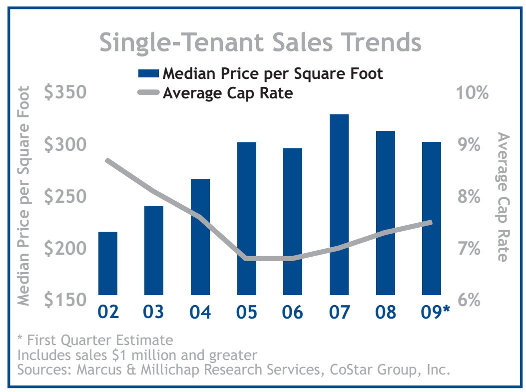


Discount Stores

Capitalizing on Frugality

The deepening recession and deteriorating wealth have led to a greater sense of frugality, even among more affluent households. Discounters, especially Wal-Mart and dollar-store chains, are benefiting from this trend. Family Dollar, for example, recently reported healthy sales figures, with much of the growth attributable to the company's expanded offerings of consumable goods, including packaged food items and some perishables. Dollar General also is outperforming amid the economic downturn and recently announced plans to create up to 4,000 jobs this year to staff 450 new stores. Wal-Mart's latest monthly sales figures came in below expectations but still reflected growth, while sales at Target were down considerably. The divergence in sales performance among the top discounters was due in part to Wal-Mart's greater focus on groceries, a segment that now accounts for almost half of the company's U.S. revenues.

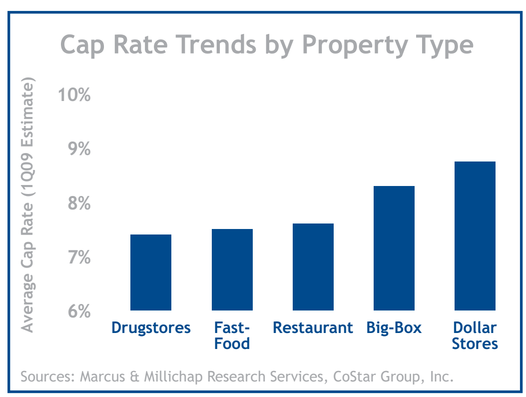
As of first quarter, cap rates for newly listed properties occupied by major big-box discounters or warehouse chains were averaging in the mid- to high-7 percent range. Unlike Target and Wal-Mart, deep discounters and dollar stores typically occupy lower-quality properties in secondary or tertiary locations. Cap rates for dollar-store properties are currently in the high-7 percent to high-8 percent range, depending on location and remaining lease term.



Big-Box Retail

Bankruptcies Send Big-Box Vacancy Skyward; Retenanting a Challenge

The big-box segment of the single-tenant sector has been hit particularly hard by the economic downturn. Retailers of electronics and appliances, construction/remodeling materials, and other housing-related goods were among the first to fall victim to the pullback in consumer spending. Circuit City and Linens 'n Things filed for bankruptcy, closing 700 and 550 U.S. stores, respectively, while Home Depot shuttered roughly 50 non-core locations, including its higher-end EXPO Design Centers. Discount department store chain Mervyns also closed, vacating 175 stores that averaged 65,000 square feet to 85,000 square feet each in size. Although a handful of former Mervyns locations have been leased to Kohl's and Forever 21, finding replacement tenants for the majority of the vacant big-box space will remain difficult in the current economic climate. Furthermore, big-box stores often have limited frontage, making it difficult to divide the space for smaller retailers that may otherwise consider these locations. On a positive note, Office Depot, which shuttered 107 stores during the first quarter of 2009, recently announced that mass closures have come to an end. The company has been able to lower its overall occupancy costs on remaining stores through various measures, including rent concessions.



Cap rates for big-box assets have increased by 40 basis points to 50 basis points over the past year, with the first quarter average in the low- to mid-8 percent range. Despite long-term leases, the viability of many big-box tenants will remain in question for many investors and lenders until the economy turns the corner. For less risk-averse buyers or those with longer-term strategies, however, now may be the time to pursue big-box opportunities. There are fewer investors in the market for these assets, and for-sale inventory has increased significantly over the past year.

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Grocery Stores

Everyone Has to Eat, Even During a Recession

As consumers cut back on overall spending, families are eating at home more often, which is good news for the grocery industry. Consumers also are looking for more ways to stretch their food budgets, leading to stronger sales of private-label goods, which typically generate higher profit margins than name-brand products. Approximately 27 percent of Kroger's sales can be attributed to its private-label products, while Alberstons' brand generates 17 percent of its sales. Wal-Mart's private label accounts for just 10 percent of its food sales, but in a bid to remain competitive, the retailer is increasing the selection and marketing of its brand.

While everyone needs to eat, grocers are not immune to changes in consumer preferences. Many new grocery concepts are smaller formats, a major change from the superstores that were gaining in popularity just a few years ago. The shift toward more compact stores is likely in response to the expansion of British retailer Tesco, though lower operating costs and the ability to gain market share in urban settings also are driving the trend. Tesco currently operates 115 Fresh & Easy stores, which average 10,000 square feet to 15,000 square feet in size, throughout the West. Although the Fresh & Easy chain has its critics and the company has reduced expansion plans, Wal-Mart and Alberstons both are test-marketing similar convenience-oriented concepts.

Cap rates for supermarket properties vary significantly. Assets occupied by the top grocery chains command cap rates in the mid-6 percent to low-7 percent range, while smaller chains average closer to 8 percent. A few Fresh & Easy properties in California and Arizona have changed hands over the past year at cap rates in the mid-6 percent range.

Recent Single-Tenant Sales Highlights

Property Name	City, State	Sales Price	Price/ Sq. Ft.	Cap Rate
BJ's Wholesale	Woodstock, GA	$16,050,000	$139	7.4%
Walgreens	Long Beach, CA	$6,850,000	$501	7.0%
Wal-Mart	Mesa, AZ	$5,393,000	$320	7.3%
CVS	Reno, NV	$5,268,565	$387	7.5%
PetSmart	Roseville, MI	$3,168,383	$122	8.8%
Applebee's	Modesto, CA	$3,111,428	$587	7.0%
Romano's Macaroni Grill	Timonium, MD	$2,704,704	$366	8.7%
Arby's	Danville, VA	$2,130,000	$666	8.1%
Taco Bell	Martinez, GA	$1,899,000	$665	8.4%
Advance Auto Parts	Harvard, IL	$1,475,000	$211	8.0%
Burger King	Tallahassee, FL	$1,434,483	$524	7.3%
Pizza Hut	Huntington Beach, CA	$1,430,000	$757	7.1%
Jack in the Box	San Diego, CA	$1,135,000	$841	6.4%
Burger King	Chandler, AZ	$1,120,000	$343	7.3%
Chipotle Mexican Grill	Pueblo, CO	$864,343	$404	7.0%

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