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Opportunities emerge as capitalization rates and single-tenant retail property inventory rise

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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 â€” those occupied by strong credit tenants and secured by long-term leases â€” 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% 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.

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. 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. Since the start of the year, cap rates for sold drugstore properties have averaged 7.4%, compared with 6.8% 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 most recent drugstore sales, for example, have been in the low-8% range and could deteriorate further during the next three to six months.

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. 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 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 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% 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% to high- mid 8% range, depending on location and remaining lease term.

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