AGREE REALTY
RETHINK RETAIL

AGREE KNOWLEDGE BASE

FUNGIBLE BOXES:

All Rectangles Are Not Created Equal

IMAGE SOURCE: O'REILLY AUTO PARTS

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Executive Summary

FUNGIBLE BOXES: ALL RECTANGLES ARE NOT CREATED EQUAL

The free-standing format provides the greatest ability for retailers to utilize their premises efficiently and effectively to meet the changing demands of consumers.* While tenants may broadly prefer the free-standing format, landlords need to be discerning when determining which free-standing assets to acquire or develop. Not all free-standing buildings have the same qualities… and the differences can meaningfully impact long-term returns. Important considerations include the real estate fundamentals of the asset, the cost of tenant-specific improvements and resulting impact on rental rates, but most importantly, the size and configuration of the space.

Free-standing buildings can be highly configured to meet a specific tenant's needs, thereby limiting the residual value of the real estate and reducing the IRR upon the eventuality of re-tenanting or disposition. Future demand for the building can naturally be inhibited by a multitude of factors, including highly specified footprints or design criteria, oversized dimensions or single purpose structures.

Artificially high rental rates also serve to decrease the probability that an owner will be able to recapture 100% of rents in the event of re-leasing. Highly specified design criteria, and/or landlord-funded tenant improvements are amortized into a tenant's rental rates, inflating per-square-foot rent and increasing the likelihood of lower recapture rates upon renewal or re-leasing.

Herein we discuss the importance of an investment criteria that focuses on "fungible" boxes and how Agree Realty Corporation (NYSE: ADC) incorporates these factors into our capital allocation decisions.

******_highlighted in several previous Agree Knowledge Base white papers_*

Non-Fungible Boxes: Now What?

There are many retail sectors that by their nature are highly specialized in their configuration or size. Several notable examples include movie theaters, gyms, car washes and entertainment retail, amongst others:

- **Movie Theaters:** two-story stadium seating
- **Gyms:** basketball courts, swimming pools and other unique attributes
- **Car Washes:** tunnels spanning 100+ feet specific to use
- **Entertainment/Experiential:** unique structures that were constructed for specific users
- **Medical/Dental/Urgent Care:** significant mechanical, electrical & plumbing

In addition to the aforementioned sectors largely tenanting unique single-purpose boxes, many of the tenants in these sectors have weaker credit profiles. The tenant's investment is limited; while the landlord's scope of work and tenant improvement allowances are elevated on a per-square-foot basis, driving rental rates artificially high and resulting in an increased basis.

By contrast, conventional sectors such as Off-Price Retail, Auto Parts, Grocery, and Dollar Stores, and well positioned junior boxes generally have strong retail real estate fundamentals due to their highly fungible nature. They occupy prototypes that are common amongst many retailers, and their size and regular dimensions increase the potential supply of replacement tenants. Additionally, landlord contributions to construction of specialized uses is limited resulting in lower per-square-foot rental rates.

IMAGE SOURCE: WWBUILDERSINC.COM

Non-Fungible Boxes Result in Lower Long-Term Returns

While pursuing alternative investment strategies with non-fungible real estate should theoretically produce higher initial cash on cash returns, the longer-term returns may be impaired when the space is repurposed for a future tenant. Upon lease rejection in bankruptcy or failure to exercise an option, the property is often burdened with various historical costs including elevated tenant improvement allowances, and/or landlord's work that includes highly specified FF&E, mechanical, electrical and plumbing installations. These improvements are generally amortized into rental rates and have little to no residual value for replacement tenants.

Additionally, in the event of failure to release the premises, the risk of selling the property upon lease maturity (given the single-tenant use) is elevated with a non-fungible property, which impairs the terminal value of the asset and limits potential future suitors. The bottom line is this...don't get caught with a vacant single purpose box!

IMAGE SOURCE: DEVELOPINGLAFAYETTE.COM

Fungible Boxes: Adaptive Reuse + Low PSF Rental Rates

While irregular, single purpose and highly specialized improvements have numerous potential pitfalls, buildings that are marketable with rents that are easily replaceable provide potential upside upon re-leasing. Highly marketable spaces have a broad array of potential future users and typically have rental rates that are at or below market. A prime example is the auto parts space. Let's focus on AutoZone (NYSE: AZO), one of the country's largest retailers with over 6,500 stores that average 7,000 square feet.

ADC's portfolio contains over 70 stores leased to AutoZone that comprise approximately 1.6% of annualized base rent. The prototypical AutoZone is located on a major retail thoroughfare, has ease of access via ingress and egress, but equally important is the low per-square-foot rental rates that the tenant is obligated to pay. Since AZO has no specialized finishes, limited mechanical, electrical, plumbing, fixtures or equipment, the average rental rate is typically between $12-$13 psf.

AutoZone prototypes are simple, fungible rectangles: polished concrete or vinyl floors, acoustical tile ceilings and ADA compliant restrooms require minimal expense to construct. Hence, the rental rates are lower, easily replaceable in the event of recapture and the buildings are highly marketable due to their smaller footprint.

A POWERHOUSE
IN THE AUTO PARTS SECTOR,
AZO HAS AN EQUITY MARKET CAP OF
OVER $45 BILLION
AND CARRIES
INVESTMENT GRADE RATINGS
FROM ALL THE MAJOR
RATINGS AGENCIES

IMAGE SOURCE: AUTOZONE

Replacement Cost: An Unreliable Measure of Value

The long-term value of real estate is often misconstrued by an over-reliance on replacement cost. Limited potential backfill candidates for single purpose structures in addition to functional obsolescence make these arguments tenuous at best. This can be applied to many areas of commercial, and even residential real estate. Think of the mega-mansion built on the dreams and ambitions of its owner.

In practice, replacement cost is a useful data point for structures that have a wide range of potential secondary users. Let's look at an extreme example of where replacement cost serves no useful purpose. The same can be applied to malls, movie theaters, large residences and other single purpose assets across the country that are no longer viable.

The Palace of Auburn Hills (completed in 1988) serves as a noteworthy example of the risks associated with overemphasizing replacement cost. The Detroit Pistons' former state of the art arena cost around $90 million to develop, or approximately $225 million today when accounting for inflation. Given the single purpose use of the building as a sports arena, there was an inability to repurpose the building for a different use when the Pistons relocated to a new arena in downtown Detroit. Alternative uses were explored including collegiate sports, and a multi-purpose venue. Ultimately the property was sold in 2021 for $22 million and The Palace was subsequently demolished. The property still sits vacant today.

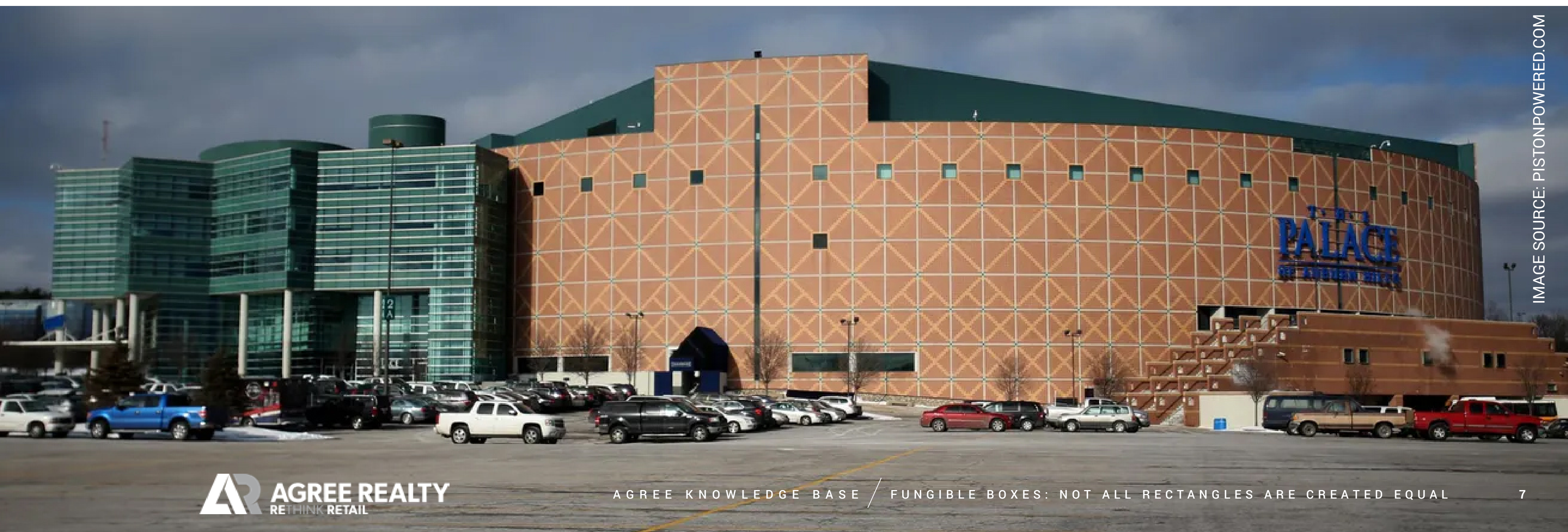

IMAGE SOURCE: PISTONPOWERED.COM

The Potential Danger of Build-to-Suit Development

As it relates to free-standing net lease properties, most structures are build-to-suit developments for a specified single tenant. The rent factor set between the retailer and the developer is based on the project's total costs ultimately aligned with the retailer's anticipated sales/profitability. If and when projected profitability is not achieved, or corporate performance is hindered, the marketability of the asset to secondary users comes into play.

Extrapolating this fact pattern further, the implication is that in sectors where sales may be declining and the box isn't fungible (casual or fine dining establishments, for example), the rent that a prospective backfill tenant is willing to pay will most likely be significantly less than the original rent. Thus, buying an asset below replacement cost in this example doesn't imply that the new owner would be able to secure long-term rents that lead to a successful outcome.

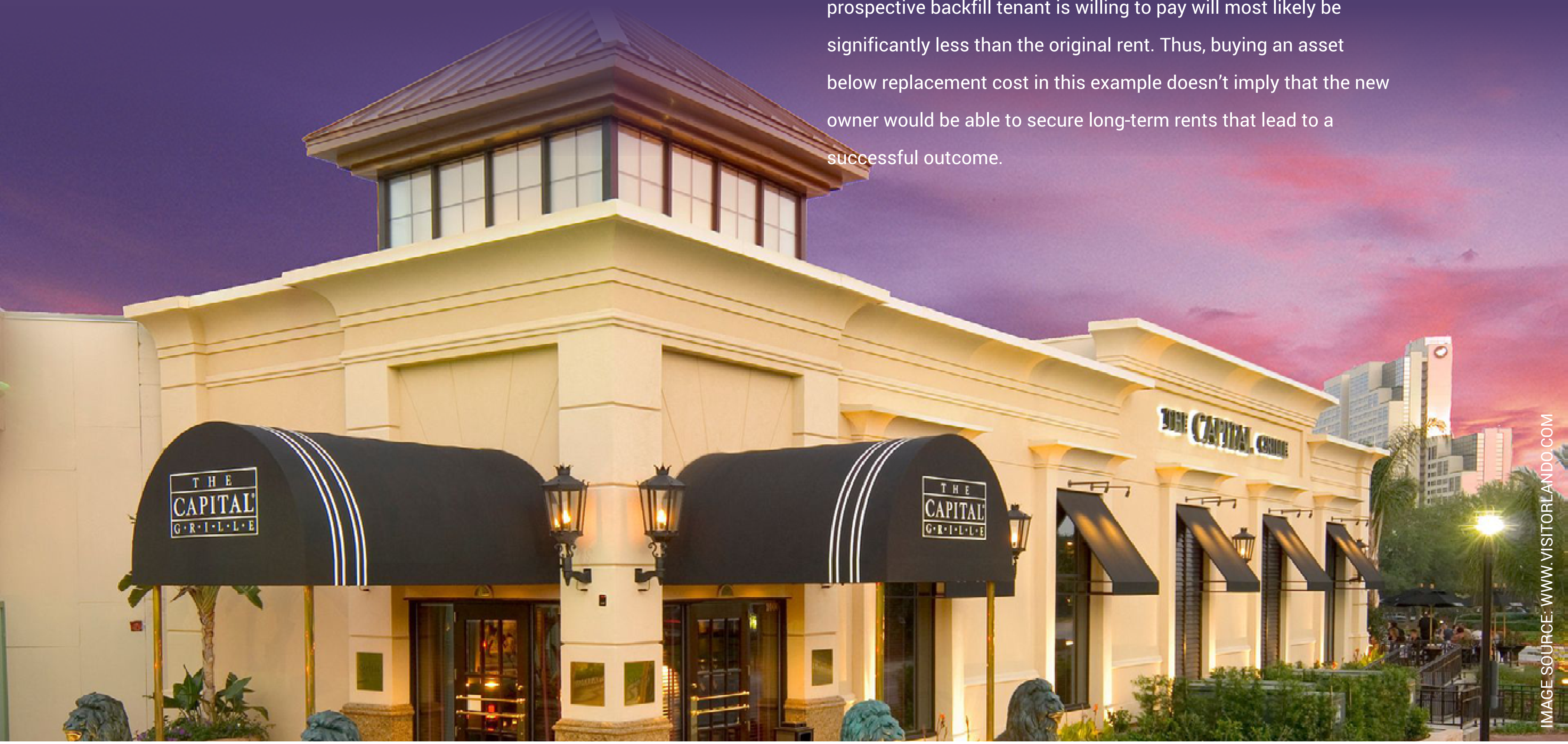

IMAGE SOURCE: WWW.VISITORLANDO.COM

A Focus on Real Estate Fundamentals

In addition to concentrating on national and super-regional retailers that are leaders in their respective sectors, ADC underwrites building configuration and potential adaptive reuse to better identify the long-term value in every investment. For each prospective acquisition and development, ADC evaluates the following real estate characteristics to ensure the greatest level of fungibility and long-term value preservation:

- Building configuration and dimensions
- Visibility & access on hard corners or major thoroughfares
- Level of retail synergy in the surrounding commercial corridor
- Barriers to entry in the retail corridor
- Strong traffic counts & demographics

By emphasizing retail real estate fundamentals in our underwriting process, we can identify the long-term value of every asset and protect against unforeseen changes to our top-down investment philosophy. While predicting the future is outside of our capabilities, risk mitigation can be achieved by focusing on real estate that has a wide range of prospective future uses.

Conclusion

Rectangles come in all shapes and sizes. While they all have four sides and right angles, the residual value of real estate is determined by the potential adaptive reuse of the vertical structure. Fungible boxes retain or increase in value as the ultimate demand for the space is determined by a broader market driving the potential future demand for the space. Net lease real estate investing is a derivative of three components: credit, term and real estate residual value. By investing in fungible properties, ADC's portfolio has differentiated characteristics with enduring value and is built for the continued omni-channel retail evolution.

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About Us

Creating Opportunity by Rethinking Retail

In 1971, Richard Agree, our Executive Chairman of the Board of Directors, founded Agree Development Company, the predecessor to Agree Realty Corporation. Over its 23-year history, Agree developed over 40 community shopping centers primarily throughout the Midwestern and Southeastern United States.

With an Initial Public Offering of 2.5 million shares in 1994, Agree Realty Corporation commenced operations as a publicly traded Real Estate Investment Trust (REIT). Agree Realty is listed on the New York Stock Exchange under the ticker symbol "ADC". Today, Agree Realty is a $8+ billion industry leader in the acquisition and development of properties net leased to the foremost retailers in the United States. As of September 30, 2022, the Company owned and operated a portfolio of 1,707 properties, located in 48 states and containing approximately 36 million square feet of gross leasable space.

Disciplined and Focused Investment Strategy

The Agree Team's expertise and strategic execution seeks to maximize value for all stakeholders. Our innovative development and acquisition strategies, adaptive real estate technology, and extensive capabilities are relied upon by our industry-leading partners throughout the United States. Building upon the foundation of excellence established throughout the past half century, Agree Realty continues to be a thought leader, rethinking retail in an omni-channel world.

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