STORE Capital

Third Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Chris Volk – *President and Chief Executive Officer*

Mary Fedewa – *Chief Operating Officer*

Cathy Long – *Chief Financial Officer*

Moira Conlon – *Investor Relations*

PRESENTATION

Operator
Good afternoon and welcome to STORE Capital's Third Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions. Please note that today's event is being recorded.

I would now like to turn the conference over to Moira Conlon, Investor Relations for STORE Capital. Please go ahead.

Moira Conlon
Thank you, Brandon. And thank you all for joining us today to discuss STORE Capital's third quarter 2018 financial results. This morning we issued our earnings release and quarterly investor presentation, which includes supplemental information for today's call. These documents are available in the Investor Relations section of our website at ir.storecapital.com under News & Results, Quarterly Results.

I am here today with Chris Volk, President and Chief Executive Officer of STORE; Mary Fedewa, Chief Operating Officer; and Cathy Long, Chief Financial Officer. On today's call, management will provide prepared remarks, and then we will open the call up for your questions. In order to maximize participation while keeping our call to an hour, we will be observing a two-question limit during the Q&A portion of the call. Participants can then reenter the queue if you have follow-up questions.

Before we begin, I would like to remind you that today's comments will include forward-looking statements under the federal securities laws. Forward-looking statements are identified by words such as will, be, intend, believe, expect, anticipate, or other comparable words and phrases. Statements that are not historical facts, such as statements about our expected acquisitions or our AFFO and AFFO per share guidance for 2018 and 2019, are also forward-looking statements.

Our actual financial conditions and results of operations may vary materially from those contemplated by such forward-looking statements. Discussion of the factors that could cause our results to differ materially from these forward-looking statements are contained in our SEC filings, including our reports on Form 10-K and 10-Q.

With that, I would now like to turn the call over to Chris Volk. Chris, please ahead.

Chris Volk
Thanks, Moira. Good morning everyone, and welcome to STORE Capital's third quarter 2018 earnings call. With me today are Mary Fedewa, our Chief Operating Officer; and Cathy Long, our Chief Financial Officer.

Year-to-date, we've invested nearly $1.2 billion in acquisitions, and we profitably divested approximately $174 million in real estate investments. For the quarter, our investment activity totaled over $500 million, the highest quarterly volume in our history. As a result, our year-to-date net investment activity, as of the end of the third quarter, was nearly $1 billion, bringing us ahead of our initial net investment guidance of $900 million for the year. Cathy will discuss the increase to our net investment activity projections and the narrowing of our 2018 AFFO guidance later on in this call.

Our year-to-date investments and property sales reflect our ability to consistently invest in and divest of assets in ways that are accretive to our shareholders. At the same time, our portfolio remained extremely healthy with an occupancy rate of 99.7%, and about 73% of the net lease contracts we have rated investment grade in quality based upon our STORE Score methodology. You'll hear more about our property investment and sales activity and portfolio health from Mary.

This quarter, we raised our dividend by 6.5%, and even so, our dividend payout ratio approximated 70% of our adjusted funds from operations, serving to provide our shareholders with a highly protected dividend and a company that is well positioned for long-term internal growth based upon anticipated tenant rent increases and the reinvestment of our surplus cash flows. We anticipate that this payout will be even lower with expected 2019 AFFO growth, which Cathy will address later when she offers preliminary 2019 guidance.

Our balance sheet remained well positioned. Our funded debt-to-EBITDA on a run rate basis remained well within our guidance range at 5.7 times for the quarter, which includes the impact of the gradual new equity issued through our ATM program. Moreover, the vast majority of our investments during the quarter added to our pool of unencumbered assets which stood at just over $4.2 billion or about 58% of our gross investments, providing us with flexibility in our financing options. Inclusive of our expected fourth quarter investments, we anticipate that our unencumbered asset ratio will approach 60% of total assets by the end of the year.

Now, as I do each quarter, here are some statistics relevant to our third quarter investment activity.

- Our weighted average lease rate during the quarter was approximately 7.88%, slightly lower than last quarter but in line with our 2018 trends.

- The average annual contractual lease escalation for investments made during the quarter approximated 1.9%, providing us with a gross rate of return (which you get by adding the lease escalations to the initial lease rate) of almost 9.8%. If you include average corporate borrowings approximating 42% of investment cost at an interest rate of 4.5%, you're going to arrive at a gross levered total return of better than 13%. Our outperforming investor returns from STORE and predecessor public companies have been mostly driven by having favorable property-level rates of return, which is why we take the time to disclose investment yields, contractual annual lease escalators, investment spreads to our cost of long-term borrowings and our operating costs as a percentage of assets, which are the four essential variables that enable you to compute expected investment rates of return.

- The weighted average primary lease term of our new investments continues to be long, at approximately 17 years.

- The median new tenant Moody's RiskCalc credit rating profile was Ba2.

- The median post overhead unit level fixed charge coverage ratio for assets purchased during the quarter was 3.1 to 1, well above our historical portfolio median of around two times.

- The median new investment contract rating (or STORE Score) for investments was favorable at A3.

- Our average new investment was made at approximately 72% of replacement cost.

- 100% of the multi-unit net lease investments made during the quarter were subject to master leases.

- And all 129 new assets that we acquired during the quarter are required to deliver unit-level financial statements, giving us unit-level financial reporting from 98% of the properties within our portfolio. This impressive fact is critical to our ability to evaluate contract seniority and real estate quality, as well as to our access to capital, including our recent issuance of AAA-rated notes.

- Our investment activity continued to be granular, with 41 separate transactions completed with an average transaction size of about $12 million. The strong demand for our solutions has enabled us to close an investment every day-and-a-half during the past two quarters. This is how we have built such a highly granular and highly diverse investment portfolio.

- At the end of the quarter, revenue realized from our top 10 customers was 18.5% of annualized rents and interest, down from 19.2% at the end of the second quarter. Our single largest customer represented just 3.1% of our annualized rents and interest, which is in line with our long-term target of having no tenants exceed 3% of our annual revenues.

And with that, I'm going to turn the call over to Mary.

Mary Fedewa
Thank you, Chris, and good morning everyone.

The third quarter was our best quarter ever at STORE, with acquisition volume exceeding $500 million, at a weighted average cap rate of 7.9%. This takes our year-to-date gross acquisition volume to nearly $1.2 billion. Our investments this quarter were spread across 41 separate transactions, which represented a more than 20% increase in the number of quarterly transactions over last year. Our continued commitment to investing in our acquisition, credit, and closing teams is what enables us to execute this high level of quarterly volume while at the same time maintaining an extremely granular portfolio with an average transaction size of about $12 million for the quarter.

Now, turning to the servicing side of the business, portfolio monitoring is pivotal to our success, and we continue to invest in our operational platform with additional resources and process improvements, including incorporating business intelligence to enhance our analytical capabilities.

Overall portfolio health is strong, with delinquencies and vacancies at very low levels, reflecting our active portfolio management and strong tenant partnerships. We ended the quarter with only six out of our more than 2,200 properties vacant.

As of September 30, 2018, our portfolio mix remains consistent, with 65% of properties in the Service sector, 19% in Retail with vital experiential components combined with strong online presence, and the remaining 16% in Manufacturing.

- Customer rankings within our top ten remain extremely diverse by design, with our largest tenant, Art Van Furniture, representing just 3.1% of rent and interest.

- We are excited to welcome one of our long-time customers, Stratford Schools, back into our top ten list this quarter. Stratford Schools is a top-ranked California-based independent private school with a reputation for quality education. It serves preschool to eighth-grade students through more than 20 locations, primarily in the Bay Area.

During the quarter, we sold seven properties, which had an acquisition cost of $13 million. One of the seven properties was an opportunistic sale resulting in a 39% net gain over original cost. Four were strategic and resulted in a 7% gain over cost. The remaining property sales were from our ongoing property management activities and resulted in a 77% recovery. Year-to-date, we've sold 55 properties which had an acquisition cost of $174 million, and have generated net gains over that original cost of approximately $14 million.

Our ability to generate profits from asset sales owes itself to our direct origination strategy. Portfolio management activities like this, which produce real economic gains, serve to offset sporadic vacancies or asset underperformance, which is a customary part of the net lease business.

And finally, an important initiative we completed this quarter was transitioning our outsourced servicing to KeyBank. This will result in enhanced reporting, improved technology, and superior customer service, as well as a substantial cost savings.

Now, turning to the overall market and our pipeline, overall market conditions remain vibrant, and market cap rates have been holding steady and strong. Heading into the fourth quarter, we have a robust and diverse pipeline that mirrors our current portfolio in terms of emphasis on Service, experiential Retail, and Manufacturing.

Before I turn the call over to Cathy, I wanted to mention that our third annual customer conference, the Inside Track Forum, is coming up on January 29th in sunny Scottsdale. This year, we are proud to announce that our keynote speaker will be Marcus Lemonis, star of CNBC's “The Profit,” and chairman and CEO of our long-time customer Camping World. This exciting event will feature a powerhouse lineup of speakers in addition to Marcus to provide our customers with at least one or two actionable ideas to help them keep the inside track.

With that, I'll turn the call to Cathy to talk about financial results.

Cathy Long
Thank you, Mary.

I'll begin by discussing our financing activity and balance sheet, followed by our financial performance for the third quarter. Then I'll review our guidance for the remainder of 2018, and introduce our guidance for 2019. All comparisons are year-over-year unless otherwise noted.

Starting with our financing activity and our balance sheet, our record acquisition activity during the third quarter was funded by strong cash flows from operations, availability under our credit facility, and equity proceeds from our ATM program. Our ATM program has been an especially effective way to raise equity this year and makes a lot of sense for us given the flow of our business and the granular size of our transactions. During the third quarter, we sold 6.7 million common shares under our ATM at an average price of $28.60 per share, raising net equity proceeds of just over $187 million. Year-to-date, we've sold 17.9 million common shares at an average price of $26.88 per share, representing net proceeds of nearly $475 million which we've put to work through property acquisitions.

As we announced last week, early in the fourth quarter, we issued our eighth series of net lease mortgage notes under our STORE Master Funding program. As Chris will discuss, this issuance was groundbreaking, enabling us to issue our inaugural series of AAA-rated notes. In conjunction with this issuance of $592 million of Series 2018-1 notes, we prepaid without penalty $233 million of Master Funding notes that were scheduled to mature in 2020. As a result, our long-term debt now stands at just under $3 billion, and we've extended the weighted average maturity of our debt from 5.6 to 6.4 years, while maintaining our weighted average interest rate at just under 4.4%.

In a rising interest rate environment, it's important to note that all our long-term borrowings are fixed rate. Our debt maturities are intentionally well-laddered – our median annual debt maturity is currently about $275 million, and with this recent prepayment, we've successfully pushed out our larger debt maturities to the year 2021.

As we've demonstrated over the past two years, our portfolio management strategy includes proactively selling properties and deploying the proceeds to acquire new properties, but we can also use these proceeds to repay debt as it matures. Taken together, the sum of our annual free cash flows reinvested in our business and our net proceeds from profitable asset sales are actually intended to exceed our annual debt maturities. Importantly, this mutes much of the impact of interest rate changes since it provides us with the opportunity to reinvest the cash at higher lease rates should interest rates rise.

At September 30, our leverage ratio was on target at 5.7 times net-debt-to-EBITDA on a run rate basis, or around 41% on a net-debt-to-cost basis.

In October, we used a significant portion of the net proceeds from our Master Funding note issuance to pay down our credit facility. Going into the fourth quarter, we have access to over $500 million on our credit facility plus $800 million from the accordion feature. In summary, we are well positioned with substantial financing flexibility, conservative leverage, and access to a variety of attractive equity and debt options to fund a large pipeline of investment opportunities.

Now turning to our financial performance, as of September 30, our real estate portfolio stood at $7.2 billion, representing 2,206 properties. This compares to $5.9 billion, representing 1,826 properties, at September 30, 2017. The annualized base rent and interest generated by our portfolio increased 22% to $578 million as compared to $474 million a year ago. Approximately $3 billion of our $7.2 billion gross real estate portfolio was pledged as collateral for secured debt, with the vast majority of that amount devoted to our Master Funding program. The remaining $4.2 billion of real estate assets, representing nearly 60% of our portfolio, were unencumbered, giving us substantial financing flexibility.

The growing demand for our real estate financing solutions gives us the ability to generate strong and consistent revenue growth. In the third quarter, revenues increased 24% compared to the third quarter of 2017 revenues of $137 million. Excluding the impact of a $4.6 million non-cash charge recognized a year ago, revenues were up approximately 19% year-over-year. I should note that because our third quarter acquisition volume was spread across the quarter, the full revenue impact of that volume won't be realized until the fourth quarter.

For the third quarter, total expenses were $90 million, up from $88 million a year ago. Excluding changes in non-cash expenses such as depreciation and amortization and impairments recognized last year, expenses increased 3% year-over-year.

Interest expense was up slightly from a year ago, primarily due to higher average balances outstanding on our credit facility. The increase is almost fully offset by a decrease in the weighted average interest rate on our long-term borrowings. Note that interest expense for the third quarter of last year included a $2 million non-cash charge related to accelerated amortization of the deferred financing costs associated with the STORE Master Funding notes we prepaid in August 2017. In the fourth quarter of 2018, we will recognize a similar non-cash charge related to the recent prepayment of Master Funding notes.

As of September 30, only six of our properties were vacant, and property costs for the quarter were less than $1 million. Over the past four quarters, property costs averaged about seven basis points of our portfolio assets. During the third quarter, property costs were lower at about four basis points.

G&A expenses were $11.5 million, compared to $10.3 million a year ago, primarily due to the growth of our portfolio and related staff additions. As a percentage of average portfolio assets, third quarter G&A decreased substantially to 66 basis points from 72 basis points a year ago. This reduction reflects economies of scale and the operational efficiencies gained through continued success in process automation and improvements to our servicing platform.

Net income for the quarter increased to $48 million, or $0.23 per basic and diluted share, compared to $29 million, or $0.15 per basic and diluted share, a year ago. Net income before gain on property sales increased to $47 million, compared to $22 million a year ago, reflecting the non-cash charges I mentioned earlier. Excluding these non-cash charges and before gain on property sales, net income increased by more than $10 million, reflecting higher revenues generated by our larger portfolio. Property disposition activity for the quarter resulted in a net book gain of $1.2 million from the sale of seven properties. This compares to a net gain of $6.3 million from the sale of 12 properties in the third quarter of last year.

We delivered another quarter of strong AFFO and AFFO per share growth. AFFO for the third quarter increased 26% to $97 million from $77 million. On a per share basis, third quarter AFFO was $0.47 per basic and diluted share, an increase of nearly 15% from $0.41 per basic and diluted share last year.

Chris already mentioned our dividend increase, so I'll just point out that since our IPO in 2014, we've increased our dividend per share by 32% while maintaining a low payout ratio and at the same time reducing our leverage.

Now turning to our guidance for 2018. Due to our record investment activity in the third quarter, today we are updating our guidance for 2018. We are now projecting 2018 annual net acquisition volume of $1.2 billion, up from $900 million. We expect AFFO per share in the range of $1.81 to $1.84, up from the previous range of $1.78 to $1.84. AFFO per share in any period is sensitive not only to the amount but also to the timing of acquisitions, property dispositions and capital markets activities. In addition, real estate acquisition volume is often weighted towards the end of the quarter, which results in little impact to AFFO per share in the current period.

Our AFFO per share guidance for 2018 equates to anticipated net income of $0.84 to $0.86 per share, excluding gains or losses on property sales, plus $0.88 to $0.89 per share of expected real estate depreciation and amortization, plus $0.09 per share related to items such as straight-line rents, equity compensation and deferred financing costs.

Finally, I'll turn to our initial guidance for 2019.

Based on our current projections for real estate acquisitions for the remainder of 2018, plus estimated acquisition volume of $1.1 billion for 2019, which is net of projected property sales, we currently expect 2019 AFFO per share in the range of $1.90 to $1.96.

Our AFFO guidance is based on a weighted average cap rate on new acquisitions of 7.85% and a target leverage ratio in the range of 5.5 to 6 times run rate net-debt-to-EBITDA.

Our AFFO per share guidance for 2019 equates to anticipated net income, excluding gains or losses on property sales, of $0.92 to $0.97 per share, plus $0.91 to $0.92 per share of expected real estate, depreciation and amortization, plus approximately $0.07 per share related to items such as straight-line rents, equity compensation and deferred financing cost amortization.

And now I'll turn the call back to Chris.

Chris Volk
Thanks so much, Cathy.

As is usual, and before turning this call over to the operator for your questions, I want to highlight some of our significant achievements this year. During 2018 STORE has continued to realize sector-leading investment yields, which, taken together with our sector leading investment spreads to our cost of borrowings, has resulted in market-leading external growth efficiency.

Add this to a dividend payout ratio that is amongst the lowest in the sector and one of the highest tenant lease escalations in the sector, we've realized and we believe are positioned to continue to realize – solid AFFO growth per share. Our approach to growth has allowed us to raise our dividends per share by 32% since 2015, including a solid dividend raise of 6.5% in this third quarter. To date this year, we've achieved some the highest levels of investment activity in our history, both in terms of dollars invested and transaction counts, all of which illustrates the strong level of demand for our efficient net lease solutions that we provide to our middle market and larger customers.

On the capital side, we have successfully issued our inaugural public BBB/Baa2 rated note offering on March 15 at a rate of 4.5%. At that time, the 10-year Treasury stood at about 2.8% and our cost of note issuance represented an approximate 170 basis point spread over this benchmark. Then, as we announced last week, on October 22, we issued $592 million in term debt from our Master Funding conduit. Between our inaugural public note issuance in March and our groundbreaking Master Funding issuance last week, the 10-year Treasury Note rose by approximately 40 basis points. Yet the yield of our comparable term notes actually fell. Our 2018-1 Master Funding issuance represented the second debt first for STORE this year because it was the first time for us to issue AAA-rated notes, making us one of the very few REITs having this capability. In fact, it was the first time AAA notes have ever been issued from a U.S. real estate master trust conduit, which makes this event truly groundbreaking. We have employed our conduit since 2012 to issue predominantly A-+ rated term notes. We started to harness our potential to issue AAA-rated notes at the beginning of 2018 as a means to lower our cost of capital and to broaden the market for the Master Funding program. We succeeded, and we were able to issue notes having the same loan to value as our historic Master Funding notes but with almost 65% of them bearing an AAA rating at an attachment point loan to value ratio of 45%. Our nine-year notes were issued at an interest rate of 4.29%, or about 20 basis points inside the 10-year BBB-rated notes that we issued in March. Or, to put it another way, our AAA-rated notes came in at a rate of approximately 70 basis points inside of where we could have issued comparable corporate unsecured BBB-rated notes. In all, relative to our historic practice of issuing A+-rated Master Funding notes, we estimate that the interest savings for STORE to be about $1.7 million annually. In all, the weighted interest rate of the recent six-and nine-year Master Funding notes came in at 4.34%. Since a large portion of the Master Funding issuance proceeds were applied to prepay Master Funding notes, STORE did not need to add any collateral to the $2.7 billion asset pool. This means that substantially all the real estate investments that we expect to make for the full year of 2018 will be unencumbered, which will drive our proportion of unencumbered assets to about 60% by the end of this year.

STORE is succeeding by meeting the capital needs of middle market and larger companies across the country and fundamental, relevant businesses for their profit center real estate. We know that the profitability of the operations conducted at that real estate says so much about real estate quality and about the seniority of the net lease contracts we are creating. Equally important, our success is centered in the assemblage of a diverse net lease contract portfolio having comparatively low likelihood for correlated risks. Our simple thought was that the value of such a diverse portfolio would sufficiently spread our investment risk so that the portfolio becomes worth far more than the sum of its parts. (And those parts are worth a lot, which you can see from the true economic gains that we've realized from asset sales over the past 2 years.) Anyway, these foundational STORE fundamentals were importantly recognized by a rating agency and by premier investors who invested in our AAA-rated notes issued out of our seasoned $2.7 billion Master Funding conduit that has grown substantially in size, diversity and debt service coverage since we first launched it in 2012.

With such an eventful year filled with important firsts coming to a close, we're turning to our vision for 2019. That vision includes continued growth and continued emphasis on strengthening our financial position. In 2019, major systems initiatives, which we set in motion this year, will represent an important emphasis for us as we invest more in business intelligence capabilities and move much of our accounting, servicing, credit analysis, database and other systems to the cloud. Effectively, we will strategically be moving to our fourth generation corporate IT platform, with the promise of improved corporate efficiency, portfolio performance and decision making. The goal is to make us better at what we do, increase our competitive moat and translate that elevated ability into a lower cost of capital.

Finally, I encourage you to take a look at our third quarter investor presentation. We are always looking to make improvements and this quarter we included a slide, page 22, designed to add more information about our 18.5% retail exposure. We've always disclosed investment diversity by tenant business line rather than by real estate investment type. We believe this is essential since there are only four broad categories of real estate (retail, multifamily, office and industrial) which represent overly broad and blunt categories that are ill-designed to represent the array of our Service, Retail, and Manufacturing sector investment exposure. In this light, our definition of a retail property is different than simply a consumer-facing property located on a retail corridor. We define our retail tenants as those that move merchandise. Retailers in recent years have often found the business of moving merchandise to represent a risky proposition since merchandise can be acquired through alternative channels such as the internet. However, as you'll see from the added disclosure, much of the merchandise, services and experiences provided by our retail tenants cannot be easily replicated by other distribution channels. We invest in net lease real estate that we believe offers strong prospects for long-term sustained relevance.

And with these comments, Operator, I'm going to turn this over to you for questions.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question-and-answer session. To ask a question you may press “*” then “1” on your touchtone phone. If you are using a speakerphone please pick up your handset before pressing the keys. To withdraw your question please press “*” then “2”. At this time we will pause momentarily to assemble our roster. Our first question comes from Collin Mings with Raymond James. Please go ahead.

Collin Mings
Hey, good morning, out there.

Chris Volk
Hey, Collin.

Cathy Long
Hey, Collin.

Collin Mings
Chris, just to the point of this being a record quarter in terms of investment activity, anything unusual in terms of deals or timing? I recognize you've generally proven to be pretty conservative with initial guidance, but just with flow, the expansion to your team and platform, why would this quarter be an anomaly versus what you can replicate in the future?

Chris Volk
Well, Collin, we're in a flow business, you know, and it becomes somewhat difficult for us to really foresee what's going to happen all the time. So we didn't, for example, initially think at the beginning of this quarter that we would exceed our annual guidance for the year at the end of the third quarter. We were fairly confident that we were going to exceed the annual guidance, we just didn't expect to quite do it this fast. And so a lot of it was timing, and you'll see that the weighted average deal size increased a tiny bit.

Cathy Long
The first half of the year, it was about $8 million and it went up to about $12 million, Collin, so the average yield size did increase for the third quarter.

Chris Volk
We didn't have anything that was hugely chunky in the third quarter, but we had some stuff that was bigger than we had in prior quarters. And that was a contributing factor as well. So it's the function of timing, some of which got accelerated faster than we expected.

Cathy Long
We are going to invest, as you know Collin, in the front end. That plan is on track and that's taking hold. So it's beginning to pay off a little bit.

Collin Mings
Okay. And then on meeting unit level coverage in the quarter, obviously it’s well above the portfolio average, so just maybe talk a little about what drove that, what was it a function of, some of the specific deals, underwriting of those deals, just to touch on that. And then maybe just touch on how that portfolio coverage has trended without the lift from new deals because, again, given the volume and the overall strength of coverage on the deals this quarter, it looks like it may have pulled your unit level coverage up a bit?

Chris Volk
Well, I think it was to some degree a function of the tenant mix, and some have higher coverages than others. But, one of the things that we have always done since day one was disclose the median coverage as opposed to the weighted average because when we do weighted average it just distorts stuff.

When we have one quarter like this where you have a three-to-one -- that's nice, but it doesn't really move the needle that much overall for the whole company. So our overall median is going to be kind of in the two-ish range. This quarter, it was nice to have a median that was three, but again it was only 124 properties, so it was just a function of the mix.

Operator
Our next question comes from Jeremy Metz with BMO Capital Markets. Please, go ahead.

Jeremy Metz
Hey, in terms of your outlook for next year, I know it's still early in the budgeting process here but you've been more active on dispositions in 2018 as the portfolio continues to mature and age so can we expect to maybe see that activity accelerate or how dependent is that cadence on acquisitions? And then sticking with that, what sort of portfolio premium do you think is out there in the market today?

Mary Fedewa
This is Mary. Yes, I think property sales for 2019 will be very similar to maybe a little more than 2018. We are seeing a lot of opportunity out there to move some properties opportunistically. Now that we’re seven years old, we’ve got a lot of embedded gains that we get from the minute we acquire an asset. And I would say that we’re still seeing at least 100 basis points of premium over our origination cap rate in the marketplace. So nice spread still, but as you know, we’re originating quite a bit higher than the marketplace.

Chris Volk
Yes, and Jeremy, the process is also lumpy too. We didn't really sell that much in Q1.

Mary Fedewa
Yes, only seven property -- Q1 was light and we just did seven in the third quarter.

Chris Volk
And Q2 was heavy.

Mary Fedewa
Yes.

Chris Volk
So it's a $174 million to date. Last year we were around $250 million, so now we expect the fourth quarter will be heavier than the last quarter.

Mary Fedewa
Correct. Yes.

Jeremy Metz
Got it, thanks. And then if I look at your pipeline, the allocation to restaurants has trended down from, call it, 20% to 15%; just wondering is this a natural result of what's in there, is there

anything more strategic going on as you look to continue to buy and shape the portfolio from here? Obviously, restaurants broadly have come down from nearly 16%, I think it's closer to 17% or 18% today. So just wondering if that will continue to shrink?

Mary Fedewa
Yes, I would say a couple of things on that. The first thing is that we have been paring down some of the restaurant exposure as it relates to companies like Applebee's and I think we've talked openly about that. It's on the full-service side. Also, the portfolio has just been growing. So the denominator is getting so much bigger as you know, and that's causing some of the decline in the restaurant space as well. We're looking at all transactions.

As you know, restaurants are a hot asset class for everybody; cap rates tend to be a little bit lower. So we're pretty mindful to pick the restaurants that make sense for us where we can get all of the things that we want to do: the strong contracts, master leases, cap rates above the auction marketplace, buy them below replacement cost and get all of the financial reporting that we want. So that's really the situation going on with restaurants.

Jeremy Metz
Thanks.

Operator
Our next question comes from Craig Millman with KeyBanc Capital Markets. Please go ahead.

Laura Dickson
Hey, everyone, this is Laura Dickson here with Craig. So I was wondering how you guys are thinking about follow-on offerings these days. I think the last one you did was in early 2017 but I know you've had a lot of success with the ATM lately, which better matched funds with your acquisitions, but just given the timing of the recent Master Funding debt issuance, just curious how you're thinking about follow-on offerings.

Chris Volk
Hey, Laura, this is Chris. The timing of debt and the timing of equity don't coincide. I would say that the ATM transactions for us have been exceedingly efficient. We're a flow business, and we're closing a transaction every day and a half. You can't get much more efficient than doing ATM issuance where costs gets a point and a half. It's far and away the most efficient form of equity we can do.

Overnights have an attraction as a way of broadening the investor base and targeting enhanced participation by the markets and I think there'll be some room for that at some point in time in the future. But for this year and a big chunk of last year, we've been very heavily engaged in the ATM marketplace and it's been really fruitful.

Laura Dickson
Okay. Thank you. And then just curious, given the AAA-rating on the Master Funding debt, and previously I think it was closer to an A+ rating, just wondering what metrics changed that made the rating companies revisit?

Chris Volk
First of all, our rating agency is Standard & Poor’s and they had published methodology with respect to how it was feasible to do this. If you think about what we have been doing historically, we were issuing A+ rated notes that were senior notes at 70% loan-to-value. And so therefore embedded in those senior notes were AA and AAA notes screaming to crawl out, ready to be

revealed. But the question is always well how much of that is AAA or how much of its AA if you wanted to break out and tranche the cash flow streams. So we started working on, at the very beginning of this year, with the prospect of seeing if we could get some AAA notes issued out of the conduit.

Now, one of the things that helps us a lot is that the conduit is no longer just a small conduit, it's a $2.7 billion conduit. There are net lease REITs that are smaller than that. We have a very big and diversified portfolio that has been seasoned over time, and it has improved by not only diversity but debt service coverage and whatnot.

So if you're going to look at getting a pool to break out a AAA piece, that's the time to do it, where you have a conduit that's big enough and has had proven performance and track record, not to mention the track record of the company as a whole. So we decided to do it, and it was truly groundbreaking to be able to be the first to ever issue AAA Master Funding notes of any kind of out of a real estate conduit. It is a big deal and stands to lower our cost of capital and make our shareholders far better off, and it's going to save us almost $2 million in interest expense next year.

Laura Dickson
Okay, great. Appreciate the color, thanks.

Operator
Our next question comes from Vikram Malhotra with Morgan Stanley. Please go ahead.

Vikram Malhotra
Thanks for taking the questions. Chris, going to 2019, I know at your last Investor Day you talked a lot about movement in net in cap rates historically, what the drivers have been. We've now seen rates here steady, kind of consistently above three. I don't think we've really seen a move in cap rates in many asset classes, at least not in the triple net segment.

Just trying to understand, given your cost of capital has continued to improve, does this make you sort of widen the property set you look at or the pool of properties look at and maybe think you can go into certain areas, that you kind of may have not looked at or I guess how do, how should we think about you utilizing this improved cost of capital going forward?

Chris Volk
Good question, Vikram. Mary mentioned earlier that there are four essential ingredients to what we were going to look at. We're going to be investing in assets that have cap rates that are higher than you can get in an auction marketplace. If we can't do that then we're not really adding value to shareholders. We're going to be investing in assets at properties below replacement cost. Again, it's very important to do that. We're going to be seeking to invest in properties subject to master leases. We think that's the only way you can get true diversity and we're going to absolutely demand financial statement reporting at the unit level. So those are the four things that we're going to demand.

We are fundamentally, and have been from the outset, value investors. When the 10-year Treasury hit 1.5% in 2016 our stock was at $31 a share and we would get questions about why we weren’t buying investment-grade assets or something like that. And the answer is because we just don't think that's where the best risk-adjusted rates of return are and we can't hit those four requirements. –On investment-grade assets, we wouldn’t be able to get unit level P&L from all of them, we can't get them below replacement costs. We can't buy them at discounted discounts to the auction marketplace. We can't get master leases, and that's before you even start to talk about returns. Our goal here is not to have the most brand name tenants. Our goal here is not to have the lowest vacancy rate, which we about do: we have six empty properties out of over 2,000 properties.

Our goal here is to make the most money and have the highest rates of return and highest risk-adjusted rates of return. So today and since we started STORE, we've had amongst the highest cap rates, the highest spreads to our cost of borrowings, highest lease escalators, lowest payout ratios, all designed to fundamentally gear you towards long-term solid AFFO growth and total rate of return performance.

And what you saw from the Investor Day that's kind of cool is that we could be trading at an 18 multiple or a 13 multiple and our total rate of return to investors almost doesn't change, which basically shows you what a finely tuned risk portfolio we're creating. You would think we're trading at 18 multiple and then returns should go up for investors.

Well, what happens for us is that obviously the dividend yield drops because you're trading at a higher multiple. So your dividend yield drops but you do offset that with a little bit more external growth. But you get to the same total rate of return. And the reason we can have almost the same rates of return irrespective of the multiples we trade at is because we have such a profound amount of internal growth here, and not to mention a nice total rate of return going in with the cap rates we have. And the cap rates we have, by the way, if you look our total rate of return, if you look at our cap rates plus our lease escalators, we're basically 30 or 40 basis points away from our gross returns in 2006 or 2007 when the 10-year Treasury was 4.50%. So we've been very disciplined about focusing on returns.

Mary answered the question about why we're not you know chasing after restaurant deals; a lot of it has to do with the four food groups and a lot that we're going to demand in terms of table stakes to do deals. And lot of it has to do with just the kind of returns that we can get and where we can get better returns. We're focusing on making returns for investors and we're not going to deviate, irrespective of what the market does, to our cost of capital.

Vikram Malhotra
Okay, that makes sense. And then, Cathy, one for you on the payout and the balance sheet here. You obviously have a very attractive payout at current levels and I'm just trying to get a sense of next year how you balance that together with leverage, again kind of tying back to kind of cost to capital, and utilizing equity at this point; where would you be comfortable taking leverage up from here from current levels in the same way where would you take payout ratios?

Cathy Long
Well, Vikram, as far as the payout ratio goes, we'd love to keep it around 70%. As you know, the free cash flow after dividends is an important component to our internal growth and internal growth is important to be able to weather all sorts of different economic environments. Even before, I could go out and get equity and debt I have internal cash flow that I can let Mary's team go reinvest for me. So we like keeping a low payout ratio. As well, it provides protection for dividends, so shareholders can feel very comfortable that their dividend is well protected at a low payout ratio.

And then as far as leverage goes, we've given a target range of five and a half to six times funded debt-to-EBITDA on a run rate basis and we feel very comfortable in that range. On a cost basis, that equates to about 40% of loan to cost and I think that works really well for us.

We have a lot of investment-grade debt options and as you know on the Master Funding side we will have higher leverage than that. But then on the senior unsecured debt side, we'll end up with lower leverage. So all in all, we feel comfortable with that range that we've given as a target. I hope that helps.

Vikram Malhotra
Okay great. Thank you.

Operator
The next question comes from Ki Bin Kim with SunTrust. Please go ahead.

Unidentified Speaker
Good morning. This is Alexi filling in for Ki Bin today. My first question relates to your acquisition pipeline, can you talk about what you're buying these days and what deals you're passing on?

Mary Fedewa
Hi, this is Mary. So as you can see, we continue to be pretty diverse across many, many asset classes. We have over 105 industries. I would say there is no one major industry that sticks out in the third quarter. And I would say the pipeline is also very diverse. We are looking for profit center real estate. We are a “pure play,” as in profit center real estate. So that's what we start and we are looking for a good cash flowing companies that are growing and where we can provide a solution and get paid for that solution. So from there, the industries sort of fall in place in a very diverse way.

Unidentified Speaker
I see because I think you mentioned earlier in the call that restaurants and Applebee's … just was wondering if there's any other concepts or sectors that are worth mentioning in terms of your future acquisition pipeline?

Mary Fedewa
No, nothing worth mentioning. Applebee's’ RMH, one of the largest Applebee's franchisees, is in bankruptcy as you know. They're paying us currently and we're working with them on a final plan. But otherwise, there's nothing that's concerning or sticks out at this point.

Unidentified Speaker
Okay. Thank you. And then my second question is about your look-through leverage. Are you seeing any trends in the leverage levels of your tenants at the corporate level?

Mary Fedewa
I would say not really, and we do look at it really closely. We have a lot of customers that are making acquisitions and they oftentimes take on additional debt to do that and then sort of put the acquisition together and grow into it and so forth. So we are seeing a little movement that way that but nothing alarming, concerning, nothing that causes pause for us.

Unidentified Speaker
Okay great. Thank you.

Operator
The next question comes from John Massocca with Ladenburg Thalmann. Please go ahead.

John Massocca

Good morning. So looking at page 25 of the investor presentation, when you look at the deal velocity and maybe the pipeline it looked like it came down a little bit quarter-over-quarter; how correlated do you think that is to your increased investment volume going forward or is it just kind of at 10x, over 10x coverage of what you're planning to buy over in the next year? Does it just not really matter how much movement there is in those numbers?

Mary Fedewa
Page 26 you're talking about the pipeline, the velocity.

John Massocca
Sorry, page 26 correct.

Mary Fedewa
Page 26, okay. Very good. There's a lot of velocity in the pipeline, you see deals get passed on and some get decisions. I think as you know we have a very large quarter in the third quarter with a lot of deals getting funded now off the pipeline. The effect of that, and continuing to bring deals on and bring deals off of it. You maybe will see a little flattening because we did fund quite a bit in the third quarter off the pipeline.

John Massocca
Okay. It'd be fair to kind of say those middle numbers there, those are going to bounce around a little bit just based on what your team can fund?

Mary Fedewa
You bet. And that's just not right and it's the team but it's also the customer. These are relationships that we're creating. Sometimes they take time. These customers do a transaction when they have a reason for the cash or a need for the transaction, so that might be making an acquisition or recapitalizing their balance sheet. So, timing is everything in this business which you hear a lot and which you've heard from Cathy and Chris today. too. A lot of it is just our team working through but also the customer and their timing.

John Massocca
Makes sense, and then kind of looking at the existing portfolio, metal fabrication kind of came up versus last year and has become a decent portion of the portfolio. Have you seen any impact of tariffs on those tenants and is there any way to kind of underwrite for the potential impact that may have?

Mary Fedewa
You bet. Yes, it did go up. You're correct. We have been studying tariffs here a lot. We've been talking to all of our customers. We've contacted most of them. I will just say at a really high level that the customers we've talked to feel like they can pass on any costs to their customer and none had any material concerns. We're on top of the tariffs here in terms of existing customers. In terms of new companies coming in, Chris Burbach and his team on the underwriting side are absolutely mindful of tariffs and when they are talking to the customer we are very careful to incorporate anything that makes sense there. You bet.

John Massocca

Alright, that's it for me. Thank you very much.

Chris Volk
Thank you.

Operator
The next question comes from Haendel St. Juste with Mizuho. Please go ahead.

Haendel St. Juste
Hi there.

Chris Volk
Hi, Haendel.

Haendel St. Juste
So I guess first one quick question. I'm not sure if I missed this or not but what's the credit loss assumption embedded in your 2019 guidance?

Cathy Long
We haven't actually given details on that. As you know, when we're acquiring properties in 2018, a lot of that total revenue impact hits 2019. So we have visibility somewhat into 2019 and we're happy to share with people our initial guidance, but we will wait till the first quarter or to our year-end call to really give a lot more color around assumptions and things like that.

Haendel St
Got it. Okay. Thank you. And I guess Chris for you, what's your comfort level, maybe even your interest level, today doing deals with middle market private equity on your platform? You just did the Meeks/ Big R deals which I'm assuming were in the pipeline for some time. Both firms I think were sold at PE platform. Not sure what the leverage on the deals were. But just curious how you're thinking about, how you get comfortable with the pricing of the underwriting length of lease and required returns today?

Chris Volk
Well, one of them was sold to a private equity platform. The other one really wasn't sold to a private equity platform. I would say that in the middle market segment there is a lot of private equity activity, and that private activity has gotten nothing but bigger since we started this company in 2011. And it's everywhere and it tends to be a consolidation play almost always. But you see it in manufacturing, you see it in veterinary clinics, you see it in ophthalmology clinics, you see it in daycare. I mean it's ubiquitous.

And so private equity participants are very good folks for us to do business with because they are really keen on creating efficient capital stacks, and net lease transactions are just super-efficient from both the return on capital but more importantly, or just as importantly, the corporate flexibility.

If they want to sell a lumber supply company like Meeks to someone else they have the ability to do that. I mean U.S. LBM Holdings, which is also in our top 10, is another lumber supply company and its equity sponsor is Kelso & Company, so you'll see that if they if they want to sell it or list it publicly or whatever, the fact that they have leases means they can do that and we'll cut that deal with them upfront.

So then the question is, do we have broader concerns about doing business with private equity versus family held enterprises and perhaps do we have a longer-term horizon from a hold perspective. And the answer is, not really. I mean if we get into something with a capital stack and the proper alignment of interests that's strong and has very potent unit level coverages, we think we're in very solid shape. And so, from a performance perspective, we haven't seen any misalignment of interests with private equity people and actually to the contrary, we've seen private equity people add capital to companies when nothing has happened.

Haendel St, Juste
Thank you for that, very insightful, thank you. And I guess one last one for me is another question on a chart in your investor presentation. This one, on page 27, shows that gross rates of return for your portfolio have remained at the 9.7, 9.8 range in the last three years but your borrowing costs are up 90 basis points over the same period last year and versus 2016 to the mid-fours while cap rates have stayed pretty steady too. I guess my question is first, I guess the appearance of spreads versus your cost of capital shrinking doesn't look necessarily good. Am I missing something or perhaps what would you offer as a retort? And how are you thinking about those returns versus debt spread cost going forward?

Chris Volk
Okay, what you're getting into in a way is how much value can we create at higher interest costs. So let's assume that you have a 4.5% cost of interest and you're 42% levered. So you have 0.42 times 4.5 and then your equity is 57% or 58% and let's say that's a 10%. And now I'm not even focusing on AFFO yield. Let's say our investors want a long-term 10, so I weighed all that and I had to come up with something like an 8% cost of capital. And then I'm investing at a 9.7% gross unlevered yield which basically gets you to 13%. So 13% is bigger than 8%. Our goal is to create market value added, which basically means we want to create the highest level of compound growth in market value added of any net lease REIT. The market value added is the spread between your cost of equity and what it trades at in the marketplace.

So you're looking for compound growth and the question is really how do we define a win. That's how we define a win. If you can do that, you're defining a win. And so the only way you win is to have a return on capital that's higher than your cost of capital. Our cost of capital is 8% and we're making 13%. That's what you want to do. You always want to have a return on capital that's higher than that.

Now the spread of that excess return is narrower than it used to be. So that means that our compound growth has to slow if it's a higher rate environment unless we could push lease costs higher, but the spread is incredibly healthy. I mean by historic standards it is exceedingly healthy and we think it offers investors a great rate of return to create added value.

Operator
The next question comes from Phil DeFelice with Wells Fargo. Please go ahead.

Phil DeFelice
Hi, guys. Thanks. As we look at your record quarter of acquisitions there are $500 million. We were wondering what percentage would you say were actively for sale versus assets where you perhaps forced the conversation and motivated a potential seller to make the move, and how is that percentage of the total compared to the past?

Mary Fedewa
This is Mary. Basically, we continue to have a very consistent mix of about 80% of those that are direct originated, and about 20% of those are with an intermediary or a broker in the middle of them. I would say that's still a consistent mix for us and the same for the second quarter and third quarter.

Chris Volk
Your question was how many of them were really for sale. I mean, they are for sale, right. So, you're going out and you're soliciting investments --soliciting customers, and they do have assets. They would like to effect the transaction.

Mary Fedewa
Yes, whether they're listed or not is the question. 80% tend to not be listed and 20% tend to be listed, if that's what you're curious about.

Phil DeFelice
I guess what I was trying to get at is if there is a portfolio that they have for sale. Are there conversations that are had where you tease it out of them, that these relationships have gotten close enough where maybe they didn't have any intention to sell and that relationship has kind of brought the conversation to the surface, and then by percentage changed over time?

Mary Fedewa
Yes, that's really where the cheese is – where you can call on operators that don't have their properties for sale and you could talk to them about how they would be better off if we own their real estate versus them owning their real estate, and how we can immediately lower their cost of capital because we're a debt and an equity substitute. And we can provide a very flexible long-term lease for them, hence, very flexible long-term financing for the real estate that's imperative for them to do business.

These are companies that without real estate, they aren’t in business. There isn't financing that is available for these companies. 80% of our time on is helping customers with long-term real estate financing that doesn't really exist for them today. And it's an amazing product for them.

Phil DeFelice
Okay, thanks. And now that your ATM has become a large part of your funding sources each quarter is your stock price playing a larger role in how are your underwriting deal flow and how competitive you get with bids? We realize you're obviously focused on spread to your cost of capital but wondering if it's impacting the bid at all or is that asset level valuation now being done independent of what's available through the ATM?

Chris Volk
Yes, I'll try to answer that. It fundamentally doesn't change our approach. On this call I talked about our notion of being value investors and trying to have a very consistent approach irrespective of whether we’re trading at a high multiple or a low multiple. We're trying to create a consistent return that’s over our cost of capital. Trading at a better multiple just helps create a better return over the cost of capital but it doesn't really change the approach that we're taking. And so that's really what we've been doing. We've been sticking to our knitting.

Operator
Our next question comes from Lee Nalley with SunTrust. Please go ahead.

Lee Nalley
Hi, thanks for getting me in. Just real quick, your LTV now proforma for the new Master Funding – is that closer to 70% or where is that going to come out in 4Q?

Chris Volk

Yes, the total LTV Master Funding is 70%. The total enterprise leverage of us as a percentage of cost – analysts oftentimes do a loan-to-enterprise-value and as an editorial comment I would find that a useless ratio because it's always driven by the AFFO multiple. But in terms of actual leverage to cost we're around 41%, 42% today, which basically means that on the unencumbered side our BBB notes are leveraged less than 30%. One of the things that's very cool about the master trusts is that if you're a BBB note buyer that master trust almost works like preferred stock where it's a form of leverage that's so efficient that it allows you to have an incredibly high unencumbered asset coverage ratio.

Overall the company is levered very efficiently but what it means for STORE investors is that we have a lot of dry powder that most companies just don't have. I mean, we have the access to a 70% conduit if we want to avail ourselves of it. We have access to unsecured debt if we want to avail ourselves of that. We’re sitting on BBB-rated notes, by the way, on Master Funding which we could always sell at any time but which we never have, so the amount of liquidity this company has availed by Master Funding is just really enhanced, and we're happy to have multiple sources of term debt capacity.

Lee Nalley
Right, yes, thanks for that reminder and overview. Then so if the Master Funding pool is now close to that 70%, how are you thinking about your secure versus unsecured mix of funding in 2019?

Chris Volk
Well, what we did last year in 2017 was a brand new master trust transaction. We in fact prepaid what was otherwise coming due in 2019. So the reason we have almost no debt coming due to 2021 is because we have been prepaying Master Funding notes. And we've been doing this in part to skew our mix of unencumbered assets to encumbered assets more towards two-thirds, one-third. Over time is it's going to be two-thirds that will be unencumbered, one-third will be Master Funding. But we can do that by doing one issuance from Master Funding every year and one issuance from the unsecured side because the Master Funding side has got twice the leverage. So you can basically keep two-thirds, one-third unencumbered assets going forward, so that will be probably around 66%, 33% on the unencumbered side.

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to Chris Volk for any closing remarks.

CONCLUSION

Chris Volk
Thank you all for attending the call today. We're looking forward to attending REIT World in San Francisco on November 7 and 8. If you are interested in seeing us there, let us know. Thank you all for listening. We're around today and tomorrow for any follow-up questions. Have a great day.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.