STORE Capital Corporation

Q3 2019 Earnings Webcast

Thursday, October 31, 2019

CORPORATE PARTICIPANTS

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PRESENTATION

Lisa Mueller
Thank you, operator, and thank you all for joining us today to discuss STORE Capital's third quarter 2019 financial results. This morning, we issued our earnings release and quarterly 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 and Results, Quarterly Results. I'm 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 up the call 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 re-enter the queue if you have follow up questions.

Before we begin, I would like to remind you that today's conference 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 accusations, dispositions, or our AFFO and AFFO per share guidance for 2019 and 2020, are also forward-looking statements. Our actual financial condition 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 the forward-looking statements are contained in our SEC filings, including our reports on form 10K and 10Q. With that, I would now like to turn the call over to Chris Volk. Chris, please go ahead.

Christopher Volk
Thanks so much, Lisa, and good morning everyone and welcome to STORE Capital's third quarter 2019 earnings call. With me today are Mary Fedewa, our Chief Operating Officer, and Cathy Long, our Chief Financial Officer.

On the investment front, we continued to be very active during the third quarter with investment activity of almost $400 million, while adhering to the granularity and diversity that we're known for. Mary will run through the numbers in more detail with you, but we're happy with our ongoing success in penetrating the large market that we address while maintaining the focus on meeting the needs of our existing customers. During the quarter, we also profitably divested approximately $290 million in real estate, which included our first transactions in the 1031 exchange market.

Year to date, we have invested well over $1.1 billion in acquisitions and have sold approximately $389 million in real estate investments. 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 rated investment-grade in quality based upon our STORE Score methodology. You will hear more about our property investment and sales activity and portfolio health from Mary.

We raised our dividend by 6.1% during the third quarter, and even so, our dividend payout ratio approximated 70% our adjusted funds from operations, serving to provide our shareholders with a highly protected dividend. With reported AFFO per share growth of about 8.8% for the first nine months of the year, our healthy dividend increase nonetheless enables us to improve on our conservative AFFO payout ratio from the same quarter last year. Importantly, with such a low dividend payout ratio, we've been able to fund a meaningful portion of our investment activity through retained cash flow. We pair that re-investment with our historical focus on maintaining annual tenant same store rent contractual increases of nearly 2% to drive the majority of our expected AFFO per share growth. As Cathy will illustrate, we combine this internal growth with external growth that is accretively funded through new share issuances which, for the past two years, have been successfully funded through our efficient At the Market program. Such equity issuances have enabled us to also maintain a consistently conservative leverage profile which, at the conclusion of the third quarter, was below our guidance range at 5.4 times. Our 2019 investment activity was funded through a combination of retained operating cash flows, proceeds from asset sales, newly issued ATM equity, and the proceeds from our first quarter public unsecured term note issuance, and limited use of our revolving credit facility.

Our balance sheet remained well positioned. At the conclusion of the third quarter, our pool of unencumbered assets stood at $5.3 billion, or about 63% of our gross investments. Given our performance consistency, STORE has enviable financing flexibility across a wide array of debt and equity options. Of particular note with our unsecured noteholders we have amongst the lowest REIT unencumbered asset leverage profiles that we know of.

Now, as I do each quarter, here are some statistics that are relative to our third quarter investment activity:

- Our weighted average lease rate during the quarter was just under 7.7%, which is slightly below where we were last quarter.
- Add in the average annual contractual lease escalation for investments made during the quarter of 1.9% and you get a gross rate of return of 9.6%. With corporate leverage in the area of 40%, our levered investor return will approximate 13%, with net returns after operating costs in the 12% range. Our outperforming investor returns from STORE and from predecessor public companies have been mostly driven by having a favorable property-level rates of return, which is why we take the time to disclose investment yields, contractual annual lease escalators, investments spread 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 major in the quarter continues to be long, at approximately 17 years.
- The median post overhead unit level fixed charge coverage ratio for assets purchased during the quarter was 2.7:1.
- The median new tenant Moody's RiskCalc credit rating was Ba3. Incorporate the potent contract-level fixed charge coverages and the median new investment contract rating, or STORE Score, for investments was far more favorable at Baa2.
- Our average new investment was made at approximately 79% of replacement cost.
- 80% of the multi-unit net lease investments made during the quarter were subject to master leases.
- All 85 new assets that we acquired during the quarter are required to deliver unit level financial statements, giving us unit level financial reporting for 98% of the properties within our portfolio. This fact is critical to our ability to evaluate contract seniority and real estate quality, as well as to our access to capital. With that, I will turn the call over to Mary.

Mary Fedewa

Thank you, Chris, and good morning, everyone. We had a strong third quarter, with almost $400 million dollars in real estate acquisitions at a weighted average cap rate of 7.7%, bringing our year to date acquisitions to nearly $1.2 billion. Our investments this quarter were spread across 29 separate transactions at an average transaction size of $13.6 million. We added 27 new customer relationships and closed the quarter with more than 460 customers, further diversifying our granular portfolio of net lease assets.

Approximately three quarters of our net lease contracts are rated investment grade in quality based our STORE Score methodology. Delinquencies and vacancies remain low due to our strong tenant partnerships and continued active portfolio management. At the end of the third quarter, only eight of our more than 2,400 property locations were vacant and not subject to a lease. As we mentioned on our last call, we anticipated selling more properties in the second half of 2019 to take advantage of opportunistic gains and to balance our portfolio.

During the third quarter, we sold 54 properties, which had an acquisition cost of $291 million generating net gains over that original cost of approximately $24 million. Of the 54 properties, 13 were opportunistic sales, resulting in a 21% net gain over original cost, 27 sales were strategic and resulted in a 6% gain over cost. The remaining property sales were from our ongoing property management activities and resulted in an 87% recovery over original cost.

Now turning to our portfolio performance highlights. Our portfolio mix at the end of the third quarter remained consistent with 65% of our properties in the service sector, 19% in experiential and service-driven retail with a substantial online presence, and the remaining 16% in manufacturing. Our portfolio remained highly diversified with no single customer representing more than 3% of our annual revenues. Our single largest customer, Fleet Farm Group, represented just 2.8% of our annualized rents and interest. Our top 10 customers were unchanged from last quarter, and at the end of the quarter, revenue realized from the top 10 was 18% of annualized rents and interest.

As we enter the fourth quarter, our acquisition pipeline remains quite robust, allowing us to be highly selective in our investments while creating value for our customers and getting paid for that value. Our unique direct origination team continues to identify attractive new opportunities across a variety of industries that will reinforce our diversified portfolio.

Before I turn the call over to Cathy, I want to mention that our fourth annual customer conference, the Inside Track Forum, is coming up on January 29th to January 31st here in Scottsdale. We are thrilled to announce that our keynote speaker will be Jon Taffer, host of the popular TV show Bar Rescue and a long-time food and beverage industry consultant. In addition to Mr. Taffer, we have another stellar lineup of speakers for this year's event, including an industry-leading economist, a futurist, and several capital markets experts who will help our customers get the "Inside Track" for 2020. And now I'll turn the call to Cathy to discuss our financial results.

Catherine Long
Thank you, Mary. I will begin by discussing our financial performance for the third quarter of 2019, followed by an update on our capital markets activity and balance sheet. Then I will review our updated guidance for 2019 and introduce our guidance for 2020.

Beginning with the income statement, our third quarter revenues increased 25% from the year-ago quarter to $171.8 million. The annualized base rent and interest generated by our portfolio in place at September 30th increased 17% to $678 million.

Total expenses for the third quarter were $119 million, as compared to $90 million dollars in the third quarter of 2018. Just over a third of the $29-million-dollar increase was due to higher depreciation and amortization expense relate to our larger real estate portfolio. In addition, interest expense increased by $7.5 million to $39.3 million, primarily due to additional long-term debt used to fund our growing pipeline of acquisitions. G&A expenses for the third quarter were $13.6 million, up from $11.5 million a year ago, reflecting the continued growth of our portfolio and associated staff additions. As a percentage of average portfolio assets, G&A expenses, excluding the impact of non-cash equity compensation, decreased to 49 basis points of average portfolio assets from 53 basis points a year ago.

Property costs increased by $2.4 million year-over-year. Half of that amount was related to the new lease accounting standards that require us to present items such as impounded property taxes and the ground lease payments our tenants make on our behalf on a gross basis as both rental revenue and property costs. On an annualized basis, excluding this lease accounting gross up, property costs totaled about 10 basis points of average portfolio assets in the quarter, with the slight increase from last year primarily due to property taxes.

During the quarter, we realized $3.8 million dollars of lease termination fee income and recorded a $7.3 million impairment provision. Both of these items were related to properties that we sold or are likely to sell in the near future, and the termination fee income serves to augment our recovery on dispositions of the properties. While impairments are excluded from FFO and AFFO, we've chosen to also exclude the lease termination fee income from AFFO, as we don't consider these fees to be part of our core operations.

As Mary noted, we sold 54 properties in the third quarter, which on a book basis, resulted in a $59.3 million gain on sale. As we mentioned on last quarter's call, we expected property sales to be higher in the second half of 2019, and much of that activity occurred in September. We continue to actively monitor and manage our portfolio, and we may see some sales activity in Q4 as well, but likely a smaller amount. Of the 54 properties we sold, 17 were part of a 1031 tax-deferred exchange transaction. We used the proceeds from these sales to acquire replacement assets.

AFFO increased 19% to $116.1 million in the third quarter, from $97.4 million a year ago. On a per share basis, AFFO was $0.50 per diluted share, a 6.4% increase from $0.47 per diluted share a year ago. Chris already mentioned our dividend increase, so I'll just point out that since our IPO in 2014, we have increased our dividend per share by 40% while maintaining a low dividend payout ratio and, at the same time, reducing leverage.

Now turning to our capital markets activity and balance sheet, we funded another strong quarter of acquisition volume with a combination of cash flow from operations, proceeds from property sales, availability under our credit facility, and equity proceeds from our ATM program. During the third quarter, we issued over 4 million shares of common stock under the ATM at an average price of $36.28 per share, raising net proceeds of approximately $159 million. Year-to-date, we've issued over 13 million shares of common stock at an average price of $34.20 per share, raising net proceeds of approximately $453 million. Our ATM program remains a very effective way for us to raise capital, given the granular size of our acquisitions.

Substantially all our long-term borrowings are fixed rate and our debt maturities are well laddered. The weighted average interest rate on our long-term debt at the end of the third quarter remained consistent year-over-year at 4.4%. Our median annual debt maturity is $287 million, and we have no meaningful near-term debt maturities. We expect that our free cash flow, which represents our cash from operations less dividends, plus proceeds from property sales, will more than cover debt maturities coming due in any one year for at least the next several years.

At quarter end, our leverage ratio was at the low end of our target range at 5.4 times net debt-to-EBITDA on a run rate basis, or around 39% on a net debt-to-cost basis. And at September 30th, approximately 63% of our gross real estate portfolio was unencumbered, giving us considerable financing flexibility.

As we head into the fourth quarter, our leverage remains conservative, and we have access to a variety of equity and debt options to fund our large pipeline of attractive investment opportunities. In addition to our ATM, we have the full $600 million dollars of capacity under our credit facility, which also has an $800-million-dollar accordion feature.

Now, I will provide an update on our guidance for 2019 and then introduce our guidance for 2020.

Due to our strong investment activity in the third quarter, we're updating our guidance for 2019. We're now projecting AFFO per share in the range of $1.96 to $1.97, up from the previous range of $1.92 to $1.96. AFFO per share in any period is sensitive not only to the amount but also 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 2019 equates to anticipated net income of $0.93 per share, excluding gains or losses on property sales, plus $0.97 to $0.98 per share of expected real estate depreciation and amortization, plus $0.06 per share related to items such as straight-line rents, equity compensation and deferred financing costs.

Finally, I will turn to our initial guidance for 2020. Based on our current projections for real estate acquisitions for the remainder of 2019, plus estimated acquisition volume of $1.2 billion, which is net of projected property sales for 2020, we currently expect AFFO per share in the range of $2.05 to $2.09. Our AFFO guidance is based on a weighted average cap rate on new acquisitions of 7.7% 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 2020 equates to anticipated net income, excluding gains or losses on property sales of $1.02 to $1.05 per share, plus $0.95 to $0.96 per share of expected real estate depreciation and amortization, plus approximately $0.08 per share related to items such as straight line rents, equity compensation, and deferred financing cost amortization. And now I will turn the call back to Chris.

Christopher Volk
Thank you so much, Cathy. Before turning the call over to the operator for questions, I want to take a moment to highlight some of the added disclosure in our quarterly investor presentation. This quarter, we elected to insert a tab on our corporate responsibility initiatives, which are often referred to in the investor marketplace as ESG, for environmental, social and governance matters. Sometime back, we added a tab for corporate responsibility to the front page of our website, so this effort is simply a continuation of that.

Candidly, I prefer the notion of corporate responsibility to ESG because the essential point is that our corporate successes should ideally benefit all our many stakeholders. And those stakeholders naturally include our shareholders, employees, creditors, customers, suppliers and the many communities around the country that we impact. With regard to our corporate presentation, prior corporate responsibility slides were limited to a discussion of corporate governance, which is something at which we've always excelled, and which impacts our shareholders.

I would also note that STORE has been characterized from the outset by a highly disciplined business model that has resulted in the highest gross unlevered rates of investment return amongst our peers and the highest spread between those gross rates of return and our cost of borrowings. The result of this effort is that we've been able to be a consistent leader in the creation of Economic Value-Added and compound Market Value-Added growth, which we disclose in our appendix, and which today is a performance metric emphasized by ISS in their evaluation of corporate leadership teams. In addition to our hard work on behalf of our shareholders, we have included new corporate responsibility slides to illustrate our commitment to other stakeholders.

We also included more extensive information on comparative lease durations this quarter. On Page 38 of the presentation, we illustrate the comparative stability of newly originated primary lease terms over the past eight quarters, which owes itself to our direct origination investment emphasis. STORE has also consistently been among the leaders in portfolio lease term, with amongst the lowest levels of lease maturities over the next 5 years.

This leadership results from consistently realizing amongst the longest primary lease terms on newly originated investments, our comparative corporate youth relative to a few more seasoned companies, and our market-leading use of master leases, which we often reset upon the addition of new properties. The importance of maintaining a low near-term lease maturity profile is to insulate our company from volatility and to make STORE more defensive should there ever be a recession.

Finally, on Page 39 we included a slide that illustrates comparative direct originations, tenant diversity, and lease profiles. We have a number of slides that we deliver that illustrate our unique place and market position within the net lease sector. Slide 39 adds to this list and illustrates some of the important business model differentiation that has enabled STORE to have amongst the most highly diversified and high-performing investment portfolios in our industry. And with those comments, I will turn the call over to the operator for questions.

Operator
Yes, thank you. We will now begin the question and answer session. To ask a question, you may press star, then one on your touch tone phone. If you are using a speaker phone, please pick up your handset before pressing the keys. To withdrawal your question, please press star, then two. At this time, we will pause momentarily to assemble the roster. And the first question comes from Nate Crossett with Berenberg.

Nate Crossett
Hey, guys. How are you doing?

Catherine Long
Hey, Nate. Good. How are you?

Nate Crossett
Good. Maybe you can give us some color on the eight new tenants in the quarter. What were the areas they were in? What were the three new industries? And then, on the disposition side, were any trends there in terms of customers or industries? It sounded like you said some of that was strategic. So, any help there is appreciated.

Mary Fedewa
Hi, Nate, it's Mary. The eight customers, it was actually a net number. So, we actually added 27 new customers and that was across a plethora of asset classes, just like we always do. In terms

of the dispositions, we did do primarily or a big portion of them were strategic in rebalancing the portfolio, and I think probably the biggest result you will see is in the manufacturing portfolio that came down from 7.1 to 16.1 on that.

Nate Crossett
Okay. So, was it a specific tenant, or was it just an area that you did want to be in?

Mary Fedewa
Yes, again, a plethora of tenants.

Nate Crossett
Okay. Maybe one just on the amount of sales and underwriting people, can you just remind us how many people you have in those departments, how that looks as you guys continue to scale? I am just curious how that looks as you ramp, because you put that slide in that you do the most direct origination of anyone in this space?

Mary Fedewa
We have actually about 17 each, on the front end in those departments. Sales and underwriting.

Nate Crossett
And then the outlook for next year, does there a need to be any adds? Or are you guys have enough for what you want to do next year?

Christopher Volk
We expect there will be some adds. They'll be at the margin. We are not looking to do a huge number. Actually, Nate, if you look this year, the net number is $1.1 billion. So, we are keeping the guidance, and we'll see if we can beat that guidance. If it's up to us, we would like to beat it. But given the sales activity that we've had this year, you can do the math yourself, but your acquisition target total for this year isn't a whole lot different from last year. So last year, we did a little over $1.6 billion for the whole year. This year, depending on where the sales come in, the acquisitions come in we could be very well kind of in that same zip code.

Next year, our initial guidance is for $1.2 billion net, which is basically a net number that's up 9% from this year. The gross number, if you were like looking at the gross number of the sales, that number maybe a 6% difference. So, we are not looking at doing a quantum leap in terms of acquisition or investment activity, and so, you're not going to see us do a quantum leap in terms of hiring new sales people or new credit people.

Nate Crossett
Okay, thanks. I will get back into queue. Thanks, guys.

Mary Fedewa
Thank you.

Operator
Thank you. And the next question comes from Caitlin Burrows with Goldman Sachs.

Caitlin Burrows
Hi, good morning. Because of your exposure to non-investment grade tenants, I think some investors are sometimes concerned about your risk in your portfolio in the case of a downturn. So, I was just wondering if you could go through some of the other important aspects of your

strategy that mitigate this perceived risk. I know there is probably a long answer that we can talk a long time about, but maybe some earnings call type response? Thanks.

Christopher Volk
Caitlin, you are leading with a massive cognitive bias. I will start there, which is to suggest that if you don't have investment grade tenants, that somehow you are more vulnerable in the event of a recession or an economic downturn. And, that might be true if our industries were loaded with investment-grade tenants. But in fact, they are not loaded with investment-grade tenants.

If you're looking at fitness clubs, there are no investment-grade fitness clubs. There are no investment-grade veterinarian clinics. There no investment-grade early childhood education companies. There are a handful of investment-grade restaurant companies, but they never seem to put the other restaurant companies out of business in a recession. So, I would put our portfolio up with anybody else's portfolio any time during a recession and the fact that we are investing in just profit centers tells you that we're going to be ahead of the boat. So, we are not just doing the cost centers, we're doing the profit centers, and most of our leases have enhancements like master leases or additional credit enhancements that we might have.

And then finally, you just look at the new slides that we've added in our deck about the lease term, and our lease terms are far and away the longest in the industry. And that's important because if there's a recession, then people in a recession might be able to walk away from leases. And over the next 5 years, we have virtually none. And one of the reasons we keep these leases long term is because since we have so many master leases, it's very common for us to re-characterize master leases when we actually add on new properties. And so, we extend those lease terms, which is why we've been able to keep kind of consistent lease term out there in our portfolio.

And then finally, just FYI, if you look at the last great recession and say who added all the jobs, I mean all the jobs were added by middle-market companies. And they were not added by large investment-grade companies. So, I hope that puts you at ease.

Caitlin Burrows
Got it. And then maybe if you could comment, STORE share price has been pretty strong this year. Can you go through what impact this has, if any, on the team's thinking, regarding acquisition volumes and funding of that activity?

Christopher Volk
Yeah, it's interesting. The marketplace, when people get multiple expansion, and the whole net lease space has gotten multiple expansion this year, so when people get multiple expansion, the notion somehow is that the street's asking you to buy a lot of real estate. You will note that this quarter, our net acquisition activity was about $100 million dollars. So, in fact, we stuck to the game plan that we set out for ourselves at the beginning of the year, and we were very clear that we would be selling real estate or recycling the cash, which is an important way of adding to our internal growth and also mitigating risk.

We're are all about here not being the biggest company, not growing the fastest from an acquisition perspective. We are about trying to be creating the best investment opportunities that offer the highest risk-adjusted rates of return and create the most market value-added, the most economic value added. And so, while the high multiples basically tell you, you could sort of fog a mirror and add to AFFO per share growth, you could buy almost anything and add AFFO per share growth from an accretion perspective. That doesn't mean that you're actually generating the highest risk-adjusted rates of return. And they are two totally different things.

STORE has had multiples in this bandwidth before. We had it in the middle of 2016, and we just stuck right through our knitting and just continued to make investments that were hugely accretive, created market value added. We just want to create the most wealth for our investors and the most benefit for our stakeholders and we are not going to just chase deals because they are accretive
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Operator
Thank you. And the next question comes from Craig Mailman with KeyBanc Capital Markets.

Craig Mailman
Hey, guys. Cathy, just curious, you mentioned you guys are kind of at the lower end of your leverage target here heading into the fourth quarter and next year. I am just curious as we think about again where your cost of capital is, versus where you guys are buying, versus maybe where we are in the cycle. Should we anticipate you guys trying to keep that a little bit lower and maybe raising a little bit of incremental equity, or would you expect that to kind of trend up and back into the range, maybe kind of middle range type movement?

Catherine Long
Hi, Craig, it's Cathy. Yeah, we are at the lower end of our target range at the moment. We feel very comfortable with our range. So, you'll see us take advantage of opportunities to issue debt. This is a nice market to issue debt. That being said, the equity market is great, too. And as you know, we make good use of our ATM all during the year. So, we are mindful of keeping our leverage within the range. We feel comfortable at the current range. I don't think that we will take it lower, though. I think that where we are, we are very, very comfortable.

Christopher Volk
And Craig, this is Chris. Our leverage today, I think at the end of the quarter is 40% as opposed to 39% on a cost basis. If you are looking at this and you are trying to compare companies, cost basis is probably a pretty good way to go about it. So, we are at 39% on a cost basis. Normally we've been in sort of the range of 40% to 42%. It's a ridiculously low number. I mean, if you think about just 40% leverage, it's just insane as well. And our secured leverage is close to 70%. And we get single A+ and even AAA financing. We have AAA financing to 45% leverage as a backside.

Think about this, our unencumbered assets, which are 63% of our assets at the end of this quarter, are levered a whopping 25%. So, if you ask us to lower our guidance and we are keeping our secured guidance, the same, then our 25% leverage would drop down to 20% or 15% leverage on our unencumbered assets, which is something I think our shareholders shouldn't like because it doesn't really help them with returns, which is important.

Craig Mailman
That makes sense. Then, the blended deal you guys had this quarter came down a bit sequentially. It's kind of consistent with what you guys are viewing for 2020. Are you guys seeing cap rate compression in specific parts of where you guys are putting capital out, or is it just a function of the 10-year coming back in and you guys are just trying to be a little bit more conservative?

Christopher Volk
We are not seeing like an abundance of cap rate compression. But a year ago today, roughly, we did our guidance for this year. And at that time, we said our cap rate would be around 7.85%. The

10-year treasury was around 3% at the time. I am expecting we'll probably close out this year at a cap rate of somewhere around 7.80%. So, we're likely to fall short of the 7.85% number.

As you saw this quarter, we're at 7.70%. So, what's happening is there's like a slight trend on this. Now that's on the cap rate side. On the borrowing side, we issued $350 million dollars of senior debt in the first quarter this year at a cost of 4.65.% Today, if we were to do that same debt, we'd probably be sub 3.50%. So, our cap rates have come in 5 basis points. Our costs of debt come in at 115 basis points. So, our spread is basically 110 basis points better. And by the way, the numerator does matter. We're not just in the spread business. So, whether we do a deal as an 8 cap or 7 cap, or 6 cap, that top line number matters and really adds to returns, so investors need to pay attention to that as well as to the spreads.

But, nonetheless, I would say our spreads are a lot juicier than they were. If we are at 7.70% for next year, it's really a function of the fact that we see rates low. There is a loose correlation between 10-year treasury rates and cap rates because, obviously, it affects the price at which people can borrow money. And keep in mind that 90% of the marketplace that gets done away from all the public companies that you cover. And all those people that are financing, all those assets are doing with secured debt and are using higher levels of leverage than we are, so they're much more higher leverage than 40% on a transaction basis which, in fact, helps them with a lower cost of capital in some respects, right, than public companies.

Since those people are going to be focusing on the cost of debt to be able to finance the assets, if 10-year treasury rates fall or LIBOR falls, all things being equal, you are going to see the cap rates tend to get compressed throughout the space. The thing that will stop that is if banks start getting nervous and they get concerned about where we are in the cycle, which is the other question. So, if they're concerned about recession, then they may elevate the spreads. So, we are going to see some give and take on this. We think 7.70% is a doable number for next year. If the spreads hold, then we'll have one of the nicest spread years that we have had in our history, hopefully.

Craig Mailman
Great, thank you.

Operator
Thank you. And the next question comes from Vikram Malhotra with Morgan Stanley.

Kevin Egan
Hi, everyone. This is Kevin, on for Vikram. Just a quick question here. The first question was just in terms of the real estate expenses, I noticed if I take a look at that as a percentage of the GAAP rent, and I understand there was an accounting change, so obviously it went up over 2018, but it was a little bit higher than we thought it would be, around 2% of GAAP rent for the third quarter. Just looking forward, is that kind of a run-rate you would expect to see about 2% of real estate expenses as a percentage of GAAP rents, or is it really going to kind of fluctuate and kind of hard to determine?

Catherine Long
Hi, it's Cathy. We kind of look at it as a percentage of the portfolio itself and it does range. I mean we've had quarters as low as 4 basis points of our assets, and as high as 10 basis points of our assets. So, projecting next year, we are not projecting as high as 10, but we are not projecting as low as 4 either. So, I think if you think of it that way as a percentage of assets, it's probably easier for you to model.

Christopher Volk
The other thing is some of it is accounting driven relating to the lease accounting this year.

Catherine Long
Right, about half of it.

Christopher Volk
About half of it was reimbursable. If you were looking at it compared to last year, they are not really comparable because of that, you have to back out the reimbursables.

Catherine Long
Right.

Kevin Egan
Got it. Thank you. Very helpful. And then just one additional one, just in terms of the STORE Scores of the assets you disposed of, I am just kind of looking into, can you disclose or just give us any idea of where those were at relative to the median of the portfolio? And I guess really kind of what I am looking at is, I understand some was opportunistic, some are strategic, but was it also just managing the portfolio and looking at tenant credit and kind of just doing some pruning, if that makes sense?

Mary Fedewa
This is Mary, Kevin. You are correct, we have some opportunistic sales, some strategic sales, and then property management. And I would say in the strategic area in particular, we are always looking to make the portfolio that we hold better, so you can probably assume that that is the case. On the opportunistic side, same mission, but a lot of times, we're looking that we haven't done business, this isn't a repeat customer. This is someone, maybe a reverse inquiry, someone who would like to buy the property, maybe we have a credit upgrade and we are going and we won't be doing business with that customer. It's a little bit different on the opportunistic side. But yes, as we are culling in the portfolio, we definitely are looking to make a stronger portfolio.

Kevin Egan
Great. Thanks a lot. Very helpful.

Operator
Thank you. And the next question comes from Shivani Sood with Deutsche Bank.

Shivani Sood
Hi, good morning. Apologies if I missed this earlier, but just on the lease termination that you highlighted, Cathy, can you give us some more color on who the tenant was and what the remaining exposure might be there?

Christopher Volk
This is Chris Volk. Cathy can answer that. We can all answer the question. But I think I want to take you to a higher plane. So, the lease termination fees this quarter amounted to $3 million dollars, in the range of $3 million bucks. It's related to three individual tenants. They related to assets that were nonperforming and about to be sold. One of the reasons we did not include our lease termination fees into AFFO, which can be a common practice, is because we thought that from a principal perspective, they were really associated with the sales of assets. I mean we are looking at trying to liquidate properties and lease termination fees were part of that.

If you take a look at the big picture, I'm just going to give you some food for thought here. So last year, we sold off $227.8 million worth of assets at cost. And our gain on that was $23.6 million, which is about a 10.6% gain on cost. The more important number actually, though, is that the cap rate at which we sold was about 50 basis point less than the cap rate that we were buying. So, there was a 50 basis point accretion there when we were buying new assets. And we've been fortunate to be able to do that. Year-to-date, we've sold $389.2 million at cost. The gain over cost is $20.7 million, but that does not include the $3 million in lease termination fees, which were really part of the strategy for that gain.

And when I'm doing this, by the way, ignore all the notions about loss impairments. Loss impairments are just timing issues, like I'm going to be selling a property the next quarter, but I'm impairing it this quarter. It's an accounting convention, not a finance convention. So, what I'm giving you is just sort of the raw financing, which encompasses all the accounting. So, we had $389.2 million at cost assets. Our gain over that original cost, was $20.7 million, which is a 5.3% gain. But if you add in the $3 million in disposition fee, that gets you to a 6.1% gain.

And because we think that way and we are thinking and we are not adding back our gains or losses in the AFFO, then we thought it was not proper for us to add lease termination fees either in AFFO, even though a lot of people do that and it would have probably been acceptable. We just chose not to do it.

Shivani Sood
Appreciate that. I was just trying to get more color on the actual tenant and if there is more exposure to the tenant?

Christopher Volk
The answer is a no. There is no exposure to the tenants. They are done. They are three individual assets.

Shivani Sood
Okay, great. And can you give us an update on how you are thinking about exposure to the full service restaurant space, just given sort of the softer traffic we are seeing come out of that sub-sector and where we are in the cycle? It looks like it had ticked down as a component of the pipeline, but I wasn't sure if that was a numerator or a denominator impact.

Mary Fedewa
Yes, you are correct. It is down this quarter. This is Mary. And it's probably a combo of pipeline and actually denominator effect, too, as we grow. But for the most part, restaurants, and we have talked a lot about this, they are a well-heeled asset class. People like them. They get a lot of activity. Again, Chris mentioned earlier, 90% of what gets done, gets done away from us. So, you got a lot of people sort of bidding on restaurants.

We pick our spots. We are going to stick to our vision of creating our own contracts, having good profitable units, be able to get paid for the risk that we are taking and so on. So oftentimes, we don't win. We don't get to play much in the restaurant space as a result, but I would say we like the space, and we take a look and pick our spots and we don't see any concerns in it at this time.

Shivani Sood
Thanks, Mary.

Mary Fedewa
Welcome.

Operator
Thank you. And the next question comes from Haendel St. Juste with Mizuho.

Haendel St. Juste
Hey, there. Can you talk a bit about the level of dispositions in the quarter, how much was it sort of budgeted or in your plans versus maybe incrementally opportunistic? Do they include any bulk, or many portfolio sales, and what was the cap rate on the assets sold?

Catherine Long
Hi, Haendel. I'll start. When we first gave guidance for the year, we were anticipating that the sales would occur earlier in the year, and so we are fortunate that the bulk of the sales activity happened in September, so we were able to keep more of the AFFO that was being generated by that portfolio in the quarter. So, outperforming where we expected to be for the quarter. And then I will let Mary comment on the mix and things like that.

Mary Fedewa
Yes, so Haendel, as I mentioned earlier, what you will see the biggest result of our sales in third quarter were the manufacturing portfolio coming down from 17.1 to 16.1. So, you'll see that that was a rebalancing of the portfolio. A lot of it was just rebalancing. So, a little bit more on the strategic side, but certainly some opportunistic wrapped in there. And as Chris mentioned earlier, we are still able to sell assets at about 40, 50 basis point lease to cap rate lower than what we are acquiring at, so that will give you some feel for disposition cap rates.

Christopher Volk
And then as far as the portfolio stuff, we don't really tend to comment on how we do, these are individual acquisitions. Sometimes we do small groups, but it varies.

Haendel St. Juste
Got it. Fair enough. And then maybe a bit on the use of the 1031 channel. I am curious, how much of that channel you may use going forward and maybe outline some of the benefits you see of using that channel?

Christopher Volk
Cathy will give you some specific numbers on this, but at a high level, the issue is, that as we get more seasoned as a company and we're selling assets, the tax basis of assets declines over time. And so, the gain for tax purposes exceeds the gain on a cost basis. And those gains are sort of the fundamental underlying pinnings of what your AFFO or your funds from operations your dividend payout ratio needs to be.

The dividends that we pay out are dictated by taxable income, not GAAP income. And so, to be able to minimize taxable income, one of the ways that you can do it, one of the tools you have is to be able to do 1031 exchanges, where basically the whole sale doesn't go through taxable income. It doesn't give you the same kind of issue that, let's say most of the big REITs out there are UPREITs, so they have incredibly low tax bases on all their assets underlying the REIT. In our case, we don't, but we will start to have some lower tax basis, not hyper low, but lower tax basis on some of the assets as we decide to 1031 assets over time to be able to essentially defer those gains. And you can defer them pretty much infinitely as long as you just keep doing 1031 exchanges.

Catherine Long
And Haendel, this is Cathy. There were 17 properties where we deferred the gain and it was about $35-million-dollar tax gain that was able to be deferred through this transaction. And we have already replaced the properties, used the proceeds for replacement assets. So that's done and we will move forward, and we will be watching it going forward.

Haendel St. Juste
Great. Thanks. And one last one maybe you could talk a bit about Art Van, looks like top three or four tenant here, 2% of revenue unchanged, just curious about how you are feeling about that exposure today? It looks like there is a lot of Art Vans on the market, so a lot of other people seem to be wanting to sell, so just curious about how you a thinking about your exposure? Thanks.

Mary Fedewa
Hey, this is Mary. I will tell you, Art Van as you know is sponsored by Thomas H. Lee. They have an acquisition and integration strategy that they are working on. They've bought other furniture companies as well. So, they are working through that integration. And as you know integrations can sometimes be difficult and take some time. So, from that perspective, we have committed to being a partner with them and they are working through that. So, I would say that's where we are with it.

Christopher Volk
We feel good about what they are doing. Just so you know, not all of our Art Vans are Art Vans. So, Art Van is the name, but it actually includes Wolf and Levin. So early on when we sold some of the Art Vans off, we did it to diversify and make sure we had diversified our geographic footprint.

Haendel St. Juste
Got it, got it. Okay, thank you.

Operator
Thank you. And the next question comes from Rob Stevenson with Janney.

Rob Stevenson
Good morning, or afternoon guys. Chris, can you talk about how close you guys were to 100% payout of taxable earnings run-rate when you did the dividend increase? In other words, how much of the 6% increase was required because of strong earnings growth over the last year, versus how much was discretionary and how the board thought about that in making their decision?

Catherine Long
Hi, this is Cathy, actually. We do payout pretty much all of our taxable income. Part of the issue is gains, right. Gains on sale of property do create taxable income and you have to consider that when you are thinking about dividends and the payout there. And the gains of course are hard to predict. So, one of the tools we use is to do the 1031 transactions to be able to defer those gains, so that you are not looking at having to increase your dividends because you happen to have a lot of taxable gains in the year. Does that help?

Rob Stevenson
Yes. I guess, the other thing was, from your standpoint, how much of the 6% increase was discretionary versus what you were going to need do to maintain the 100% payout, and whatever you needed to do with gains, et cetera?

Christopher Volk
I'm just going to say this. I could be a little bit off here because what you're asking wasn't really discussed that way at the Board meeting because we haven't really been close to the issue of having to increase dividends in order to meet our taxable REIT status. We have room that we could move lower if we want to on our payout ratio. The lawful issue that Cathy is talking about is the gains from the sale. So, if you're looking at sort of core FFO or core AFFO from operations and you ignore gains on sales activity, we would have been fine. There would have been no issues at all. So, if we wanted to raise our dividend less, we could have done that, and how much less we might have been able to not raise our dividend. But if you included the gains on sale, then that creates a different picture altogether, which is why you want to avail yourself of the 1031 market.

Rob Stevenson
Sure, okay. And then, Mary, what's been your success ratio these days, in terms of when a property goes dark or tenant moves out in terms of you guys releasing it versus just deciding to sell it?

Mary Fedewa
Year-to-date, we've had actually an 87% recovery wrap.

Christopher Volk
And I would say we're agnostic on whether we lease and sell them, which you would have to be. When we calculate recoveries, we don't calculate it necessarily the way everybody else does. So, for example, let's say we have a property and it costs $1 million bucks, and we get $1 million bucks back for it. That may not be 100% recovery. The recovery is defined by what you can do with the proceeds that you're reinvesting. We're really focusing on AFFO growth per share.

If we have $1 million in rent coming in, we replace it with $900,000 dollars in rent, that's a 90% recovery. If we have $1-million-dollar property costs and we sell it, and we reinvest the money and we get 90% of the rent back from reinvesting it, then it's a 90% recovery. So, we're looking at it from that perspective, and we're going to try to maximize the AFFO per share, which is the whole goal.

Rob Stevenson
Okay. Thanks, guys

Mary Fedewa
You're welcome.

Operator
Thank you. And the next question comes from Ki Bin Kim with SunTrust.

Ki Bin Kim
Thanks. Just wanted to go back to the, kind of earlier topics about tenant quality and recovery ratios. I'm not sure how you want to answer this question, but maybe this year or over the past 5 years, how often are you giving rent relief to tenants? Just trying to get a sense of the leakage that might occur over time.

Christopher Volk
The answer is that once a year in our book, we have a whole slide on losses, and we do it on an average basis, so we don't do it on an annual basis. But in the corporate presentation on page 43, and so you have losses on an annual basis for property management, and also, you have sort of work in process. Work in process includes all of the leakage that you're talking about. So, you want to include everything, so if you're giving somebody a 50% rent break or something like that, it's going to get included in that, it's special servicing, it's a loss. And we're treating that the same way as we're treating a vacant asset. Net lease companies are good at reporting vacancies. What net lease companies tend not to report are how many vacant and paying less than optimal properties there are, and that's just because there's no consistent way of doing it.

So what we do is we calculate this for you, and then we basically do it on an annual average for you. It's going to swing from year-to-year, and sometimes the swings can be meaningful. Now that's one of the things that we also try to get people to sort of avoid looking at because if you have some year that's a bad year, it doesn't mean that there's some huge secular trend going on. It's just part of the business cycle. It's like 12 months in this business does not equate to a business cycle. A quarter is not a business cycle. So, what we're having from a portfolio nonperformance issue in a quarter is not going to be a business cycle. So, the reason we disclose our cumulative nonperformance…

Mary Fedewa
It's ever to date, once a year.

Chris Volk
Yeah. And I would say that collectively, out of the whole portfolio, there have been, let's say, 40 instances 40 some-odd instances, of tenants nonperforming that we've had recoveries for, including people that went bankrupt and never paid us to people that just left us. It's been like 40-plus tenants over 9 years, and it's all there for you to see.

Ki Bin Kim
You said Page 43? Is that what you're looking at?

Mary Fedewa
Yes.

Christopher Volk
We'll update Page 43 at the end of this year, so for Q1, and we're doing the 2019 numbers, you'll see it on Page 43. And if you see those numbers tick up, it'll mean that we have more activity that happened in 2019 than we had previously, so you'll know that the trend was higher. And then on next quarter's earnings call, you can ask us about it.

Ki Bin Kim
Okay, a similar question. When you look at the credit quality and how resilient that credit quality is, or the median cash four wall coverage ratio, whichever metric you want to look at, over time, as the cohorts age, meaning your 2014 investments, right? How that credit quality ages over time, how the 2015 cohort investments age overtime? Obviously, there's a natural tendency probably to come down a little bit in credit quality. That's just normal business. But any kind of lessons learned from that?

Christopher Volk
We learn lessons like that every day, and whenever we have issues, we're looking at what those issues are. And we try to learn from this stuff. I've come to the conclusion, Ki Bin, that the thing to look at is-- two things are really important. One is, do we really like the business people are in? Do we think they have a good business model? And the second is, we're focusing on the unit level coverages. And the third is, of course, we're looking at the leadership and the management team and the alignment of interest.

If you're looking at big things, we look at that stuff. Credit moves around all the time. So, credit individually, companies that were really great credits then sell to other private equity firms and then they hovered up and their credit profile has changed. We spent a lot of time looking at capital stack issues. So, for example, if you're looking at Slide 40, which will give you three years' worth of credit histograms over time, overlaid onto each other, which will give you an idea of sort of how the whole portfolio looks at. You're going to see that there are going to be some gaps where, on a Moody's EDF score basis, the credit profile of pool has gapped out a little bit.

In other words, we were better in 2017 as a pool than we are in 2019. And so then the question is, what would cause those issues? And a lot of them are driven by growth of our tenants. So, they're just growth driven, i.e., we don't have a full year's worth of revenues, but we have a debt stack that reflects less than a full year's worth of revenues. So that's a big piece of it. Another piece of it is some of the corporate recaps that some of our tenants have gone through, and that's part of it. But if you look at the STORE Scores, the STORE Scores haven't really changed at all. I mean they've been pretty flat. And, on of the things that we're going to be looking at in the years to come, are going to be capital-adjusted STORE Scores.

For example, a lot of our tenants have massive amounts of unsecured or under-secured borrowings that are way behind us, which is sort of equity-like from a performance perspective which would effectively make the credit a lot better. And I think that would tick up the credit by probably three notches, from a credit grade perspective and move those bottom numbers on the corporate EDF just way up. So, we spend a lot of time looking at this. We've been investing a lot of BI systems, through using SAP, and Tableau, and looking at how to trend this stuff, and you'll start to see the fruits of that become more evident in the years to come.

Ki Bin Kim
Alright. Thanks Chris.

Operator
Thank you, and once again, in light of time, we ask that you do limit yourself to one question, please. And the next question comes from John Massocca with Ladenburg Thalmann.

John Massocca
Thanks. Good morning, afternoon on our end, actually. Just a question, do you expect, given 2020 guidance, do you expect the disposition volumes to kind of remain more at a 2019 level, versus kind of what you're doing in 2018, 2017, a little more elevated?

Catherine Long
Yes, this is Cathy. We do.

John Massocca
Okay. And then touching again on Page 43 of the presentation quickly, if I am trying to think about, maybe backing into kind of an SSNOI growth number for you guys, it's essentially just the internal

growth un-levered, x, the kind of portfolio management and kind of the ability to realize gains on dispositions. Is that kind of a fair assumption? And then as a result, where has that number kind of trended in prior years? As you were kind of saying, to Ki Bin's question, a measurement of the entire history of the portfolio.

Christopher Volk
If you look at our average capped lease escalation number, is 1.8%, 1.9%. We have not historically always gotten the 1.8% or 1.9%, because inflation sometimes dips below the 1.8% or 1.9%, which if that happens, it's going to create issues. And also, by the way, keep in mind that about 63% of that happens every year and then the other-- the rest of it is mostly every 5 years. And that 5 years could be lumpy, too, in terms of when it comes in. But on average, it's 1.8%, 1.9%.

Then you take your 1.8%, 1.9%, subtract your losses from property management, subtract your losses from work in process, which is 50 basis points, so that gets you to effectively same-store NOI. Long-run average of 1.3%, which is what you would look at if you were looking at office REITs or anything else, if you are trying to compare same-store with same-store, it would be kind of 1.3. And, of course, then you add in the fact that we're reinvesting all this AFFO and then you get more internal growth on top of the 1.3, but that's how you do it.

John Massocca
Okay. So, that 1.3 that kind of comes out in Slide 43 is fairly comparable today, to the entire history of the portfolio?

Christopher Volk
We don't make comments about what happened in 2019 versus 2018 in specific. We obviously have some views on where it is. But I would say we're not seeing anything in 2019 that's strange. And we're seeing, in fact, a watch list that's less than it was in the beginning of the year of assets.

John Massocca
Okay, that's it for me. Thank you very much.

Operator
Thank you. And the next question comes from Spenser Allaway with Green Street Advisors.

Spenser Allaway
Hi, thank you. Just going back to the credit loss discussion, I realize you guys provide that the annual average, that kind of helps us back into the same-property NOI number. But why not provide the enhanced disclosure and show a true same-property NOI number quarterly? I realize, you said, Chris, it's not reflective of a full business cycle, but I think the investment community obviously realizes that and would just benefit from having the enhanced disclosure and the transparency on how the business is doing quarter-to-quarter?

Christopher Volk
Well, we will consider it. I've gotten that question. I think we're the only REIT in the net lease space to even do Page 43. If everybody else wants to sort of give you revenue walk on-- and by the way, it's got to be a cash revenue walk--it's got to be sort of an AFFO revenue walk. So, you've got to back out all the non-cash stuff, which there is a lot of non-cash stuff in the revenue stuff.

For example, we have, on the revenue side, 10% of our business includes construction. We don't always get the rents on the construction, so you're accruing some of that stuff or you're not getting the rents. So, what you're asking for is a very big undertaking, and it will result in pronounced volatility from quarter-to-quarter because of the business that we're in. But on the other hand, if you're sitting back in your chair and you're looking at and saying, I'm going to take their NOI, try to back out the non-cash stuff and then divide it into the gross fixed asset number to see what my yield is, it's going to be in the ballpark of where you think it should be.

Spenser Allaway
Right. I certainly understand, obviously, the components you just laid out, construction deferrals or rent-deferrals. It's volatile, and it varies quarter-to-quarter, but I think there's something to be said, obviously, for being an industry leader on the disclosure best practice front, and I just think that there's a lot of good that comes from the enhanced transparency in the business quarter-to-quarter.

Christopher Volk
Yes, thank you. We will take it under advisement.

Operator
Thank you. And the last question comes from Collin Mings with Raymond James.

Collin Mings
Thank you. Good morning out there everyone.

Mary Fedewa
Hi Collin. How are you?

Collin Mings
Good. I just wanted to quickly follow up on the disposition discussion. I know we've covered a lot of ground there already but specifically, I just want to drill into your rebalancing comments on the manufacturing front, Mary. It looks like there was a notable decrease quarter-over-quarter in the plastic and rubber products bucket, but then further growth in metal fabrication. Just tying that together with the pipeline, I just want to get a better sense for how you think about where there is the most opportunity in that broader category and potential for further refinements?

Mary Fedewa
Okay, great question. We really don't look at it like that. We just look overall at our manufacturing and starting to cull the a portfolio. So, we didn't get into, sort of, industry types. As you know, we're looking for profit center, manufacturing assets that make a product. And so, metal fab happen to come up a little bit in this quarter. Again, we spoke a lot about the quarter not being a trend, but our manufacturing goes anywhere from supplying a good, or to a finished good, from metal roofing, to chain link fences, to making pet beds, to steel for high-rises, so it goes across a lot of different industries, as you can tell. And I would say the disposition was not industry specific like that.

Collin Mings
Okay, thank you.

Mary Fedewa
Welcome.

Operator
Thank you. And at this time, I would like to return the floor to Christopher Volk for any closing comments.

Christopher Volk
Well, thank you very much, operator. Just to say, Happy Halloween to everybody up here. We're going to be at NAREIT in Los Angeles on November 12th and 13. If you have no already set up an appointment to see us, we look forward to seeing you then, and with that, goodbye.

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