STORE Capital

Q4 and Full Year 2017 Earnings

Thursday, February 22, 2018
12:00 PM Eastern

CORPORATE PARTICIPANTS

Moira Conlon - *Investor Relations*

Christopher Volk - *President and Chief Executive Officer*

Mary Fedewa - *Chief Operations Officer*

Catherine Long - *Chief Financial Officer*

PRESENTATION

Operator
Good afternoon and welcome to the STORE Capital Fourth Quarter and Full Year 2017 Earnings conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero.

After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your touchtone phone. To withdraw your question, please press star, then two. Please note that today's event is being recorded.

I would now like to turn the conference over to Moira Conlon, IR for STORE Capital.

Moira Conlon
Thank you, Andrea, and thank you all for joining us today to discuss STORE Capital's fourth quarter and full year 2017 financial results. This morning we issued our earnings release and quarterly investor presentation, which will include 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 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 one 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 comments on today's call will include forward-looking statements under the federal securities laws. Forward-looking statements are identified by words such as: will, be, intend, believe, suspect, anticipate, or other comparable words or phrases.

Statements that are not historical facts, such as statements about our expected acquisitions or our AFFO and AFFO per share guidance 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 actual results to differ materially from 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 go ahead.

Christopher Volk
Thanks so much, Moira, and good morning everyone and welcome to STORE Capital's fourth quarter 2017 earnings call. With me today are Mary Fedewa, our Chief Operating Officer, and Cathy Long, our Chief Financial Officer.

During 2017, we invested nearly $1.4 billion in acquisitions, including more than $360 million in the fourth quarter alone.

At the same time, we profitably divested approximately $250 million in real estate investments, with more than half of that happening in the second quarter. Combined, our *net* investment activity for the year exceeded our net investment guidance of $900 million by over 25%.

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 healthy, with nearly 75% of the net lease contracts rated investment-grade in quality based on our STORE Score methodology and just eight vacant properties at the end of the year. You will hear more about our property investment and sales activity and portfolio health from Mary.

Our dividend payout ratio for the quarter approximated 72% of our adjusted funds from operations, serving to provide our shareholders with a well-protected dividend and a company that is well-positioned for long-term internal growth based on anticipated tenant rent increases and the reinvestment of our surplus cash flows. Our payout ratio is down from 76% in the third quarter when we raised the dividend almost 7% and so is on track to more closely approximate 70% over a full year based on our guidance.

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

- Our weighted average lease rate this quarter was approximately 7.89%, up slightly compared to 7.85% last quarter.
- The average annual contractual lease escalation for investments made during the quarter approximated 2%, providing us with a gross rate of return (which you get by adding the lease escalations to the initial lease rate) that was slightly increased from last quarter. Adding the initial lease rate to the contractual lease escalations results in an unlevered gross return of almost 9.9%.
- The weighted average primary lease term of our new investments continues to be long, at approximately 18 years.
- The median new tenant Moody's RiskCalc credit rating profile was Ba1.
- The median post overhead unit level fixed charge coverage ratio for assets purchased during the quarter was 2.1:1.
- The median new investment contract rating (or STORE Score) for investments made during the quarter was favorable at Baa1.
- Our average new investment was made at approximately 82% of replacement cost.
- 75% of the net lease investments made during the quarter were subject to master leases.
- And, all of the 110 new assets we acquired during the quarter are required to deliver unit-level financial statements, giving us required unit-level financial reporting from 97% of the properties within our portfolio, which is truly unprecedented.
- Our investment activity continued to be highly granular, with 47 separate transactions completed and an average transaction size of $7 million.
- At the end of the year, the proportion of revenues realized from our top 10 customers was 18.5% of annualized rents and interest, up slightly from 16.7% at the end of 2016. Further, our top 10 customers continued to be highly diverse, and the largest single customer represented just 3.4% of our annualized rents and interest.
- Finally, during the quarter, we sold 15 properties, which represented an original acquisition cost of about $44 million, which in combination with property sales earlier in the year, netted a gain over our original cost of $13 million. Mary will dive deeper into

this number for you, but our ability to generate profits from asset sales owes itself to our direct origination strategy. And, as I have long stated, 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.

With that, I will turn the call over to Mary.

Mary Fedewa
Thank you, Chris. Good morning everyone. 2017 was another solid year for acquisitions, with originations up over 12% versus 2016 and continued strong portfolio performance.

In the fourth quarter, we funded over $360 million of acquisitions at a cap rate of 7.9%. For the year, we funded nearly $1.4 billion of acquisitions at a cap rate of 7.8%. We sold $254 million, bringing our net acquisition volume to $1.1 billion, ahead of our 2017 target of $900 million, net of dispositions.

Active portfolio management has enabled us to minimize portfolio investment risk, and throughout 2017, we continued to sell certain properties. We sold 55 properties in 2017 at an aggregate gain over cost of around $13 million, or about 5%. 25% of the properties sold were opportunistic sales and delivered the bulk of the gains, averaging a 21% profit over cost. We were also able to make money on the 18 properties we sold for strategic reasons to reposition the portfolio. That gain was 8% over cost. These gains were slightly offset by the remaining 23 properties that were sold as part of our ongoing property management activities, which resulted in an impressive 91% recovery.

Now turning to some portfolio performance highlights. As of year-end 2017:

- The service sector accounted for about 67% of our portfolio.
- Less than 18% was in experiential retail.
- About 15% was in manufacturing.
- Customer ranking within our top 10 remained unchanged from last quarter, with our largest customer representing just 3.4% of annualized base rent and interest. Our portfolio continued to be highly granular and well diversified.
- Delinquencies and vacancies remained very low due to our active portfolio management and strong tenant partnerships. As we ended the year, only eight properties of nearly 2,000 properly locations in our portfolio are vacant.

And now, turning to our target market and our pipeline.

Our target market is the US middle market, which is generally defined as companies having between $10 million and $1 billion in annual revenues. This market consists of approximately 200,000 companies. The average middle market company has annual revenues slightly exceeding $50 million. Our average customer has approximately $800 million in annual revenues. Between 2011 and 2017, middle market companies represented more than half of the job creation in the US, and currently account for about 48 million employees, representing over one in four workers in the US.

We estimate that our tenants employ 1.8 million workers and have added approximately 180,000 employees to their workforces as they grew their revenues in 2017 approximately 10%.

Such revenue growth is nearly 30% more than the middle market as a whole, and about 40% more than the growth rate realized by the S&P 500 over the past 12 months.

As a result of such a large and dynamic target market, or acquisition pipeline has grown by approximately 40% compared to year-end, 2016.

Finally, I wanted to mention that we recently hosted our second annual customer conference, the Inside Track Forum, in Scottsdale at the end of January. At this conference, our customers enjoyed a full day of presentations from a leading economist, a futurist, a capital markets panel, ASU business professors, and a keynote address from Shark Tank star Daymond John. Our goal is to continue to provide resources to our customers that can help them grow their businesses. STORE University, which is a series of business lessons hosted on our website, is another example of how we add value to our customers.

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

Catherine Long
Thank you, Mary. I'll start by discussing our capital markets activity and balance sheet, followed by our financial performance for the fourth quarter and year ended December 31, 2017. Then I'll review our guidance for 2018. Please note that all comparisons are year-over-year unless otherwise noted.

From a capital markets perspective, 2017 was an active year for STORE. Over the course of the year, we raised net equity proceeds aggregating $743 million from the sale of approximately 34 million shares of our common stock. This included the $377 million investment by Berkshire Hathaway in June, our follow-on stock offering in the first quarter, and the sale of 5.75 million shares under our ATM program at an average price of $25.63 per share. Our ATM program has been a very efficient and effective way to raise equity and makes a lot of sense for us given the flow of our business and the size of our transactions.

During the first quarter, we added $235 million of new secured and unsecured long-term debt. This included a $100 million unsecured bank term loan at an effective rate of 2.57%, with a two-year term and three one-year extension options. We also sold $135 million of A+ rated, 10-year net-lease mortgage notes under our STORE Master Funding secured debt program at an interest rate of 4.32%.

Then, during the third quarter, we prepaid without penalty our series 2012-1 Class A Master Funding notes, which had a principal balance of just under $200 million and a scheduled maturity of August 2019. These notes carried an interest rate of 5.77%, and by paying them off early, we reduced the weighted average interest rate of our long-term debt by about 11 basis points.

As a result of these capital markets activities, at December 31st, our long-term debt outstanding stood at $2.3 billion, with a weighted average interest rate of just under 4.4%, and a weighted average maturity of six years. In an environment of rising interest rates, it's important to note that all of our long-term borrowings are fixed-rate, and our debt maturities are intentionally well-laddered. Our median annual debt maturity is approximately $250 million, and we have no meaningful near-term debt maturities until the year 2020.

Subsequent to year-end, on February 9th, we expanded our unsecured revolving credit facility from $500 million to $600 million and expanded the accordion feature from $300 million to $800 million. This allows us to increase the maximum borrowing capacity under the facility up to $1.4 billion. The amended facility matures in February 2022 and includes two six-month extension options.

At year-end, gross investments in our real estate portfolio totaled $6.2 billion, of which approximately $2.9 billion had been pledged as collateral for our secured debt, and the remaining $3.3 billion was unencumbered. Our unencumbered assets increased to 53% of our portfolio in 2017, up from 43% in 2016. Longer term, we're targeting an unencumbered asset ratio of approximately 65%.

Our leverage ratio at the end of 2017 was a 5.7 times and net-debt-to-EBITDA on a run-rate basis. This equates to around 42% on a net-debt-to-cost basis. Heading into the new year, with the closing of our expanded credit facility earlier this month, we had borrowing capacity of $310 million in addition to the $43 million of cash on our balance sheet. As I indicated earlier, the accordion feature of our expanded credit facility provides access to even more liquidity. 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. Acquisition activity during the fourth quarter was funded by cash on hand, net borrowings of $208 million on our credit facility, and cash proceeds of approximately $44 million from fourth quarter asset dispositions.

As of December 31st, our real estate portfolio stood at over $6.2 billion, representing 1,921 properties. This compares to 5.1 billion, representing 1,660 properties at the end of December 2016. The annualized base rent and interest generated by our portfolio in place at December 31st increased 20% to $501 million, as compared to $419 million a year ago.

Acquisition activity drives revenue growth and in the fourth quarter, revenues increased 18% year-over-year to $120 million. Total revenues for the year were $453 million, an increase of 20% over 2016 revenues. Our 2017 acquisition volume was spread throughout the year; therefore, the full year revenue impact of that volume will be realized in 2018. Our consistently strong revenue growth reflects the broad-based demand for our real estate capital solutions.

For the fourth quarter, total expenses increased 12% to $83 million, compared to $74 million a year ago; nearly 80% of this increase is due to higher depreciation and amortization reflecting the growth of the portfolio.

For the full year 2017, total expenses increased to $330 million, compared to $266 million last year. Again, this was due to the growth of the portfolio, and much of this increase was related to higher depreciation and amortization expense.

For the fourth quarter, interest expense it was relatively flat compared to a year ago. Interest expense for the full year 2017 included a $2 million non-cash charge related to accelerated amortization of deferred financing costs associated with the STORE Master Funding notes we prepaid in August. Excluding this charge our interest expense increased about 13% over the prior year as we continued to finance a portion of our acquisition activity with attractively-priced, long-term, fixed-rate debt. This increase was partially offset by a decrease in the weighted average interest rate on our long-term debt.

Property costs were $1.5 million for the fourth quarter and $5 million for the year. The year-over-year increase was primarily related to property taxes, insurance, and maintenance costs on properties that were vacant during a portion of 2017, as well as properties where we determined that our tenant was unlikely to pay those obligations. Property costs can vary quarter-to-quarter, but since 98% of our real estate investments are subject to triple-net leases, property-level costs are the responsibility of our tenant, and, therefore, are not a significant portion of our annual expenses.

G&A expenses in the fourth quarter were $11.2 million compared to $8.7 million a year ago. For the year, G&A expenses increased to $41 million from $34 million primarily due to the growth of our portfolio and related staff additions. For 2017, G&A expenses, expressed as a percentage of average portfolio assets, decreased to approximately 72 basis points from approximately 75 basis points during 2016, reflecting the scale efficiencies that come with portfolio growth.

Net income increased to $41 million for the quarter, or $0.21 per basic and diluted share, compared to 32 million or $0.20 per share a year ago. Net income for the fourth quarter of 2017 includes an aggregate net gain of $3.8 million from property sales. This is consistent with an aggregate net gain of $3.7 million from property sales in the fourth quarter of 2016.

For the year, net income was $162 million or $0.90 per basic and diluted share, compared to $123 million, or $0.82 per basic and diluted share for 2016. We had an aggregate net gain of $39.6 million from the sale of 55 properties in 2017. This compares to a net gain of $13.2 million from the sale of 31 properties in 2016.

Net income for 2017 includes an impairment charge of $13.4 million, primarily related to two properties that became vacant during the year.

For the quarter, AFFO increased 22% to $82 million, or $0.43 per basic and diluted share, from $67 million, or $0.43 per basic and diluted share last year. For the year, AFFO increased 24% to $306 million, or $1.71 per basic and diluted share, compared to AFFO of $246 million, or $1.65 per basic, and $1.64 per diluted, share in 2016.

Our dividend is an important component of our overall stockholder return and for the fourth quarter we declared a quarterly cash dividend of $0.31 per common share. For the year, we declared dividends totaling $1.20 per common share, which included a 6.9% dividend increase in the third quarter. Since our IPO in 2014, we've increased our dividend per share by 24%, while maintaining a low dividend payout ratio, and at the same time reducing our leverage.

Now, turning to our guidance. We are affirming our 2018 guidance first announced last November. Based on projected net acquisition volume for 2018 of approximately $900 million, we expect AFFO per share to be in the range of $1.78 to $1.84. AFFO per share in any period is always sensitive to the timing of acquisitions during that period as well as the amount and timing of dispositions and capital markets activities. In 2018, we expect acquisitions to be spread throughout the year, though they're often weighted towards the end of each quarter. The midpoint of our AFFO guidance is based on a weighted average cap rate on new acquisitions of 7.75% and target leverage in the range of 5½ to 6 times run-rate net debt to EBITDA.

Our AFFO per share guidance for 2018 equates to anticipated net income, excluding gains or losses on property sales, of $0.82 to $0.86 per share, plus $0.88 to $0.90 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'll turn the call back to Chris.

Christopher Volk
Thanks so much, Cathy. As is usual for me to do, and before turning the call over to the operator for questions, I'd like to make a few added comments.

First of all, we are really proud of our performance. Evaluating a company like STORE, which has so little performance volatility and is highly predictable in the near-term, is best done over a much longer timeframe.

Since we took STORE public with AFFO of $1.39 per share in 2014, we've increased this amount by 23%. At the same time, we also raised annual dividends per share that we paid out to shareholders by a sector-leading 20%. That means we maintained a low dividend AFFO payout ratio in the range of 70%. While the multiple we trade at has had some volatility over the past three years, it has tended to center on the multiple at which we went public in 2014, meaning that our dividend yield at the conclusion of each year has not been not far from the approximately 5% at which we introduced STORE to the public market and shareholders in 2014.

This overall annual stability has meant that our shareholder returns have deviated little on an annual basis at 12.6% in 2015, 11% in 2016 and 10.7% in 2017. In fact, our compound annual rate of return over three years of 11.4% is right on top of the performance of the S&P 500 and more than double the 5.4% compound annual rate of return of the MSCI REIT Index.

Over the same period, we've more than doubled the size of our balance sheet, more than tripled our unencumbered assets, meaningfully lowered our financial leverage, maintained our sector leading investment and portfolio diversity, and added to our A+ capital access through our Master Funding conduit by having now BBB and Baa2 ratings with stable outlooks from all three major credit rating agencies.

As a result of our efforts, STORE today is bigger, more diverse and financially amongst the strongest in the net lease sector. Moreover, with sector leading gross rates of return and investment spreads to our cost of borrowings, we have continued to grow our shareholder value in excess of its actual cost, creating material and sector leading compound growth in Market Value Added.

Now, I mentioned all of this to take some stock in accomplishment, but also because we have accomplished all of this without trading at the highest multiples in the net lease space and while generally trading at below the aggregate multiples of the MSCI REIT Index. I believe that our track record over the past three years, like our leadership of prior successful net lease real estate investment trusts over the past 20 years, illustrates that this valuation gap was and is unwarranted. But more than this, the net lease sector on its own ranks near the bottom of real estate sectors today, with few sector companies trading at multiples that even equate to the broader RMZ average. I believe that the net lease sector deserves better.

Interest rate sensitivity today is the primary concern of investors, with a frequent notion that net lease REITS *have* to be more interest rate sensitive than other sectors as a result of our comparatively long lease terms. And STORE’s are amongst the longest in our sector, averaging 14 years. But we are not a long-dated bond. We are a *dynamic* operating business having sector leading rental increases, together with amongst the sector’s most protected dividends to arrive at a high level of imbedded internal growth that today approximates two thirds or more of our expected AFFO growth for 2018.

But addressing growth issues is just part of interest rate sensitivity. We are also over 40% leveraged as a percentage of investment cost, with no material debt maturities until 2020 and with laddered debt maturities on an annual basis that are not projected to be much more than our free cash flows in those years.

That means that our liability sensitivity, or interest rate sensitivity on the maturation of our liabilities, will likely range from a mere 1% to less than 2% of our total assets on an annual basis. In other words, the 10-Year Treasury could rise to 4% and have little impact on our future cash flows from our investment portfolio. And more importantly, we have intentionally built STORE with leases having gross rates of return that are not far from those we had more than a decade ago in a prior company we led. With base lease rates close to 8% and lease escalators averaging about 1.8%, the gross unleveraged returns have been in the area of 9.6%.

From 2003 to 2007, with average 10-Year Treasuries in the area of 4.4%, our lease rates averaged 8.6%, with escalators of about 1.6%, for a gross unleveraged rate of return just 40 basis points higher than today. And I should mention that this prior net lease platform delivered compound annual shareholder returns between 2003 and 2007 of nearly 20%. By the way, our very first net lease investment platform was public from 1994 to 2001, with 10-Year Treasuries averaging 6.2%. That company produced an investment rate of return of 12.2% compounded, or almost double that of government securities, which works in just about any investment market model. We also were able to surpass the S&P 500 with regularity. I'm mentioning all this to attempt to dispel the notion that longer lease terms equate to elevated levels of interest rate risk. This is a prevalent cognitive bias, but is mathematically not so.

As to what changing interest rates might do to impact our external growth, we can expect elevated rates to accompany higher investment lease rates. Based upon our history of more than 30 years, while this relationship does exist and the correlation is positive, it is nowhere near perfect. I believe the word imperfection could also apply to other real estate sectors, so my conclusion is simply that interest rates adversely impact all corporate valuations.

As I remember Warren Buffett once a saying, "Elevated interest rates are like gravity for the stock market." The discounted cash flow potential from all businesses just becomes worth less. Here, a well-constructed net lease company should not be impacted any more than any other well-constructed corporation. Which gets me back to the thought that, based on our performance and based on our construct, there's no reason why we should not trade at the very least at a multiple equivalent to the overall REIT index that we have shown a long-term ability to exceed.

Now, the net lease business itself is truly amazing, and I'm saying this from the perspective of a former commercial banker. The profit center lease contracts that we create are highly senior and allow us to have contracts that exceed the implied credit quality of our tenants. Whereas banks are happy just to be paid, we're happy to be paid more next year. Whereas bank loan portfolios are less liquid and seldom worth more than par, we have shown an ability to regularly sell assets and material gains over our cost. And whereas non-performing loans for banks can result in material losses, our investments are backed by hard assets and our average recoveries on resolved credit events has averaged 70%, inclusive of administrative costs. So, with this thought in mind, we're starting to, at least annually, produce an integrated lifecycle analysis in our appendix of our presentation. There, you're going to see that our average annual credit loss on resolved tenant issues has been just 20 basis points since we started STORE. We have offset this 20 basis annual point loss by about half through the profitable sale of real estate.

At any given time, we also have what I would call “work in process,” which is underperforming real estate that's in the process of being administered. Over many years in this business, we have generally tended to average six months or so to administer to underperforming assets. I mention this because this amount is not illustrated on the chart in the appendix, but is material and could add another 40 or so basis points annually to our average AFFO drag since we started STORE. So then you take the total drag and compare it to our unleveraged internal growth, which we expect to approximate 3.6% annually and you still have a number that's more than 3% a year. The reason for the long view when looking at our business lifecycle is that tenant performance is volatile. One of the reasons that we top out our larger exposures at just around 3% of rents is to construct a portfolio that's always capable of internal growth, even if we have an issue with a larger tenant as we did with Gander Mountain in 2017. STORE is, by design, a defensive company and it would take a lot for us not to have revenue growth in any one year.

And so, with these comments, our group here is joined by Chris Burbach and Michael Bennett as well, and I'm going to turn the call over to the operator for questions.

QUESTION AND ANSWER

Operator
We will now begin the question-and-answer session. To ask a question, you may press star, then one 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 star, then two. At this time we will pause momentarily to assemble our roster.

Our first question comes from Vikram Malhotra of Morgan Stanley.

Vikram Maholtra
Thank you. Just wanted to follow up on your comments regarding the net lease sector and the ability to grow. I want to sort of get your thoughts on what would make you deviate dramatically downward from the acquisition base that you've been doing recently, and vice versa, is there something that you would say would make you go the other way, where maybe there are large portfolios, maybe there's other factors. Can you just sort of talk about the tails?

Christopher Volk
Sure. I'll start and Mary can probably add to some of these comments. And good morning. I would say that first of all we tend to stay away from large portfolio transactions, so historically we've stayed away from that. Today, we're trading at a roughly 13 times AFFO multiple, which is sort of silly because that means were trading at a discount to net asset value.

So a 13 times AFFO multiple, by the way, equates to a cap rate of around 7.2%. So the good news for us is that we are able to buy assets a discount to NAV, so we're buying assets at 7.75, 7.80, 7.90, so that's the good news.

But in terms of where we can sell the assets and what they would be worth, they would be worth better than 7.2. So where were trading today is almost like a bank that's trading less than book, which makes absolutely zero sense to us.

My guess is over the long term that we will be more in a range that's been in the media, and if you look at the REITS as a whole from an FFO yield perspective, the spread today is a record six-year spread between AFFO yields and government securities. So that implies that perhaps there's a decoupling of where REIT securities trade.

So if you assume all of that and you look at the long-term running AFFO or FFO multiple of net lease REITS over the last 10-to-15 years, you get to sort of around a 15 times kind of median multiple, in lots of different interest rate environments, by the way. So I think that long-term, that's where we'll be.

In the near-term it's trading at 12 or 11 times AFFO. I guess we'll slow down acquisitions. I mean, our ability to make accretive acquisitions is probably better than anybody in the space just due to how we originate. We may have to start managing money for other people.

The private market might just be more efficient than you guys. And if that's the signal that gets sent to us, there are other ways that we can deploy capital. And we started this company with Oaktree Capital and Howard Marks and Bruce Karsh, and we can find other people to give us capital on a private basis if that's where we have to go.

I'm expecting that won't happen. I think it makes no sense that a private market that's not liquid and not diverse would somehow trade at a better valuation than a marketplace where it is liquid and is diverse and is BBB rated and does have access to different and more efficient costs of capital.

But that's not for me to say. I mean, that's going to be driven by the marketplace. What I know is that we have options. You know, we've created a huge platform here with the best acquisitions group in the business, and it is hugely valued as an operating platform, and sometimes people think of these companies as a conglomeration of assets, but you really have to think about companies as ongoing operating businesses.

This is basically a financial services company by any other means, because we're providing real help to people who need it on their capital stack. I mean, today, if you are in middle-market America, there is virtually no good long-term financing for real estate. I mean, you just can't get it. It just doesn't exist. There's no assignable debt. There's no pre-payable debt.

Debt is very difficult to modify, so the solutions we're giving people are such that they'd rather have a landlord than a banker, and we're replacing both of their debt and equity needs. And so we're fulfilling a very huge need in the businesses of these companies. As Mary says, , our company has 1.8 million employees.

So from a stakeholder perspective, we're gratified to fill a need for these customers and we're going to find a way to do that no matter what.

Vikram Maholtra
Okay, that's helpful, Chris. And then just a quick question related to Gander. Maybe just sort of give us a final update there, in terms of dealing with it and what the outcomes were. And given your comments, if I remember last, maybe just the prior call, where you sort of said if there's one thing you'd go back and redo, you saw all the Gander coverages turning down and you would like to have gotten ahead of them.

Are there any other subsectors, maybe specific tenants, where there are no red flags right now but you've seen this sort of deterioration and you might start considering potentially disposing some?

Christopher Volk
Well, there are always some assets like that, Vikram, and we've done that over the years. I mean, we had, I think, little bit more optimism on Gander then we should have had, and do so in retrospect we should have done it differently, and so it is a lesson for us.

In terms of the recovery, I think on the last earnings call we had estimated the recovery would be between 50% and 70%. And it's really a function of whether we hold it or don't hold it. So if we don't hold the assets, which we may not do, then the recovery goes up, so we can flip them at a profit and redeploy the capital.

So we'll see exactly what we do with Gander a bit today. At the end of the year, there were technically four vacant properties that were on our sheet as vacant, four them are Ganders, but two of those were in CMBS, and we noted in our 10-Q that those were assets where we weren't paying any debt service and whatnot. And the recoveries on those transactions are not expected to be much different from the actual balances on those transactions, so you can expect the lender there will take our advice on what kind of recoveries to have and take the leads that we've given them in terms of how to maximize recoveries.

So that would take you down to six vacant properties at the end of the year, if you think those are sort of being administered by someone else. And the other two Ganders are properties where they're a little harder to move. But there are nice locations and we want them next to a, you know, Walmart that's brand new and so on.

What we may have to do is subdivide them, and that's fine. So we'll look at doing that, and we have interest in the property, so it's not like we don't have interest in the properties. So I expect that we'll resolve them before too long.

Operator
Our next question comes from Craig Mailman of KeyBanc Capital Markets. Please go ahead.

Craig Mailman
Hi, guys. Chris, I just wanted to follow up on the commentary in response to Vikram. You know, you guys in the past have sold companies. You sound a little bit frustrated about where the valuation is. I mean, have you or the board kind of pursued a potential privatization with outside money?

Christopher Volk
No, we haven't.

Craig Mailman
I mean, do you think that there is a bid at a significantly higher valuation in the private market versus public market at this point?

Christopher Volk
I couldn't begin to tell you that. I think that when you're running a company, you should evaluate your cost of capital and your alternatives not just from day-to-day, but over the long-term. On a certain days, there may be people that might value a company more in their market. But over a

year, over the whole course of 2018, that may not be true. So I think that you have to be very careful about that kind of stuff.

Craig Mailman
Okay. That's helpful. And then just one quick follow-up. Post the tax bill getting passed, are you guys seeing an increase in potential net leaseback opportunities?

Christopher Volk
Do you want to talk to the pipeline?

Mary Fedewa
No, Craig, I wouldn't say that the tax bill passage has been driving any of that, but I would say that the deal flow is strong and the pipeline is strong, but not particularly related to that.

Operator
Our next question comes from Todd Stender of Wells Fargo. Please go ahead.

Todd Stender
Hi, thanks, and thanks for the added commentary in your opening remarks. You've got the highest annual run escalators in the net lease space. Can you go over the escalators you were able to get on the properties acquired in Q4?

And then just with that theme, just speak about how the conversations with the sellers go, you know, with the backdrop of a pretty robust economy we're in right now, can you push that higher, or no matter what it's going to be in that 1%-2% range?

Christopher Volk
We raised them 2% in the last quarter, which was 10 basis points more than the prior quarter. Our cap rate was, let's say, another four basis points higher, so together the gross return is 15 basis points higher than the previous quarter.

Does 15 basis points make a trend? No, I wouldn't say so, nor does one quarter. But we are seeing that cap rates are certainly remaining the same, and while the stuff tends to be sticky and it tends to be sector-specific.

So we're seeing, for example, when we survey brokers, and we don't do a lot of business with the brokers market, but when we survey brokers, we're seeing that assets are being listed for longer periods of time. We're seeing that certain sectors are becoming a little bit less desired, like drugstores and dollar stores, potentially.

We're seeing other sectors, like restaurants, being highly sought after, industrial assets being highly sought after, so people have a tendency to sector-rotate just like REIT investors do, and so you can see some of that happening in the marketplace. Overall, I would say that cap rates in the private marketplace are still very low and are reflective of individual investors having a bias towards names that they know and trust, and they have no ability to really underwrite portfolios, and they're doing one property at a time, right? And they have no access to deal flows, so for all of those reasons, they're wanting to accept a much lower yield than we're willing to accept.

But that's about it. I mean, we're not seeing any sort of huge movement in relation to interest rates today.

Todd Stender
Thank you.

Operator
Our next question comes from David Corak of B. Riley FBR. Please go ahead.

David Corak
Hi, good morning everyone. I just want to start on projected sales. Obviously you haven't given an exact number yet, or at all, but how do you think about the breakout of that between the three buckets that you guys talk about? And then within that, what industries do you expect to fall into the more strategic bucket?

Christopher Volk
You know, we're not seeing anything that's broad-based or sector-specific, so we could see clients in certain sectors having performance issues, or the potential for future performance issues, and we may decide to get in front of that by selling some assets. But that's not to speak of the whole sector. So basically, you can look across our portfolio, and you know that restaurants is our number one sector, so restaurants tend to be the number one things that we sell just numerically in terms of property count.

Last year, the biggest property we sold was an industrial asset and it was actually opportunistic. By size, it was the biggest asset we sold. Last year, 25% of the assets, numerically, made up the bulk of the gains – like, 80% of the gains. It was probably bigger than 25% of the dollars, because that included the industrial asset that was expensive. But that made up the vast majority of it.

We're booking all this stuff with embedded gains from day one. I mean, that's very important to us. We want to be able to have embedded gains, because if we have embedded gains, then you have much better liquidity options and you have a much better chance to create market value added. You have a much better chance to have margins of safety.

We've been able to periodically actually lower tenant rents and sell the properties and get all our money back for properties that we are concerned about. So we're basically helping those tenants work better so that a subsequent owner of the property feels better about where the sales are and whatnot, and then we're able to get all of our money back out. And then we can redeploy it. In some cases, we actually make profits on that stuff.

So I think that's just very important to us. And so if we wanted to sort of be opportunistic and sell off more assets, we could. It's just a trigger that we could pull. And that's important, because you could take an average of 20 basis points of loss over the last 6 ½ years and offset it with 10 basis points in gain and basically you have a portfolio that has very little frictional loss against AFFO per share, and the internal growth becomes better. I think that’s important to us.

David Corak
Okay, that's helpful. And then going back to some of the prepared remarks, you know, you talk about the various iterations that you had of this strategy and the success in various different economic environments, but is there an environment that I guess would be reasonably conceivable where single tenant, kind of freestanding real estate underperforms a broader CRE, or do you feel kind of confident that the strategy that you have, given the kind of the potential economic scenarios going forward, you know, stands to outperform?

Christopher Volk
Well, I would say that the single tenant real estate market is not monolithic. It is comprised of different companies having different strategies, different approaches to the market, so different views on that marketplace. And some companies have higher payout ratios, some companies have lower rent increases.

So when you're taking a view on STORE versus other companies, you have to sort of weigh those differences, and you have to decide for yourself whether you like our approach or their approach or whatever. I'm extreme comfortable with our approach. We have the highest lease escalators in our portfolio that we've ever had.

This goes back to 1980. 2% may not seem like a lot for this quarter, but it is a lot. 2% on a levered basis is north of 3 from an AFFO perspective. There's some friction against that. You'll have some vacancies and some friction against it, but you have to start off with a big number. That's meaningful. It costs us nothing.

Whereas other companies might post bigger rent numbers than 2%, they've got to put up money for T I to do that. So on a net basis, 2% flowing right through is a big number. And so we feel good about the rent increases. Our AFFO payout ratio is the lowest we've ever had.

So that basically gives us the ability to wall off cash and get, basically, another two and half percent or so growth. So you're starting off with, basically, another 2-1/2 % or so growth. So you're starting off with basically 5% plus embedded growth in the AFFO per share before you turn lights on on January 1.

I think that's just really critical, so if you move some of that to vacancies, fine. At a 13 AFFO multiple, our external growth is not as exciting. Right? So basically what happens is external growth addss another point to a point and a half of AFFO growth per share. If you guys would be nice and let us trade at 15 or 16 AFFO growth, then it gets a lot more exciting, but the irony of it is actually if you're really worried about interest rates and you want higher rates of return, you should trade us at a better AFFO multiple, because we'll put up much better growth numbers.

But as it is, if you take our internal growth and you add some external growth, it's going to still be the 9% or 10% number that the S&P has posted for the last 40, 50 years. I think that's a heck of a thing to say, so I don't know who else could say that, and I think that for this company, anyway, we're happy with where we are in this marketplace.

Operator
Again, if you have a question, please press star, then one.

Our next question comes from John Massocca of Ladenburg Thalmann. Please go ahead.

John Massocca
Good morning, everyone. I know you kind of mentioned some potential leverage you could pull for proceeds if you felt equity markets get even more challenged. Would you ever consider maybe bringing up your leverage targets, if that was the case and you thought there was still some attractive acquisition opportunities out there?

Christopher Volk
I think the answer is that if we were going to bring up leverage numbers, we might do it in the short term, but just as a blip, right? I think being a BBB company is important. We want to make sure that we maintain ratios that are consistent with that.

You know, personally, I think that having a BBB rating in concert with having a structured finance A+ rating is just better than having a BBB rating by itself. Or, by the way, an A+ rating on our Master Funding conduit by itself.

I just think that they're very complementary. And long-term, I think that they're going to cause us to lower our cost of capital relative to people that don't have those multiple choices. And the logic for that is that, if you look at our unsecured debt ratios, basically the unencumbered assets to unsecured debt ratio or the unencumbered asset debt service coverage ratio (and there are slides on our presentation that go through this), they're better than basically anybody else in the space, no matter what the rating is.

They're better than most any REIT, no matter what the rating is. The reason for that is because the master funding assets are leveraged 70%, but we're basically leveraged on a consolidated basis, 45%. So you end up being sort of 33% levered on your unsecured debt and uncovered asset ratio.

So I think that that kind of synergy is going to help us maintain competitive leverage ratios in the aggregate, which lower our cost of capital and make us more efficient than anybody that would be having one or the other.

John Massocca
That makes sense. And kind of shifting gears, maybe the portfolio mix. Your exposure to what you guys classify as a service experience has been kind of ticking down over the last two years by about 450 basis points since 4Q '15. What's driving that? Is that just a more attractive acquisition opportunity somewhere else or is that a conscious decision to shift portfolio exposures?

Mary Fedewa
This is Mary. No, it's not a conscious decision. We're still very focused on the service as our primary asset. It's been near 70% right along. So it's just timing of acquisitions and timing of asset classes, but absolutely it's our main focus, the service industry, for sure.

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

Christopher Volk
Thanks, operator, and thank you all for attending our year-end earnings call. I'm going to remind you that we have a biannual investor day coming up on the afternoon of April 11 at the New York Stock Exchange and we're also going to ring the closing bell that day. At that event, we planned to offer a high-level look at what the future holds in STORE, a market and portfolio discussion and customer case studies with STORE relationship managers, and we're also going to deliver an analysis of evidence-based real estate investing and cognitive biases, which you're going to find fun. It's kind of like a Moneyball for real estate.

I'd also like to draw your attention to our modified investor presentation entitled Values Added By Design, which follows on last year's presentation by illustrating foundational elements that we designed from the outset and combined to make STORE the exceptional company that it is. The presentation also expands on the values that we add to our stakeholders and our important corporate values of strong governance and investor disclosure.

By the way, STORE University is part of an effort to add value to our customers, as Mary pointed out. And part one of Lesson 9 has been posted, if you were holding your breath and you can't wait to see it. If you want to binge watch now, you can watch episodes of Lessons 1-9 and just have a blast. Or you can wait until Lesson 10 gets posted sometime soon.

STORE University was designed to have 10 modules from the start, so finally we are able to follow this earnings call up with our CEO letter, which should be announced and posted on the website shortly. Thank you so much for listening and have a great day. We'll be around for questions if you need us.

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