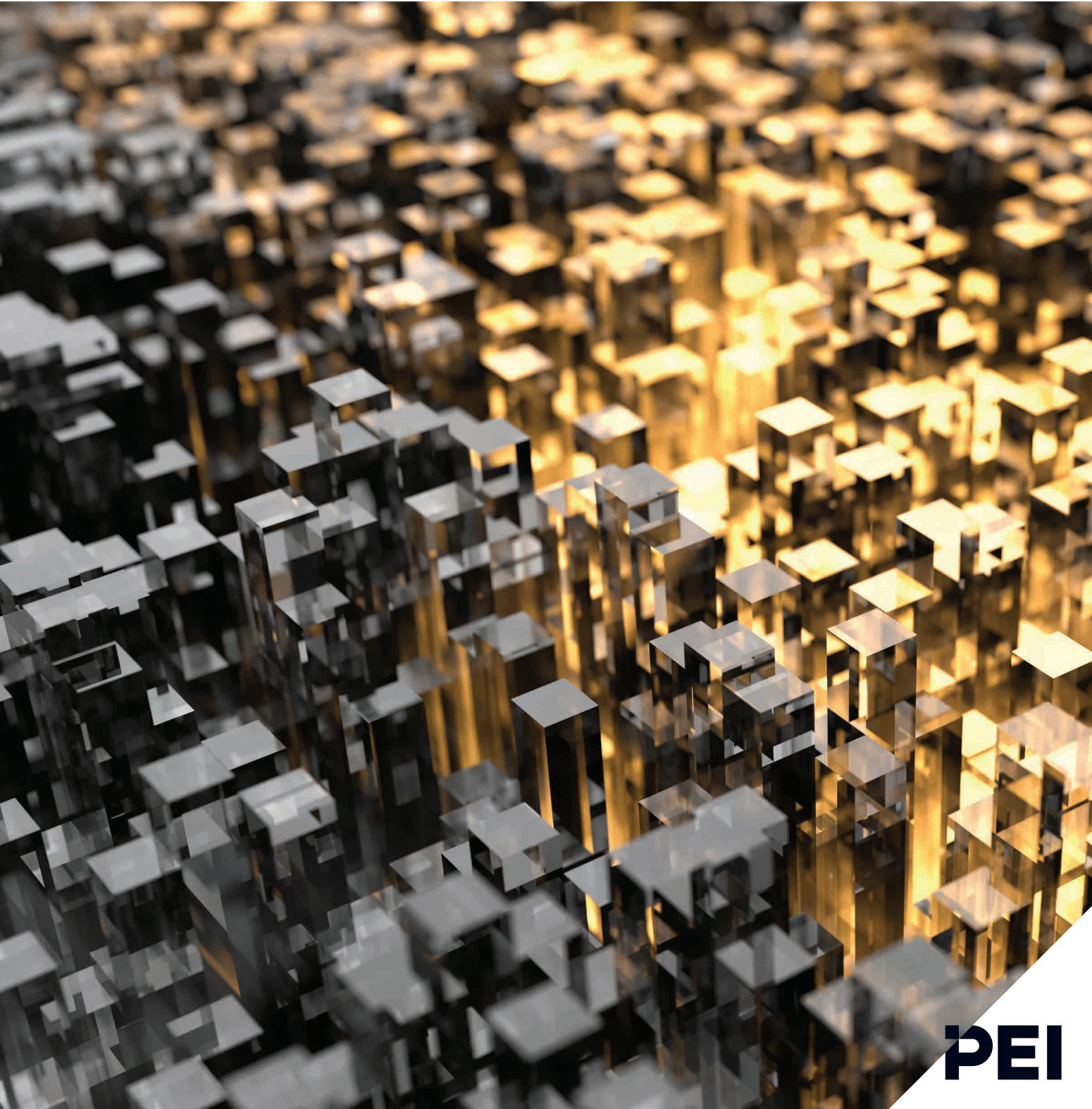


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May 2026 • perenews.com



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KEYNOTE INTERVIEW

Selectivity rises as investors refocus on fundamentals



*Tenant strength, asset quality and demand drivers are increasingly shaping where real estate investors find durable income, says Morgan Stanley's **David Gross***

Net lease remains a core income strategy, but today's market is demanding a more disciplined approach to both credit and real estate, says David Gross, managing director at Morgan Stanley Real Estate Investing.

As more and more managers and investors navigate elevated interest rates and uneven tenant performance, the focus is shifting toward businesses with durable demand, mission-critical assets and long-term structural tailwinds.

At the same time, underwriting is becoming more nuanced, with greater emphasis on balancing tenant credit with residual real estate value and positioning portfolios to perform across a range of economic scenarios.

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Q How is net lease positioned to succeed in the current environment?

In a world defined by inflation uncertainty, geopolitical fragmentation, elevated rates and capital market volatility, we believe the case for high-quality, triple-net lease investing has never been stronger. A well-constructed net lease portfolio can deliver durable, growing income with downside protection and, often, tax-advantaged status backed by creditworthy tenants and mission-critical real estate. The triple-net lease structure is designed to

insulate investors from operating cost volatility and compound in real terms over time. Importantly, we do not view this as a purely defensive strategy; it is an income-oriented approach built for today's environment.

Based on our analysis, current market conditions also present an attractive entry point for real estate, with acquisitions often at approximately 20-25 percent below peak levels and replacement cost, creating a compelling basis relative to other asset classes.

In our view, the triple-net lease structure provides clear visibility into net operating income, which is particularly valuable when inflation and operating costs are unpredictable.

Because expenses are generally passed through to the tenant, NOI remains stable even as operating costs fluctuate. Meanwhile, contractual rent escalations help preserve purchasing power over time.

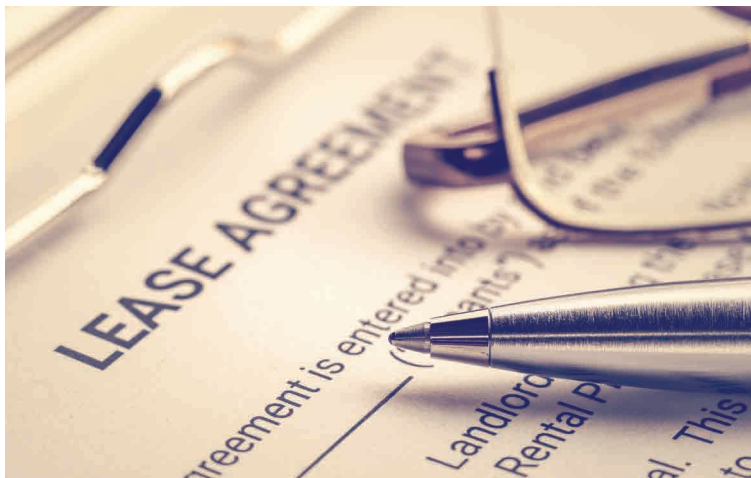
Downside-protected income can be further enhanced through disciplined asset selection. Today, a triple-net lease structure can be particularly successful when investors focus on tenant credit, emphasizing well-performing businesses with moderate leverage and strong cashflow; mission-critical real estate that is integral to a tenant's operations; exceptional real estate quality defined by location, demographics, depth of tenant demand, supply constraints, investment basis and functionality for alternative uses; and diversified portfolio construction where this approach is repeated and scaled to mitigate risk.

Together, these elements can create multiple layers of protection at the tenant, asset and portfolio levels, supporting durable income generation in an environment of elevated geopolitical risk and macro uncertainty.

Q Given that net lease is a credit/real estate hybrid, which sectors and asset types should investors target to minimize the credit risk?

We typically target sectors and asset types with durable demand drivers, including industrial, healthcare and essential retail.

We view industrial demand as being supported by structural forces and also benefiting from the pullback in new supply, with construction starts down meaningfully in recent years. Within industrial, we prioritize modern facilities – particularly assets with higher power capacity and those that are mission critical to a tenant's manufacturing or distribution operations – located in large population centers. We view these markets as benefitting from high supply barriers and a severe undersupply of modern stock per capita.



Q How are investors assessing tenant quality and credit risk in today's environment?

We focus on investment-grade and other creditworthy tenants with leading market positions, strong returns on invested capital and sustainable competitive advantages. In addition to traditional credit analysis, we also consider four-wall economics and mission criticality as potential credit enhancements.

From a portfolio perspective, we aim to build a diversified roster of tenants across industries, targeting investment grade or near-investment grade credits with strong balance sheets, performance across economic cycles and business models that are not overly dependent on a single, highly cyclical demand driver.

We believe healthcare real estate benefits from aging demographic trends. In this sector we typically target medical office properties tied to higher credit health systems. We have seen that essential retail has demonstrated resiliency across cycles supported by healthy levels of consumer spending and low levels of new supply. We favor assets in larger markets with broad trade areas, high foot traffic and strong employment and income growth fundamentals.

Q How can underwriting the credit risk of the tenant be balanced with the real estate residual value risk?

We view the optimal balance between credit risk and real estate residual risk as not being static, but rather a function of lease duration and tenant credit

quality. The shorter the lease or the weaker the tenant credit, the more you are relying on the real estate itself. The longer the lease and the stronger the credit, the more you are relying on the income stream derived from the credit.

For long-term investors, an investment may start out overweighting to credit risk but, as time goes on and lease term burns off, the real estate risk may become overweighted. Investors with shorter time horizons may seek to exit before this transition, at which point interest rates, cap rates and tenant credit may still have greater influence than the intrinsic real estate value. This investing approach, however, introduces meaningful dependence on rate movements. What worked in the last cycle of declining rates may not work in an environment with elevated or sticky rates. We prefer to invest

through a long-term perspective with optionality to opportunistically exit early. Under this approach, our goal is to make no sacrifices when it comes to real estate quality, even if the lease term is long and the tenant credit is healthy.

Q Which mega-trends are driving investment in real estate as it relates to asset selection?

The mega-trends we are most focused on include deglobalization, aging demographics and AI driven technology diffusion.

We believe that in a multipolar world driven by elevated geopolitical risk, event-driven supply chain disruptions and increasing trade fragmentation, deglobalization is fundamentally reshaping where goods are produced and how they are distributed. In parallel, our analysis shows that higher defense spending is accelerating R&D and production across equipment, aerospace, electronics and related components. Together, we see these forces are increasing demand for warehousing, distribution and specialized industrial and manufacturing facilities.

In our view, aging populations represent another powerful structural tailwind. The population aged 75 and older is expected to grow at approximately 4 percent per year over the next decade. Given that older populations consume a disproportionately high share of healthcare services, this trend should drive sustained demand for healthcare-related real estate, including medical office properties. We believe medical offices will also benefit from the continued shift away from inpatient care toward outpatient delivery models.

Finally, we believe the accelerating and broader adoption of digital technologies, including e-commerce and artificial intelligence, is reshaping both economic activity and real estate demand. We expect this trend favors markets with strong technology ecosystems, as well as real estate that directly or indirectly

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supports higher e-commerce volumes and AI related investment, most notably industrial and data center assets.

Q Lease duration is a hallmark of net lease investing. When might a manager want shorter or longer lease durations?

We believe lease duration is one of the defining features of net lease investing because it determines how much of an asset's value is supported by contractual cashflow. Weighted average lease term, or WALT, therefore matters a great deal: it is a key measure of the downside protection that investors seek in the asset class.

Many market participants cite WALT as though a higher number is always better, but that can be too simplistic. A more sophisticated approach does not seek to maximize lease term for its own sake, but to maximize the right type of contractual income, while balancing the additional downside protection and upside potential that can come from an attractive basis, strong asset quality, favorable rent positioning, extension options and real estate fundamentals.

In our view, a longer WALT is most valuable when tenant credit is strong and the investment thesis is centered on dependable, bond-like income. That is especially true for purpose-built or specialized assets, where long lease duration can increase the share of value supported by contractual rent and reduce reliance on future real estate assumptions. In those cases, duration is a core part of the protection that defines net lease.

Base WALT is only part of the story. The structure of lease extension options can fundamentally change what you own. We see that fixed-rate extensions are generally tenant-favorable in an inflationary or rising-rate environment because they can cap future rent growth.

FMV extension options, by contrast, may better preserve the landlord's ability to capture market rent. That distinction matters: long-WALT assets with fixed extension rights can carry more interest-rate sensitivity, while shorter-duration assets, especially with FMV options, tend to have less duration risk because value is driven more by re-leasing events and current market rents than by discounting a very long contracted stream.

That is why somewhat shorter lease duration can be attractive when the asset still delivers substantial contractual cashflow and the real estate is well covered. We like that set-up when rents are below market, the location is supply-constrained, the tenant is performing well and our basis provides downside support. Upside can be realized through renewal or re-leasing without sacrificing net lease discipline.

At a portfolio level, we believe portfolio construction should reflect a deliberate balance of lease duration. Longer leases should anchor cashflow, while select shorter duration assets can add well-underwritten upside. In our view, the edge is not in chasing WALT as a headline statistic, but in optimizing lease duration and extension structure asset by asset. ■

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RO: 5478396
Exp. Date: 5/31/2027

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