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INDUSTRIAL IS IN A CLASS OF ITS OWN

Investors are swarming to the safest real estate bet post-pandemic, but are owners willing to sell?

By John Nelson

The U.S. industrial sector has by most all measures weathered the COVID-19 pandemic the best of all the major real estate categories. Gabriel Garcia-Menocal, executive director of NAI Miami, says last year the collective industrial real estate community braced itself for a slowdown in activity and a rise in vacancy, but that never materialized.

"Renewals began coming in, and things were moving incredibly fast," says Garcia-Menocal about activity in Miami's industrial market last spring. "Overall industrial demand was accelerated by the pandemic and lockdown, it was an eventuality."

The ultimate driving force of the sector continues to be e-commerce, sales of which grew by 32 percent in 2020 ($788 billion) compared to 2019 ($596 billion), according to the U.S. Census Bureau. Government-mandated restrictions for stores and a general shift in consumer patterns last year boosted online sales to north of 20 percent of total retail sales for the first time in history.

"Because of the global dynamics of e-commerce and how we were living our lives, industrial has been the absolute benefactor of the problems that the pandemic caused in other asset classes," says Erik Foster, principal of Avison Young's Chicago office. Relative to the other major categories of commercial real estate, especially hotels, office and retail, industrial is seen as the surest bet and safest haven for investors amid the pandemic. Institutional investors, REITs, private equity firms and high-net-worth individuals and families have all been competing for industrial properties, albeit at different tiers. The level of competition has driven pricing up for new acquisitions. According to data from CommercialEdge, part of the Yardi Systems network of research platforms, the average sales price for the first two months of 2021 is $112 per square foot, a 10 percent in-crease from fourth-quarter 2020. "Pricing is up and cap rates are compressing based on the credit of the tenant and the rent generated," says Garcia-Menocal.

The uptick in pricing is ubiquitous as industrial real estate is seen as an investor darling, almost regardless of location. Foster says that one phenomenon he's noticed is that traditional secondary markets are now pricing similarly to industrial's gateway markets such as the Inland Empire, Lehigh Valley and Chicagoland.

"The pandemic has taught us that we can go to different markets and achieve what we need to from a logistics and warehousing standpoint in a market with cheaper labor costs," says Foster. "There used to be top five distribution markets in the country, but that needs to be expanded to 20. We are seeing pricing in markets six through 15 that's comparable to some of the top five markets." Sim Doughtie, president of Atlanta-based King Industrial Realty Inc./CORFAC International, says that developers are building ahead of the investment demand and are also future proofing their projects to be desirable for these buyers, as some developments are being purchased ahead of completion.

"Developers are building these properties not just to meet the requirements of the tenants, but also the requirements of other investors," says Doughtie. Dodson Schenck, managing director and director of industrial services at CBRE|Triad in North Carolina, says that the growth of e-commerce and on-shoring and near-shoring from manufacturers should combine to keep investment demand strong for the foreseeable future. Additionally, he notes the Southeast's tax-and business-friendly environment is an added bonus for investors. "The Southeast is viewed as a desirable part of the country for people to invest in because of the region's population growth and business-friendly markets," says Schenck. "The Southeast is benefiting from the overall interest for industrial investments and it gets the added benefit that people want to live here."

Rental rates are also peaking for the U.S. industrial sector. CommercialEdge reports that average industrial rents are $6.47 per square foot in February 2021, a 5.1 percent increase over the past 12 months. With net operating income and pricing trending up, one of the few challenges facing the investment community is getting sellers to the negotiating table. "We are going to have more investment sales in 2021 if we can get sellers to sell, that's the challenge," says Cody Cress, vice president and commercial real estate advisor for The Cress Group/Coldwell Banker Commercial Sun Coast Partners LLC. "Owners are having a hard time because they don't know what to do with their money — stock market, bank, real estate, etc. It's hard to find a better asset to buy than what they already have."

Deep buyer pool

Industrial brokers from around the Southeast note that the buyer pool today is deeper than it has ever been as investors are creeping in from other property types and are chasing the emerging life sciences subcategory, which is marked by research and development space in clusters such as Raleigh-Durham, Atlanta and Tampa.

"The buyer pool for industrial is much more broad," says Foster. "It's international and it's traditional buyers and owners of other product types that are shifting resources and equity to purchase industrial. If you're a fund operator or you have a separate account, your investors are charging you with a desire to put more money into the industrial space to the detriment of office, retail and hotel investing."

Foster says that he's noticed a rise in passive investors that are interested in owning industrial real estate but are backing other firms that have more familiarity with the product type. One prominent example is EQT AB, a private equity firm based in Stockholm, purchasing Pennsylvania-based Exeter Property Group, a prolific developer and investor of industrial parks around the country.

Garcia-Menocal says that the buyer pool for Miami's industrial facilities are mostly institutional investors and private funds, and there's a higher barrier to entry to clear for properties exceeding 100,000 square feet. "Every buyer seems to have an abundance of cash and they're looking to place it in Miami, which makes sense because industrial land and buildings here are a sought-after commodity," he says.

Thinking bigger

Last year the U.S. industrial sector, like all real estate categories, experienced a slowdown in investment sales volume. Real Capital Analytics (RCA) reported that industrial sales totaled $98.8 billion in 2020, a 16 percent decline from 2019. The February 2021 sales volume didn't much better as RCA reported a 69 percent drop compared to February 2020. However, the research firm points out that the data may be skewed because February 2020 marked the closing of the $13 billion acquisition of Liberty Property Trust by industrial giant Prologis.

While no transaction comes close to that mega deal, portfolios remain the most noteworthy transactional method for industrial assets in the Southeast region. Recent deals include an undisclosed consortium of institutional investors buying Birmingham, Alabama-based Growth Capital Partners' 11.6 million-square-foot portfolio for $800 million; Global investment firm KKR buying an Atlanta-area portfolio for $136 million; and Preylock Holdings, a private equity firm based in Los Angeles, buying Core5 Industrial Partners' three-property portfolio in Memphis and Atlanta for $166.7 million. "Buyers are looking for portfolios to buy, but there are very few and far between that sellers are willing to sell," says Cress.

Foster says that with the industrial sector experiencing a capital infusion of investor interest, there's an urgency for investors to deploy larger amounts of capital. "Sometimes the only way to do that is through portfolio transactions," he says.

"We're marketing a number of portfolio deals right now, and it's garnering a lot of attention."

In addition to portfolios, investors are also upsizing their acquisition criteria in terms of total square footage.

"From an investment standpoint, the sales are getting bigger," says Doughtie about Atlanta's industrial market. "In this past year, there were over 130 deals above 100,000 square feet — 25 of those were 500,000 square feet or above. We've never seen that before in Atlanta."

Garcia-Menocal also notes that REITs and other investors have shown a willingness to go smaller than ever before on their acquisitions, especially for infill properties that are within urban districts or are near Miami International Airport or PortMiami.

"Investors are targeting any building above 25,000 square feet, which is crazy because a couple years ago they were only looking in that 50,000-to 100,000-square-foot range," says Garcia-Menocal. "It almost begs for smaller owners to buy below the 25,000-to 30,000-square-foot threshold these REITs have. The smaller stuff is healthy and active, there's a lot of movement."