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Healthier Retail Sector Drives Industrial RE Investment

By **Kaitlin Ugolik**

Law360, New York (April 08, 2013, 8:19 PM ET) -- Real estate investors have more confidence in industrial real estate than they've had in years, buoyed by a strengthening retail and manufacturing sector that experts say warrants participation in an increasing number of deals.

While analysts are skeptical about retail sales numbers for the first quarter of this year, which are expected Friday, experts say it's been clear over the last several quarters that the sector is improving and encouraging businesses to lease more industrial space around the country.

Institutional investors, real estate investment trusts and others who feel they have exhausted the yield potential of asset classes like office and multifamily in certain markets are now flocking to industrial as the next good bet, Len Rosenberg, a partner in Mayer Brown LLP's real estate practice, said Monday.

"Given the compression in cap rates seen in other kinds of assets — office in particular — this becomes the next logical haven for investors seeking a certain amount of core-oriented return," Rosenberg said.

Sales of industrial property reached $2.2 billion in February, a 22 percent jump from the same time in 2012, according to commercial real estate research and consulting firm Real Capital Analytics Inc. About $1 billion of that came from deals in so-called tertiary markets, or those outside major metro areas and heavily populated by businesses in the service sector.

That $1 billion in tertiary market deals represented a 174 percent increase over the same period last year, another sign that investors are becoming more comfortable looking outside the so-called safe havens of urban office and multifamily, experts say.

Many of these deals involved large portfolios of industrial property. In one major example, Australian property manager Dexus Property Group announced in January that it had sold most of its U.S. portfolio of industrial properties for $561 million to real estate investment manager Heitman LLC in an effort to exit the U.S. market.

Rosenberg, who represented Heitman along with a team from Mayer Brown, said the firm used to see about one large industrial portfolio deal — though not quite as large as the Heitman deal — per quarter, and things have started to ramp up again.

The office and multifamily sectors have stabilized, but for many investors like pension funds and REITs, whose shareholders rely on good returns, the so-called "safe" investments just aren't enough anymore. According to Real Capital Analytics, institutional buyers spent around $5 billion on industrial deals in 2012, a 68 percent increase over the year before.

"Industrial property is sort of a no-fuss, high-yielding investment," Philip Feder, a partner in Paul Hastings LLP's real estate department, told Law360. "Particularly today when apartment buildings are so expensive and the returns are so low, I think smart investors are looking at alternatives, and industrial property is [a good] one."

The fact that industrial properties tend to be higher yielding than other types of assets — because the rent roll is typically small and more stable, with triple-net leases that put most of the maintenance in the tenants' hands — also means that many lenders are currently more willing to finance industrial deals than those in other asset classes, Feder said.

On the West Coast, Scott Buser, also a partner in Mayer Brown's real estate practice, said he has seen industrial deals approaching the size and frequency that his team often experienced in the precrash era of 2006 and 2007.

In one example of this renewal, Buser said he has seen two parties that used to work together on industrial deals before the recession come back together for a new project recently.

"I think the fact that this deal is coming together, these parties are coming back to the table for the first time since then, is a good sign," Buser said.

While most of these deals involve purchasing and triple-net-leasing an industrial property, experts say they're seeing a wide spectrum of interest in the sector that also includes adaptive reuse, depending on the location of the deal.

The properties with the best access — those near airports or other major transportation centers — are the most popular with investors looking for yield, but members of the agricultural community, which is also experiencing a revival, are doing their share of deals in the more remote markets, according to Andrew Miller of Pennsylvania-based MPL Law Firm LLP.

MPL has been involved in several recent transactions in which industrial properties that had been viewed as potentially lucrative assets have been purchased by farmers and converted to an agricultural purpose because the land values and locations have been a better fit for the farmers' needs.

"Farmers have been doing well finally for the past few years, and so we have some large farm operations that have actually started buying up some of that outlying industrial land," Miller said.

And deals within certain cities are heating up as well; the Los Angeles market has been a hotbed of industrial activity in recent months, in part because many of its neighborhoods are being redeveloped from industrial to residential and mixed-use. In an effort to encourage this adaptive reuse and more mixed-use development in general, the city recently broadened its zoning code to allow developers to more easily transfer residential density across parcels in large projects.

A great deal of formerly industrial space is being converted into loft-style residential and high end retail in LA, according to Feder, spurring even more development in the form of supermarkets, drugstores, barber shops and everything else that people need close to where they live that might not already exist in an industrial area.

"You're seeing that in LA, you see that in the Lower East Side of Manhattan, in San Francisco," he said. "It's another byproduct of this industrial boom."

--Editing by John Quinn and Katherine Rautenberg.