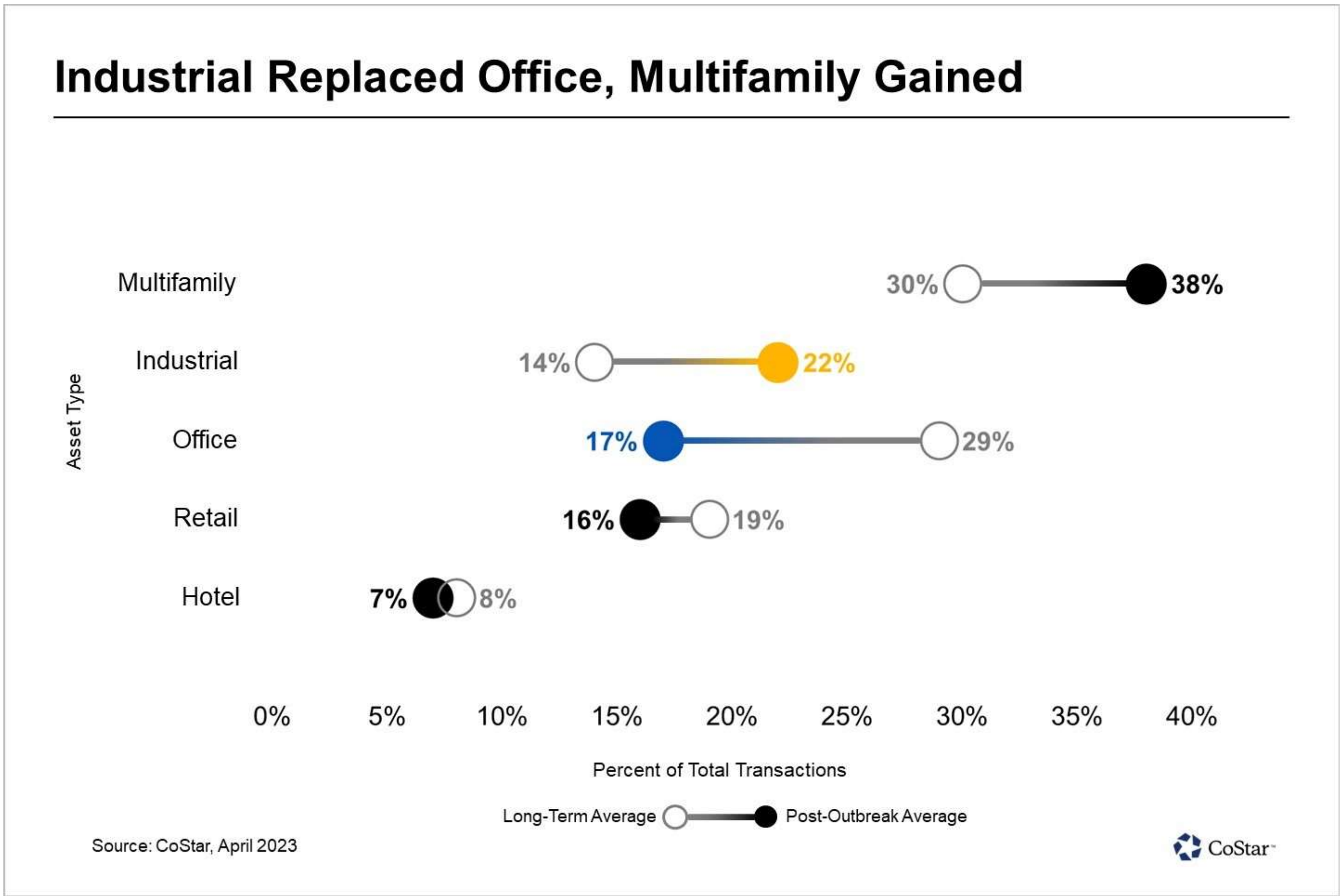
COSTAR INSIGHT

Industrial's Rise as a Preferred Investment Began Earlier Than You Might Think

Investors Began Pivoting Toward More-Certain Cash Flow Associated with Industrial Property Around 2015



By Chad Littell

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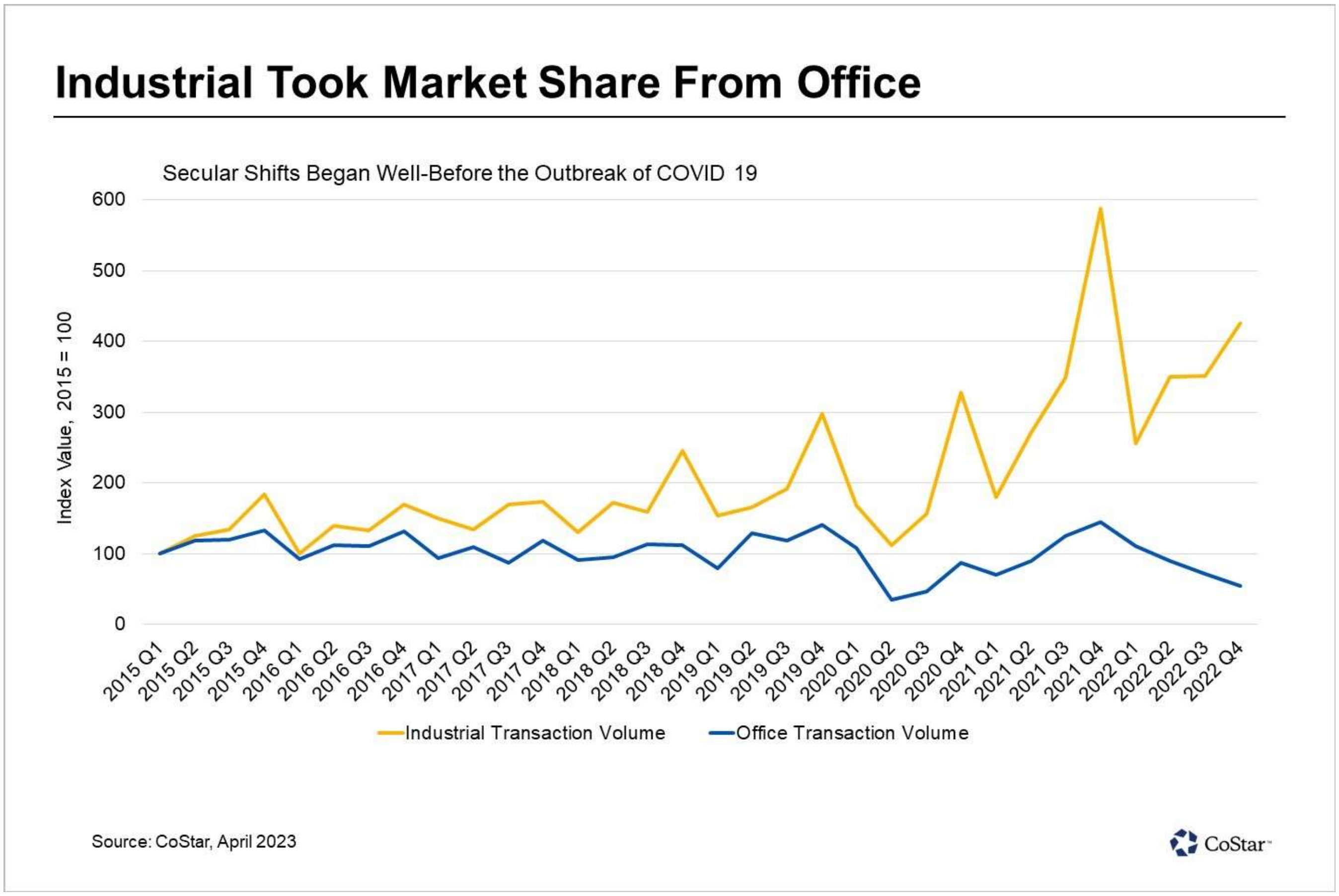
Commercial real estate investment has shifted significantly, with industrial property now being the primary focus for investors. In the post-outbreak era, industrial assets comprised almost one-quarter of all commercial property transactions, a considerable increase from its long-term average of 14% of commercial property transactions since

2007. For many, the rise of industrial property as a preferred investment was simply due to changing consumer-buying patterns.

However, other trends have emerged that tell a fuller story. Namely, the high cost of office building ownership has been cutting into investor profits. According to Preqin data, office returns for core and core-plus equity raised between 2000 and 2007 did not meet fund targets in many instances. Ballooning tenant improvement costs and the ongoing capital expenditures needed to maintain aging office stock forced some owners to spend more on capital expenditures than they anticipated.

Yo-yoing space requirements from tenants wanting to forego open floorplans in favor of disparate office layouts forced landlords to move interior walls and update finishes regularly, which led to unpredictable tenant improvement costs. As these expenditures began eating into investor profits, operators pivoted toward more predictable cash flows in other asset types rather than face the uncertainty posed by office space.

Before the Great Recession, office was the dominant property investment sector, where transactions accounted for 40% to 60% of the total sales volume. Yet, the asset class has fallen out of favor, and sales slowed to account for just 17% of total transaction volume in the post-outbreak era. Office assets used to be much more prevalent in investors' portfolios due to historically strong rent growth in periods of economic expansion. At the same time, the industrial sector held a smaller piece of the pie as its rent growth tended to trail by comparison.



Despite offering similar going-in yields historically, by around 2015, capital allocators began moving toward the industrial sector en masse, seeking a more-certain cash-on-cash return than what the office sector could provide. One nationally active owner stated that the pass-through nature of triple net expenses makes underwriting industrial cash flows more bond-like compared to the complex expense reconciliations associated with office leases.

Additionally, as the growth of e-commerce provided developers with opportunities to construct more sizable warehouses, the price tag for new industrial assets swelled. A prominent investment broker noted, "Before the mid-2000s, bread-and-butter industrial was 250,000 square feet per warehouse facility. It takes a lot of those to build a portfolio. That all began to change with the delivery of the industrial 'bombers.'"

Today, new warehouse distribution facilities line the nation's freeways, commonly reaching sizes of a million square feet or more. The added sizing allowed acquisition officers to place more capital into each investment and achieve scale faster than in earlier cycles.

On a forward-looking basis, the industrial sector should continue to benefit from solid rent growth, relatively stable income, and favorable capital flows. Covid-era buying patterns and supply chain bottlenecks have driven double-digit rent growth in recent years. At the same time, the sector's low capital expenditures and predictable cash flow have enticed investors away from buying capital-intensive office buildings.

Long-term demographic trends, same-day delivery, and the reshoring of U.S. businesses should also contribute to the industrial sector's performance in the years ahead.