INDUSTRIAL — CAPITAL MARKETS

# Private & institutional capital allocations shift

The industrial sector has been a consistent headliner in commercial real estate, boasting overwhelming demand from end users and investors alike. This asset class has been flooded with investors who see value in allocating capital toward industrial and away from office and retail as a safer investment vehicle in today's favorable economic environment. The increased investment volume into the sector has created changes to both individual and portfolio opportunities as the market has more aggressively pursued this asset class. The composition of capital pursuing the various industrial asset class subtypes has been notably shifting as well, which has led to record-breaking pricing and heavily competed transactions.

Garrett Neustrom
*Director, Kenai Capital Advisors*

As competition has increased for industrial assets, institutional investors have reduced their minimum equity check size in an attempt to place capital. Simultaneously, private investors have increased their interest in industrial opportunities and have exchanged or diversified out of their retail, multifamily and office assets for industrial holdings. This has led to intense competition for middle-market industrial assets (meaning those valued between $5 million and $30 million). Portfolios that traditionally may have been uninteresting to institutional buyers because of the tenant credit and building vintage are being seen now as opportunities for institutional capital in the current market. The individual assets within these portfolios were traditionally geared toward private investors, but now as a package, these assets are being flooded with offers from institutions trying to place equity to meet capital allocation goals. Although many of the marketed portfolios still are large from a valuation and square footage perspective, the makeup of many portfolios on the market includes properties that typically would have been on the smaller size for institutions. On an individual asset basis, institutions are proving to be less sensitive to remaining lease term on existing buildings, as well as more willing to involve themselves earlier in forward contracts for new construction assets whereby they assume lease-up risk for a discounted spread versus a similar, fully occupied asset. Furthermore, many large investors have adopted aggregation strategies that add middle-market products into their portfolios as a strategy to meet their allocation demand.

Jules Sherwood
*Principal and founder, Kenai Capital Advisors*

*The Church Ranch portfolio in Westminster was recently purchased by Kenai Capital Advisors to meet investor demand for industrial products outside of traditional high cube distribution. The 150,000-square-foot flex industrial portfolio is made up of three buildings and a development parcel.*

Many private investors, high-net-worth individuals and family office groups who traditionally have played in the multifamily space have identified value in diversifying their portfolio into the industrial asset class as multifamily returns have shrunk. These groups, specifically family offices, recognize industrial as an opportunity for consistent dividend paying assets, an extremely liquid debt market and longer-term leases than multifamily or office. As family offices and other private investors shift their allocation goals to meet their portfolio return requirements, they are realizing that industrial assets provide arguably better risk-adjusted returns compared with multifamily in today's market. Not only are they shifting their asset allocations, but also they are writing larger equity checks to compete for both portfolio and individual industrial assets. As family offices enter the already heavily competed upper-middle-market industrial space, their adjusted return profiles and larger equity checks place them in direct competition with private equity firms, funds and other institutional investors in the space. Denver has been identified as one of the preferred geographic locations for private capital to invest, with family offices and high-net-worth individuals diligently looking for investment opportunities. The result for current owners of industrial assets, regardless of the size or age of the buildings, is that there will be someone

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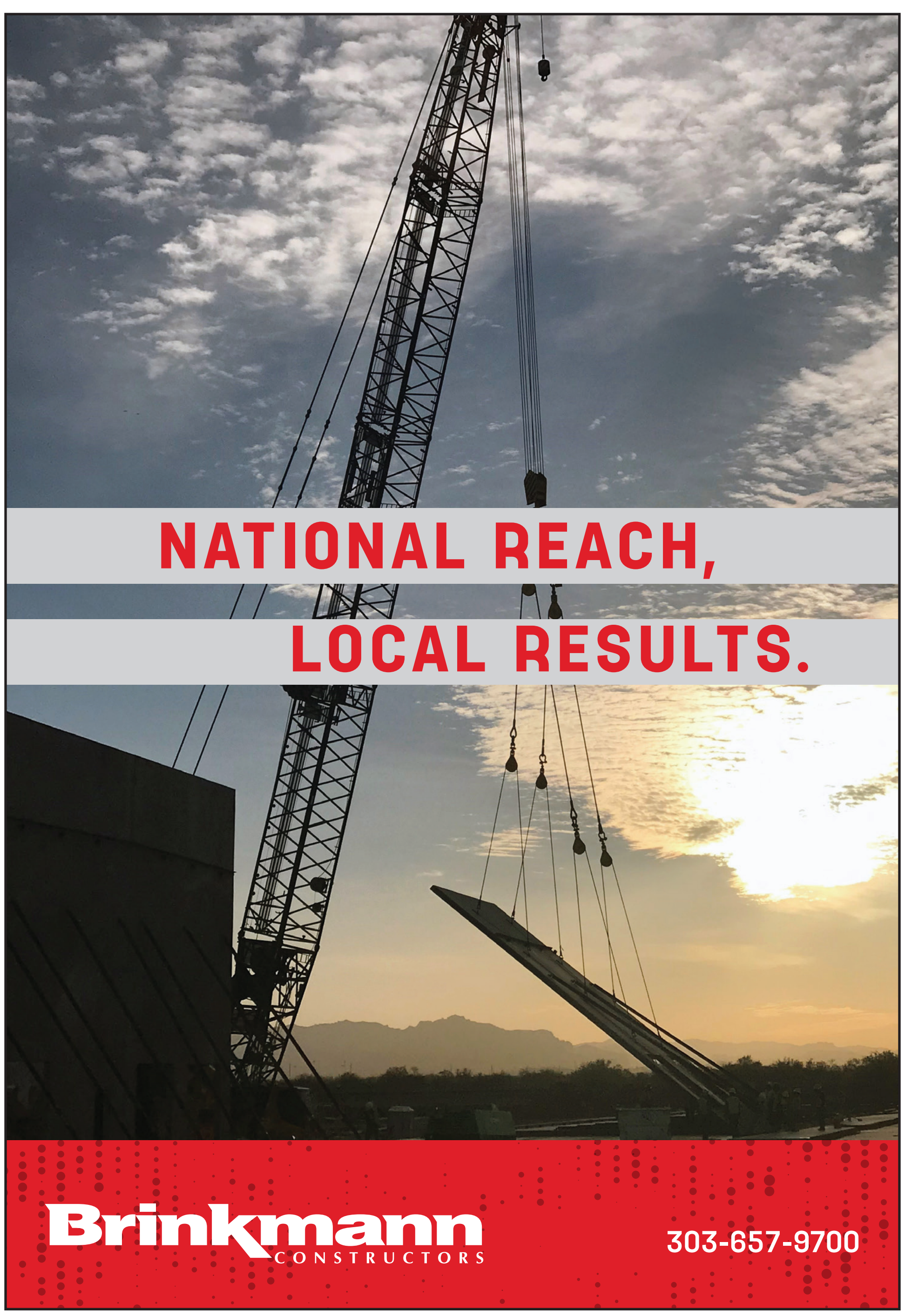


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## INDUSTRIAL — MARKET TRENDS

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the community's review. Though the document cites a land use plan that proposes to increase the industrial land usage from its current 1.4% to 2.1% in the future, the development characteristics set forth seem to support more flex/research lab space, and indeed the plan stipulates, "The city may impose a stricter standard for more intense industrial uses." Within the plan, warehousing and wholesale distributors are classified under secondary uses, which "are not intended to be dominant within a character type and are evaluated on a case-by-case basis to determine appropriateness." As a result, there is not a single piece of land outlined in the 2040 comprehensive plan that allows distribution as a use by right.

The de-emphasis of industrial-use zoning is common practice within community planning, where the development of industrial warehouses often feels antithetical to the community goals of fostering beauty, sustainability and future growth. While this may have been the case 20 years ago, new strides within efficiency and design practices have spawned a new era of industrial development, one in which industrial buildings are more efficient and attractive as well as play a vital role in the economic prosperity of their communities.

The first and most important change within industrial development is the increase in LEED-certified industrial projects within the last decade. Though LEED certification was contained to build-to-suit industrial projects, given the narrow parameters, a 2013 revamping of the U.S. Green Building Council's criteria allowed for speculative buildings to achieve LEED certification as well, driving a shift toward green building practices. As of 2016, there were 307.1 million square feet of LEED certified industrial projects in the U.S., with another 348.8 million sf of industrial projects registered to be certified.

Along with the trend of lessening the environmental impact of industrial buildings, the shift toward LEED certification and green building also has had a profound influence on industrial building design. Far from the dreaded "big box" of old, features like clerestory glass windows and sustainable landscaping make industrial buildings more visually appealing. With this shift, buildings have become less intrusive and fit more comfortably within community visions of synergy and beautification among property types.

Another factor that often seems overlooked in community development plans is the fiscal impacts of different land uses, which influences the types of services that shall be rendered, tax rates that must be levied, budgets for school systems and public safety, costs of infrastructure projects, etc. This information often is determined by a "cost of community services" study, which calculates the net fiscal impact of land use by comparing revenue generated by a particular land use to its associated expenditures to identify the overall impact.

Residential land uses, for example, often have a negative fiscal contribution, meaning that the local government must spend more on services than it receives in tax revenue. On the other hand, commercial/industrial have a positive fiscal impact, providing tax revenue and local employment opportunities while requiring relatively little in terms of public service.

Even before the pandemic, the industrial sector has been a major driver for economic activity and growth within a community. However, the perceived negative impact of industrial buildings on neighborhood values has caused local municipalities to work to restrict industrial development, causing a shortage of industrial-zoned land. As industrial buildings evolve to be more efficient and less intrusive and the need for last-mile space grows, it's reasonable to hope that land allocation for industrial product in the Denver market may increase. ▲

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trial real estate.

Experts expect Denver to follow that trend, with JLL's Industrial Insight reporting that: "Tenant appetite for space caught up with new supply added in Q1 and Q2 2021, helped in-part by the ease of new construction starts compared to the prior quarter. Another shift from quarter to quarter was the rise of a more diverse tenant mix engaging in the market, as the previous darling, e-commerce, took a temporary back seat. The return of a more varied tenant mix over the past three months – present in both leases executed and users seeking space – is a promising sign that Denver's economy, payrolls and consumer confidence have begun to rebound."▲

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in average asking rent this year. The gain will prolong a stretch of positive annual rate growth that started in 2011.

The capital markets and investors in Denver industrial real estate ultimately will be the biggest benefactors from this unprecedented bull run. Industrial deal flow in Denver rose 5% during the trailing 12-month period ending in June. The number of transactions executed during fourth-quarter 2020 represented the highest three-month total dating back to at least 2000. Amid the uptick in sales activity, average pricing fell 2% to $176 per sf, while the mean cap rate increased 20 basis points to 7%. Warehouse sales have accounted for three-fourths of all sales activity since last July, with nearly 70% of these trades involving sub-$5 million properties. Investors have been most active in east I-70/Montbello and northeast Denver, with the two submarkets accounting for roughly 40% of metrowide deal flow since July of last year. Out-of-state investors have accounted for approximately 40% of total deal flow since the onset of last July, with these buyers most active in Centennial, Commerce City and north Denver. Outside the Denver metro area, industrial sales activity was elevated during the past year ended in June. Deal flow in both Boulder and Colorado Springs more than doubled on a year-over-year basis, while transaction velocity in Fort Collins improved by nearly 20 property trades.

So, you ask, how is it to be in industrial real estate here in Denver? The answer is simply great! ▲

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interested in buying their properties.

As the industrial market continues to see increased competition, investors still feel compensated for their risk, even as cap rates continue to compress. Market characteristics show a favorable outlook that generally supports the increased pricing on a square-foot basis, as construction prices for new product have accelerated upward at a faster rate than existing product's sales pricing per sf. Positive absorption is promoting investor movement toward industrial products and bolstered the belief in upwardly trending market rents. The low interest rate environment and lender demand for industrial product also have supported the yield compression within the sector. Each of these items allows investors favorable conditions to underwrite industrial assets and feel comfortable with their risk-adjusted returns compared with other assets classes.

There are risks associated with the sector, however. As new supply is planned and delivered in the Denver metropolitan statistical area from developers rushing to build product to meet current demand, investors are seeing new industrial assets coming on line (and to market) at a record pace. High-cube distribution and manufacturing spaces top the list for product in the pipeline, yet subsections of the industry such as flex-industrial, life science and data center space also are teed up for near-term delivery. Projections are for approximately 9 million sf of supply to come on line in the Denver MSA over the next few years, potentially applying downward pressure on rents and rent growth as demand for space is met and excess supply is realized.

To combat this risk factor, some developers have begun to diversify their offerings of new properties to life science and single-story flex properties, as these asset types have become desired for their high ceilings and multifaceted uses. Thanks to COVID-19, traditional office users are finding value in the single-story, open floor plans and lower occupancy costs found in flex-industrial assets. With no elevators, less common area to maintain (lower operating expenses), lower rents and the popularity of an industrially designed office, there has been increased demand from tenants for this type of space. As more user types enter the industrial market, the risk of oversupply diminishes and may create even more opportunities for investors to enter the industrial space, and into assets that are not just oriented toward logistics, manufacturing and warehousing.

Owners of existing industrial assets should rejoice, as the current market conditions are extremely favorable for them if they choose to sell, refinance or recapitalize. The investment market continues to show favor toward, and value in, industrial assets as more investors and lenders have entered the space. The shift in portfolio allocation from nearly all classes of investors also has led to increased demand for industrial opportunities. This has led to an increase in developer activity, promoted by tenant demand for all types of industrial product, and favorable capital markets that have kept prices rising. Even with significant supply coming on line, investors can realize favorable risk-adjusted returns in today's climate. Whether it is institutional or private equity, capital allocation has shifted favorably toward the industrial space with investors looking aggressively for more opportunities in Denver. ▲

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## O'Brien

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McWhinney, to support brand commitment and core values, is also focusing on amenities, architecture and the worker experience to make for a healthier, safer and friendlier environment. The Iron Horse Industrial Park in Johnstown will include a landscaped outdoor plaza with a communal fire pit and seating, featuring an artistic stone bench to be fabricated by a local artisan.

■ **On the horizon.** As the pandemic recovery advances, Colorado's industrial real estate sector will continue to benefit as demand for industrial product remains strong. Changing consumer patterns will continue to drive e-commerce, and retailers will continue to increase inventories to avoid shortfalls. CBRE is forecasting that the U.S. market will see positive absorption for the foreseeable future.

McWhinney is planning further development in Centerra with a new industrial campus for large distribution users and additional spec product in Iron Horse. In Baseline, additional speculative flex industrial space is underway with 152,000 sf under construction plus two buildings totaling over 300,000 sf in the design and entitlements stage, planned to be fully permitted and in position to break ground by March 2022. The community also has about 15 acres currently available for build-to-suit flex industrial users.

While the past year has been a stark reminder to always remain prepared for the unexpected, we feel confident in the future of industrial real estate, with the best yet to come.

*Additional contributors to this column include: Peter Lauener, executive vice president of master planned communities for McWhinney; Clyde Wood, vice president of commercial development – Northern Colorado for McWhinney; and Mike Eyer, first vice president with CBRE.* ▲