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THE INDUSTRIAL Spotlight

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High Demand for Stabilized Assets With a Long-Term Lease Boosts Investor Interest in Industrial Sale-Leaseback Deals

Appeal of sale-leasebacks on the rise. The convergence of three factors has sparked increased interest in sale-leaseback options for companies that own and occupy industrial space. The extended growth cycle and emergence of e-commerce has spurred demand for industrial space nationwide, pressuring vacancy rates to their lowest levels on record. At the same time, industrial property values have risen substantively, offering property owners significant profit potential that can be reinvested into their businesses. Adding to this mix, new tax rules placed in effect this year will reshape business interest deductions and the cost-effectiveness of businesses owning the real estate in which they are located. The new tax code also allows for businesses to depreciate 100 percent of certain assets over one-year, leading business owners to invest more extensively into current operations. As a result, more companies are investigating sale-leaseback options. Through a sale-leaseback, the owner-user sells the real estate in which he or she operates to an investor, and then leases the property back for a fixed period of time. This process unlocks the equity of the property, providing the company with additional capital to grow the business. The seller continues to occupy the facility per the terms of the agreement.

Strong fundamentals grows investor sentiment for industrial properties. Last year, the U.S. industrial vacancy rate fell 20 basis points to 5.1 percent, the lowest rate in more than 17 years and down 510 basis points from the high recorded in 2010. Substantially tight vacancy comes at a time of robust supply growth, with completions reaching a new high for the current cycle in 2017, at 245 million square feet. Considerable rent gains have also been recorded, marked by four straight years of 5 percent or greater increases, topped off by a 7.8 percent bump in 2017. Fundamentals in the sector will remain favorable through this year as the vacancy rate is forecast to decline 20 basis points in 2018, supporting an anticipated 6.6 percent increase to the average asking rent.

Owner-Users benefit from tax law changes. The new tax reform rules, signed into law last December, restrict companies'

Executive Summary

- Investor's desire to own a stabilized asset with a long-term tenant, and the ability for an owner to unlock equity for re-investment into operations pushed industrial sale-leaseback transactions to a new cycle-high.
- With rising interest rates compressing yield spreads in sectors such as traditional multifamily and retail, the higher returns generated from industrial properties and more mainstream awareness of the industry have become more attractive to investors.
- Changes to the tax code have limited the benefits for businesses to own the real estate in which they operate while at the same time promotes investment into the company through accelerated depreciation.
- Industrial owner/users are most prevalent in the 20,000 square foot to 50,000 square foot range, occupying roughly 54 percent of properties traded in this tranche last year.

Construction vs. Vacancy

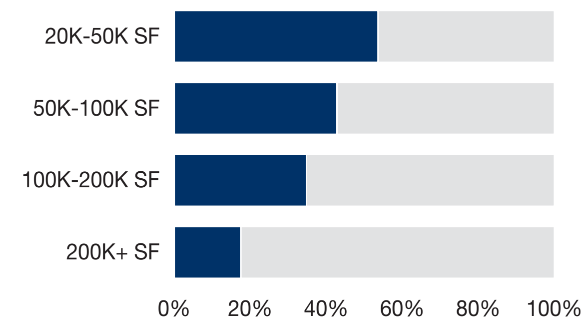
Source: CoStar Group, Inc. Transactions $1M+

ability to deduct the interest on debts, but the new law keeps lease expenses fully deductible. As a result, some companies could reduce their tax expenses by selling their facilities and leasing them back from the investors who purchase the properties. Because of the structure of the sale, the companies can retain the right to manage the use of their space while maintaining stable real estate costs.

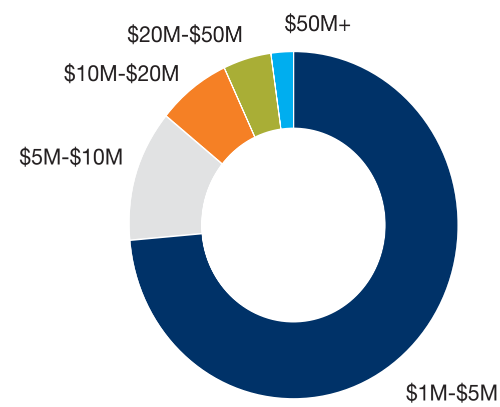
Bulk of sales trade for less than $5 million. Sale-leaseback transactions of industrial buildings last year were greatest in the 20,000-to-50,000-square-foot range, as owner-users dominated this space. For properties traded in this tranche last year, the average price was $93 per square foot, providing private investors with a large inventory of assets for less than $5 million. Deal flow in 2017 recorded a 13 percent year over year increase to a dollar volume just above $2.6 billion. The first-year yield on assets in this segment varied greatly in 2017 and was largely dependent on location and tenant creditworthiness. Cap rates for these assets trended higher than most other property types, ranging from the upper-6 percent to low-7 percent band.

Private investors motivated by ease of operations, stable cash flows. Institutional investors and REITs have traditionally been active buyers in sale-leaseback properties, but in 2017, private investor activity accelerated for this segment. Investors find these assets particularly appealing because of their very limited management needs and their steady income stream. Key considerations are the tenant's creditworthiness, how critical the property is to the function of the business, the property location and the lease terms.

Owner/User Percentage of Sales By Size Tranche in 2017



2017 Industrial Sales by Price Tranche



Source: CoStar Group, Inc, Transactions over $1M+, Includes Flex

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Moody's Analytics; Real Capital Analytics.

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