Industrial Sale-Leaseback Deals Continue To Boom Despite Rising Interest Rates

Owner-Users More Willing to Cash Out Real Estate Due to Increased Debt Burdens, Recession Fears

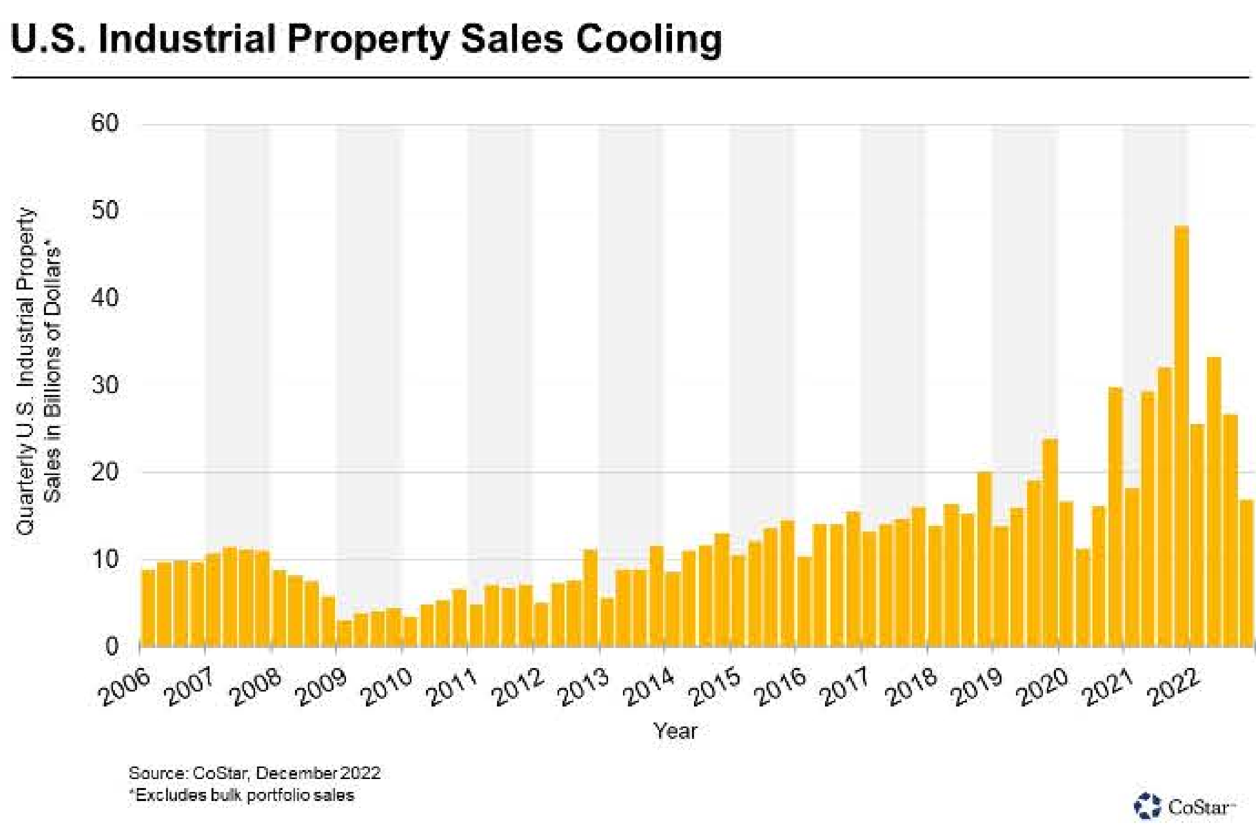
By Adrian Ponsen

In response to the Federal Reserve's rapid interest-rate hikes, mortgage rates on new commercial loans hit more than 10-year highs during the fall of 2022 and have remained elevated ever since. These higher rates have created a more challenging environment for brokers looking to finalize commercial property sales, and for investors looking to add properties to their portfolios.

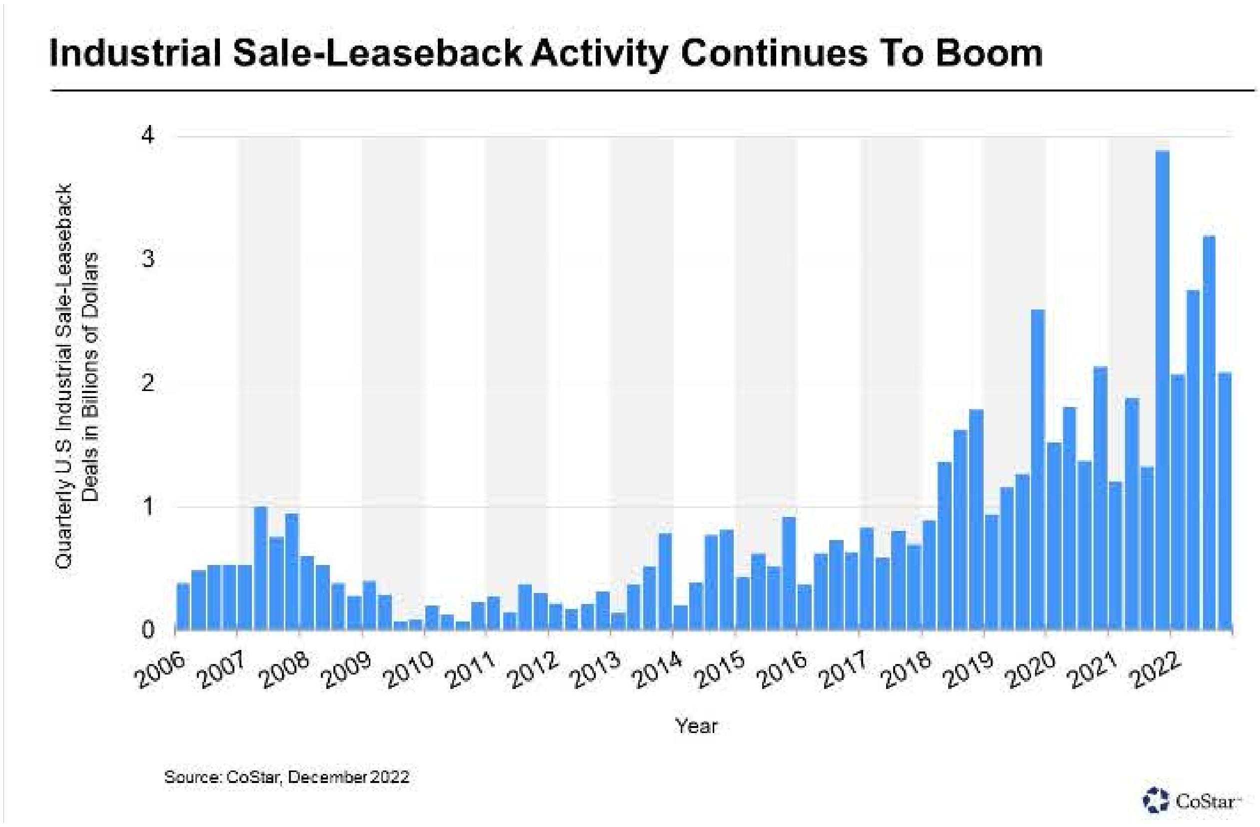
Even investment in the red-hot industrial market has begun to slow despite the sector posting double-digit year-over-year rent growth. At the end of 2022, U.S. industrial real estate sales, excluding large portfolio transactions, recorded the lowest fourth-quarter tally since 2018.

But amid this disruption, one type of deal continues to post record sales volume: sale-leasebacks of industrial property. In these deals, companies, typically retailers or manufacturers, sell the warehouse or distribution properties they own and agree to lease them back from the new buyer as a part of the transaction.

U.S. sale-leaseback deals involving industrial properties totaled over $5 billion during the second half of 2022, more than double the typical seasonal volume recorded during the five years before



the pandemic. The list of top buyers for these transactions in 2022 spans public real estate investment trusts such as W.P. Carey, pension funds including the Ontario Municipal Employees Retirement System, and privately owned institutional investment funds such as Oak Street Real Estate Capital and Angelo Gordon.



Smaller Markets Welcome

Several of the largest industrial sale-leaseback deals over the past 12 months have unsurprisingly involved properties in the country's largest markets, including Los Angeles, Chicago and Atlanta. However, institutional buyers have also acquired properties in smaller markets.

In September, Angelo Gordon & Co. acquired eight industrial properties in a portfolio deal from Intertape Polymer Group, a global tape and packaging manufacturer. The portfolio spanned markets such as Danville, Virginia; Tremonton, Utah; and Menasha, Wisconsin. As part of the sale, Intertape Polymer agreed to lease back the properties on a 20-year deal that includes two 10-year renewal options. The deal closed for $177 million, or $99 per square foot at a 6.7% pro forma cap rate.

Another example is Roskam Baking Co.'s sale-leaseback in October of seven buildings located primarily in and around Grand Rapids, Michigan. Broadstone Real Estate bought that portfolio for

$325 million, or $84 per square foot.

Owner-Users More Flexible Than Most Sellers

The unique flexibility of the sellers in many of these sale-leaseback deals likely explains, at least in part, why these transactions have continued to close in large volume despite challenging capital markets conditions.

Sale-leasebacks aside, one factor driving the recent moderation in broader industrial property sales has been the widening gap between buyer and seller expectations regarding pricing.

Faced with commercial mortgage rates that have doubled since the beginning of 2022, buyers expect to factor these higher financing costs in transactions through discounted prices.

However, most potential sellers hold industrial properties with record-high occupancy rates and fast-growing rents, giving them little motivation to capitulate to buyers' demands, resulting in lower property sales activity.

But owner-occupants of industrial buildings weigh a very different set of variables when considering whether to sell their properties. When engaging in sale-leaseback deals, owner-occupiers often focus on raising capital and reducing their businesses' overall debt.

These were key factors driving ShopHQ's decision to sell its headquarters in Eden Prairie, Minnesota, along with two of its distribution centers in Bowling Green, Kentucky, for $48 million. The home shopping network plans to use proceeds from the sale to retire existing debt and increase working capital, according to Tim Peterman, CEO of ShopHQ's parent company iMedia Brands, as stated in a November release announcing the deal.

Those considerations mean that owner-users are often less concerned about timing their property sales to correspond with an optimal interest rate environment than a typical private equity real estate firm that may be solely focused on maximizing returns.

Higher Capitalization Rates to Cushion Higher Mortgage Rates

As a result, even amid turbulent capital markets, owner-users may be more willing than other sellers to accept higher cap rates that still offer buyers a premium over prevailing lending rates. For example, Intertape Polymer Group's aforementioned September 2022 sale-leaseback with Angelo Gordon closed at a 6.7% pro forma cap rate, above the fixed interest rate of 6.3% that the new buyer secured via a 10-year, interest-only CMBS loan totaling $103 million.

Pigment manufacturer Venator's sale-leaseback of its 1935-built Los Angeles manufacturing facility in October also closed at a 6.7% cap rate, one of the highest cap rates CoStar has recorded on a sale of a Los Angeles industrial property larger than 100,000 square feet since 2015. That property is also notable for playing a supporting role in Michael Jackson's iconic "Thriller" music video.

There appear to be few obstacles that could slow this boom in sale-leaseback deals over the next several months, particularly for industrial properties. CoStar currently tracks more than 32,000 owner-occupied industrial and flex properties larger than 50,000 square feet across the U.S., almost double the combined total of office and retail properties that meet this same criteria.

Meanwhile, even if U.S. economic conditions deteriorate further in 2023 as many expect, this could create even greater impetus for industrial owner-users to consider sale-leaseback deals as a way of fortifying their balance sheets against softening sales and higher borrowing costs.