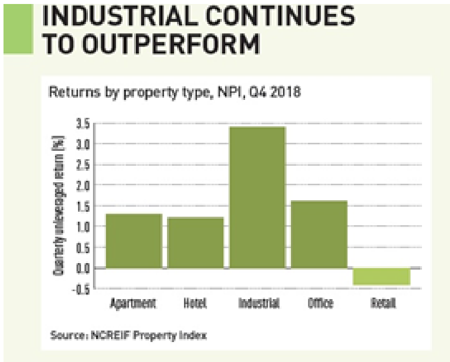
**Commentary from Cohen Asset Management**

As industrial real estate continues to outperform the other real estate sectors, more and more core fund managers are seeking to increase exposure to the industrial sector. However, this has proven to be a challenge given that industrial product is generally cheaper on a unit basis than other asset types and typically involves smaller deal sizes. As a result, the desire by fund managers to increase exposure efficiently has led to an increase in larger scale portfolio transactions and entity investments.

## US core funds: Industrial odyssey

By Christopher O'Dea | March-April 2019




*Industrial real estate continues to outperform all other sectors.*

The NCREIF NFI-ODCE index, made up 25 open-ended funds with US$211bn (€186bn) in assets under management collectively, is an effective proxy for the core US real estate market. But it is struggling to reflect the unprecedented demand for industrial and logistics exposure among institutional investors. To go by the sector weightings of US core funds, one might imagine the e-commerce boom, which has reshaped consumer buying behavior and global supply chains, never happened. Warehouse property remains a modest slice of the typical core fund allocation, with some funds holding as much as 80% of assets in office, multifamily and retail property.

But this is changing. In recent years, core funds and their investors have been on a digital odyssey. They are seeking to increase exposure efficiently and are searching for ways to access the complex sector. "We've seen a structural shift in managers' focus on industrial," says Avery Robinson, senior vice-president and co-manager of Callan's Real Assets Consulting Group. "Industrial is one of the four major sectors, but it has historically been the smallest one."

Following several years of strong relative income and price performance, core fund managers have "concluded from the underlying tenant demand and rental growth outlook that the prospects for the industrial sector remain positive", Robinson says. "So, although industrial is still a smaller allocation than other sectors, it's definitely growing and there's a comparative reduction in allocations to some of the other sectors."

The boom in industrial property took investors by surprise. The "expansion in e-commerce has seen supply chains repurposed and demand for logistics facilities surge", according to a recent global real estate report by UBS Asset Management. "We have been upbeat on the industrial sector," the report notes, but "our expectations proved too cautious and performance has been even higher than we were expecting".

Industrial outperformed all other sectors in the last three months of 2018, according to the NPI (see figure), generating a total return of 3.4%, exceeding office (1.65%), apartment (1.35%), hotel (1.21%) and retail (-0.43%).

In fact, industrial has led all property types in total return in every quarter since the first quarter of 2016, when industrial performance was, ironically, beaten by retail, according to Chad Messer, director, portfolio management at EverWest Real Estate Partners. How times have changed. In an assessment of industrial property performance in the NCREIF Property index (NPI) in the third quarter of 2018 NCREIF Performance Report, Messer notes that "retailers have been rushing to compete with their e-commerce counterparts, resulting in retailers reallocating space usage from stores to warehouses", while investors, "seeing industrial as the new retail, have followed suit and are rebalancing portfolios towards higher industrial exposures".

As a result, industrial property constitutes 17.4% of the NFI-ODCE index – up 80bps on the previous quarter and 2.6% compared with the 14.8% allocation five years ago, according to a review of ODCE funds by Thomas Miller of Union Square Capital Partners for NCREIF. The increase was funded by reductions in other core buckets. "Another notable change in property-type allocations was a decrease in the office allocation by 60bps," Miller writes. This trend "has been noticeable over the past few quarters".

With all that going on, investors have changed their tune and are now scrambling to either increase their allocations to the industrial sector or deploy capital to warehouse assets for the first time. The Oregon Public Employees Retirement Fund (OPERF), for example, is considering how to increase its exposure to industrial property as part of a plan to commit up to $1bn to real estate in 2019. The capital could be deployed via open-ended funds or separate accounts, and could lead to changes in the investor's manager line-up. Lincoln Property Company has managed a $668m industrial property portfolio on behalf of OPERF since 2000, but the pension fund has yet to decide whether to continue the relationship.

But building exposure quickly to logistics is invariably a challenge, principally because it tends to involve small individual lot sizes. "Pound for pound, industrial is a less expensive product," says Robinson. "To aggregate industrial assets into a portfolio, or to achieve a higher degree of exposure to the sector, can be challenging simply because of how small in value some industrial product is as opposed to, for example, office product, where you could buy one trophy office building and materially shift the diversification of your fund. It's been challenging even before industrial became the soup de jour, if you will. It will continue to be challenging for large fund managers to materially increase their exposure in a short amount of time."

If you are a very large investor you can look to corporate deals and acquire platform. At the beginning of the year, two of Canada's biggest institutions – Caisse de dépôt et placement du Québec (CDPQ) and Ontario Municipal Employees Retirement System (OMERS) through their respective real estate arms Ivanhoé Cambridge and Oxford Properties – took joint ownership of IDI Logistics, a platform with 111 operating assets encompassing 31m square feet, previously owned by Brookfield Asset Management.

Core fund managers are having to devise innovative ways to increase their exposure significantly. The JP Morgan Strategic Property Fund, the largest vehicle in the index with $32.4bn in assets, is a case in point. In its bid to increase its 11% weighting to industrial property it has formed a $400m partnership with Denver-based logistics specialist Black Creek Group.

Black Creek is no stranger to the industrial sector. The 25-year-old firm is perhaps best known for creating DCT Industrial Trust and building it into one of the biggest industrial REITs until it was sold to Prologis in 2018 for $8.4bn.

But the partnership with JP Morgan is more notable because it marks the first time that an ODCE fund has invested directly in another commingled fund. According to an investor, who wishes to remain anonymous, the JP Morgan fund has made a commitment to another fund managed by Black Creek as part of the arrangement.

Its unprecedented nature reflects the need to be innovative. "Core funds investing in other funds is rare," says Robinson. "As always, it boils down to economics and opportunity. If the arrangement is structured in a way that's advantageous to investors, you can understand why they would do it."

The push for greater logistics exposure is unlikely to be a short-term phenomenon. Core investors can reasonably expect total returns from industrial allocations to include price gains as well as net-operating income growth.

"Compared to the other property types in the NPI, industrial's implied cap rate is still relatively high," writes Messer. Strong demand from the ongoing evolution of supply chains is expected to support the financial performance of logistics property as investors allocate additional capital to the sector. "While there has been a pick up in supply in selective markets, absorption and rent growth have been keeping up," Messer writes.

At the same time, "investors remain under-allocated to industrial, leading to robust competition and pricing for assets", Messer notes. "Given industrial's perceived income durability and growth prospects – especially in the types of locations owned by NCREIF contributors – it's not a stretch to expect further cap-rate compression for industrial relative to the other property types."

When will industrial's outperformance relative to other property types come to an end? Investors expect industrial to remain the top performing property type for the foreseeable future.

"Barring an [external] event," writes Messer, "industrial appears poised to continue its relative outperformance over the upcoming quarters."

Source: IPE Real Assets

## Who We Are

Cohen Asset Management is a private real estate investment firm that is headquartered in Southern California with a regional office in Northern New Jersey. With a primary focus being the industrial sector, Cohen Asset Management has an established history as an active owner-operator that is comprised of a team of seasoned real estate professionals who create value for our investors by establishing mutually rewarding relationships within the industrial real estate community in each of our Target Markets, particularly with tenants (our customers), brokers, sellers and ultimately the buyers of our real estate when we monetize investments.