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Industrial: The mark to market investment strategy - by Harrison Klein

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Why are institutions buying industrial buildings at extremely aggressive cap rates? It’s all about the opportunity to move the low in-place rents up to market. This is known as a “mark to market” opportunity. While office and retail rents generally sit at or above market, industrial rents are commonly 10%-50% below market. Buy one of these buildings, push rents up by 30%, sell at a similar cap rate, that’s the basic strategy. This strategy is not only open to large institutions buying massive properties. We see these conditions frequently on smaller $1-$5 million properties.

A client of ours recently bought a small industrial building near Cape Cod. The single tenant is currently paying $13,000 per month with three years remaining on their lease. This space would command rent today of $18,000 per month, the current market rent. Unfortunately, because the tenant has a legally binding lease the rent cannot be changed during the three-year lease. When that lease ends, the rent will increase to at least $18,000 per month, a $5,000 increase! If you elect to sell the property, that $60,000 per year will be worth $850,000 assuming a 7% cap rate. This investor will be more than doubling an initial $650,000 down payment in only three years! Conversely, that increase in rent would allow you to refinance the building, pulling out 100% of your initial equity. All within three years and achieved without assuming any increase in market rents.

Key factors when evaluating this type of investment strategy:

1. What is the current cash flow? Is it enough to support debt service while you wait for the lease(s) to roll over? Are you comfortable with that cash-on-cash yield for several years?

2. How long will it take to achieve the higher market rents? A 1-3 year mark to market opportunity is very different than a 10 year one.

3. What will it cost you to achieve the higher rents? How fast can you re-lease the property? What are the tenant improvement budgets? Will you need to evict some tenants or renovate the building?

4. What will be your strategy after achieving higher rents? What are cap rates for stabilized buildings in this market, will that go up or down? What financing options might be available? Are all partners on the same page?

This strategy exists because industrial rents have doubled in the past five years. Most owners have fixed leases that have not yet reset to today’s high rates. For investors willing to defer cashflow today in exchange for long-term returns, this is, in my opinion, one of the best investment strategies. Warehouses might not be sexy, but they can be extremely profitable!

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