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Institutional Real Estate Americas

Dermody Properties

Investing in choppy waters:

Strategic investment in the current market

An interview with members of Dermody Properties' leadership team

The Logistics Campus, Glenview, Ill.

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with members of the Dermody Properties' leadership team: **Douglas A. Kiersey Jr.**, CEO and president; **Timothy Walsh,** partner and CIO; **Elizabeth Kauchak,** COO; and **Wes Hardy,** partner, Southeast Region. Following is an excerpt of that conversation.

Doug, can you speak to Dermody Properties' main strategy?

Douglas Kiersey: Our strategy is built around investing in markets and submarkets where there is a high barrier to entry. That high barrier to entry allows us to be able to maintain landlord pricing power by growing rents faster than the national average. When we look at a tier 1 market, such as Chicago, Atlanta or New Jersey, it is always with our rifle-shot approach into the submarkets and even the micro-submarkets where those conditions persist.

We have a mantra in the company, "Great assets and great locations attract great customers." While that seems very simple, it is hard to execute. When we talk about high-barrier markets, we are talking about a high percentage of actual redevelopment versus greenfield development, which, by its nature, has more moving pieces. We have built a very mature team around the strategy of sourcing and executing these types of difficult assignments.

The industrial sector has had a great run, predating COVID-19. What's next?

Kiersey: The value of logistics assets has been affected by a rising interest rate environment. The immediate impact is that asset valuations have had downward pressure. Cap rates have moved from the high threes and low fours into the mid-five range for class A products in the top U.S. markets. So, the assets are worth less on an apples-to-apples basis than they were two years ago.

The second impact is that the higher interest rate environment has made a lot of new projects infeasible, which has resulted in limited supply. Limited supply is a good thing if you are a landlord looking for pricing power, and we think that is manifesting itself in the markets today. It is likely going to peak in 2025 and 2026 if these trends continue. In the very near term, however, there is a little bit of a supply overhang from the days of the pandemic, when a lot of new product was conceived and executed. Against that, a slowing economy driven by higher interest rates manifests in a longer decision period with our customers and lower demand for U.S. logistics real estate. Those lines are going to cross at some point in 2025. We will have worked through the supply overhang, and there will be a shortage of new supply from that point. Vacancies will peak in the 5.5 percent to 6 percent range, we believe, and then they will start to trend back down during the next 18 to 24 months.

Tim, how do you evaluate development versus acquisition opportunities?

Timothy Walsh: In a market such as this, where there is some oversupply in certain places and a little more caution from tenants coming into newer buildings, there is a sentiment that you are not exactly getting paid for development risk — given the permitting and approval process and the risk inherent in getting buildings built. It is almost riskier to be adding older product to your portfolio because tenants today need newer facilities to take advantage of the efficiencies needed in ecommerce and advanced manufacturing. Our approach is to look for newer products to add to the portfolio. When evaluating acquisition opportunities, we are interested in acquiring buildings built within the past 10 years. We are comfortable in taking development risk, given our company's 60-year foundation of primarily development activity.

Are you seeing signs of overbuilding in certain markets? Is that affecting leasing terms from prospective tenants?

Elizabeth Kauchak: We are seeing signs of deceleration. As of July 2024, the U.S. is on its fifth consecutive quarter of declining construction starts. Leasing is up compared with first quarter

Building 5 at The Logistics Campus, Glenview, Ill.

2023. Vacancy rates in our markets are still very tight. The taking rents growth year-over-year was 9.6 percent, and we are still seeing robust rent escalations in our portfolio. They are higher than the national annual rent escalations — we are at 3.7 percent compared with a national average of 3.6 percent. We are not seeing an impact to leasing terms from the customers currently in the market.

Have the macroeconomic tailwinds — ecommerce, onshoring, etc. — already been priced in?

Walsh: One of the things I love about the logistics real estate market today is the secular tailwinds. There is a lot of momentum in our product type. When we think about the ecommerce revolution, we estimate we are only about halfway into that transition from brick-and-mortar stores to people getting their products through an ecommerce format. Likewise, when it comes to nearshoring and some decoupling from Asian manufacturing as we move away from globalization's extended supply lines, we seem to be in the very early stages of much of that manufacturing coming back to North America — to the United States and, in particular, to Mexico. Insecurities that have come with the war in Ukraine, including the energy insecurities related to the gas pipelines out of Russia, have led some European companies to locate manufacturing in the United States and Mexico. Those tailwinds are strong. As to whether they are being priced in, it is hard to gauge, but we have a long runway for those themes to influence the product type.

What markets or submarkets have continued to perform during the past 24 months? Where have you seen signs of trouble?

Kauchak: For the past 24 months, the majority of the tier 1 coastal markets we are in have performed very well. More recently, Chicago has been doing very well in terms of net absorption during the past few quarters. In terms of markets where we have concerns, New Jersey and Las Vegas are the two that stand out to me, mainly because of the construction supply online right now. We are still seeing strong demand and a diversity of customers, however, which include ecommerce, food and beverage, and construction materials tenants.

Our strategy is to go deep in markets where we have high conviction, so we are active in only about 15 U.S. markets. In the near term, I don't see that expanding substantially. Rather, we would like to capture market share in the markets where we have a high degree of confidence we can invest wisely on behalf of our investors. Everything we do is through the lens of: What is the right thing for investors? How can we achieve returns as a manager on a risk-adjusted basis that are attractive? Looking ahead, we will add strategically to our team as we grow and focus on the markets where we have had very good success.

We recently completed the capital raise for our fourth flagship fund, Dermody Properties Industrial Fund IV. The first and second funds have been fully invested and realized. The third fund is fully invested, and we have already begun investing out of the fourth fund. One of the strengths of the firm is not trying to be too many things to too many people. We have stayed very focused on what it is we do well, and we try not to chase the shiny object. That sounds easy to do, but it is hard to maintain that discipline when you have a constant stream of opportunities coming your way. We are known to have discretionary equity; we are known for our ability to finance our projects in a very difficult lending environment. Some of our competitors who can't meet those standards have had to take a step back in the current landscape.

Why is the Southeast Region such an attractive market for Dermody Properties?

Wes Hardy: We think of the Southeast Region as Atlanta, Savannah, Nashville and possibly markets such as Charlotte, N.C., and Central Florida — Orlando and Tampa. Dermody Properties has great projects going on all over the United States, and the Southeast Region has some long-term demographic tailwinds we will take advantage of, not only in the next few years, but in the next couple of decades.

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First, is net in-migration of population, which leads to more consumer demand for our product type. Second, relative to other parts of the country, the Southeast Region has a relatively low cost of doing business. Third, the Southeast Region has very business-friendly state governments that use all the tools at their disposal to attract industry. Georgia, at last count, had roughly $25 billion of new manufacturing projects started in the past two years. Finally, I would mention current growth and the expected future growth of the Port of Savannah, which is playing off international and national shipping realignments to facilitate its growth in the future. Those are the major long-term trends we can take advantage of currently.

Where do you see the most opportunity and room for growth?

Walsh: As we look to deploy capital nationally, there is a big pricing differential between the West Coast markets and the New York markets, versus the Southeast Region, which generally has lower land and construction costs, and also lower labor costs. We do see the Southeast Region as a cost-effective area of the country that our customers can take advantage of.

Are there any challenges that go along with that?

Hardy: You need to have knowledge and expertise at the micro-market level in markets in which you choose to participate. If you are in the right markets, there are always going to be opportunities for you if you are always focused on the right things. If we do that the right way with the great teams we have in place, we will see growth in our investment platform. And because all these cities are going to grow, there are opportunities in all of them.

We try to be very laser-focused on certain geographic areas. For instance, Atlanta is a 750 million-square-foot market. The northeast submarket in Atlanta is 200 million square feet, which is comparable in size to the entire Nashville market. One interchange off I-85 in northeast Atlanta is drastically different from the next. On a linear basis, that submarket is roughly 50 miles long, highly educated, with different municipalities, counties, cities and demand drivers. You have to have a rifle-shot approach.

Kiersey: To us, a rifle-shot approach means getting down to the neighborhood level, understanding traffic patterns, understanding where the fat part of the demand curve is in terms of the size of buildings you are delivering, understanding the trade area, the demographics of the trade area and the labor situation. One of the outcomes of this strategy, with its focus on urban and close-in suburban locations, is that our average building is a little more than 200,000 square feet. We are unlikely to build a 1 million-square-foot building in the exurbs on a greenfield site, regardless of the market.

Walsh: In each location, Dermody Properties is organized around regional partners. Regional partners have 20 to 30 years of experience in their individual markets. They can tell us what works and what doesn't, which street to be on, what the customers are going to need, what product works in those particular places, how design elements may vary from region to region and micro-market to micro-market.

So, when you have determined the location, then what?

Walsh: Our mantra is to find ways to create pricing power as a landlord. For instance, we have a project in Ontario Ranch, Calif., that is a 1.1 million-square-foot building. We recently signed a lease with Amazon to take that building. In the Southern California market, our building was deemed to be the best situated due to its location. The fact that we built it with 42-foot clear heights, which is a market-leading height, and it had abundant trailer parking, which most buildings in that location could not provide, made it a good fit. It was a highly competitive situation to get control of that site, but we knew it would be valuable over time. Also in Southern California, we have recently secured two sites that are bulls-eye locations in Irvine, Calif. They are designed to be 90,000-square-foot and 130,000-square-foot buildings, respectively, and are at the center of the Orange County market, where very little new product is being delivered to that larger submarket or micro-market.

Given the economic landscape this past year, what has changed for Dermody Properties?

Walsh: We are seeing more acquisition opportunities. Before interest rates started rising, we found there was a lot of capital in the market, and people had forgotten to be afraid of leasing risk because of rising rental rates. We found returns that could be generated from acquisitions had been crowded out by this wave of capital and people's lack of fear of vacancy. That has changed a little bit. Today, we are seeing more acquisitions in our portfolio now than we had three years ago. What hasn't changed is our strategy. We are still pursuing the same quality of building in the same types of locations, and we are competing every day to get the yields we need to generate returns for

LogistiCenter at Ontario Ranch, Ontario, Calif.

investors. It is a little bit harder to hit the numbers we need to hit today, but with patience and with a lot of effort, we are securing the right kinds of investments.

What does the future hold for Dermody Properties and its investments?

Kiersey: Providing class A logistics facilities to the best customers operating in the United States is a very competitive business. If you assume that is never going to change, there is a lot of fragmentation in the market. We have national competitors, both public and private, and we have regional and local competitors. The process we described for unearthing these opportunities is quite laborious. We have a team of 78 professionals spread across eight regional offices; we are in-sourcing mission-critical functions, such as the sourcing, development, diligence, project management, construction management, debt placement, asset management and leasing oversight. This vertical integration is one of our strengths.

Are there any areas of concern or challenges your team or the industry is navigating to remain in a position of steady growth?

Kiersey: It is no surprise to anyone that it is more difficult to execute the infill strategy we have described in areas where there is a high degree of sensitivity to truck-centric uses. Every situation has its own facts and circumstances, but being able to obtain entitlements for our projects is probably the biggest hurdle we and our competitors face in the marketplace.

Walsh: We have been successful in getting projects launched in sensitive locations because of our approach. Our aim is to partner with these municipalities, with a willingness to listen and to adjust based on concerns locally. We design our buildings to be environmentally sensitive with abundant landscaping, with solar installations to be energy efficient and, in some cases, with electrified parking lots, so users can use electric fleets in their facilities. We carefully design the traffic flows, minimize noise and light pollution, and we do careful studies so we can demonstrate this will be the case. The best example to date is The Logistics Campus in Glenview, Ill., which is the former Allstate World Headquarters. The site is 232 acres in the middle of a well-established neighborhood. We replaced a leading corporate citizen with a logistics campus carefully designed to fit in, and we received unanimous approval by the city council after a lengthy process of collaboration and discussion with them.

The second challenge on the list that everyone in the industry is facing is increasing demand for power in the United States with a decreasing supply. Coal-burning plants are being removed, with no immediate replacement, and data centers and AI are causing an explosion of demand for power. We are all faced with pretty significant and lengthy delays in getting or securing power for the users who have a lot more need for that key resource.

CORPORATE OVERVIEW

Dermody Properties is a diversified private equity investment management company focused exclusively on the national logistics real estate sector. Founded in 1960, Dermody Properties has invested more than $10 billion of total capital across all platforms nationwide, having acquired and developed approximately 110 million square feet of logistics and industrial facilities. In addition to its corporate office in Reno, Nev., it has regional offices in northern and southern California, Atlanta, Phoenix, Seattle, Chicago, Dallas and New Jersey.

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