BREAKWATER
1031

# Guide to Industrial Real Estate

## What Is Industrial Real Estate?

Industrial real estate is a general term used to describe one of the primary categories in the commercial property market. Industrial real estate supports trade, e-commerce, and supply chains globally and ensures the efficient movement of goods and materials across various markets. This category is one of the most versatile and specializes in providing properties for non-public commercial use.

Industrial properties include:

- Warehouses
- Manufacturing
- Production
- Research and development
- Storage
- Hybrid warehouse/office flex spaces
- Distribution facilities

Think of these properties as where the behind-the-scenes work goes on, such as for scientific research, parcel deliveries, mechanical engineering, or transporting goods. These properties can be both small and large and can range from hundreds of square feet to hundreds of thousands of square feet.

## Industrial Building Classifications

All industrial buildings will have a specific class grade attached to them. Each of these class grades will describe a different type of industrial property investment, as some of these assets may be more likely to see capital appreciation while others are better suited for capital preservation.

Though your return on investment (ROI) will be influenced by many different property factors, identifying these industrial real estate differences can help you make a better-informed decision as you move forward during your search.

## *Pros And Cons Of Industrial Real Estate Investing*

As with the considerations above, you'll also want to be informed of any potential benefits and drawbacks of investing in industrial real estate. Keep the following pros and cons in mind when searching for property and narrowing down your decision.°

### PROS

Industrial real estate can potentially bring several positive aspects to your investment portfolio. Here are some of the top advantages of investing in industrial real estate:

**1. Demand**

If you're looking to add to your investment portfolio, industrial real estate may be a flourishing market in the coming years. The study of demand for industrial real estate in the U.S. shows that nearly 1 billion square feet of warehouse space will likely be needed by 2025 to accommodate the fast-growing e-commerce industry. This soaring warehouse and e-commerce demand brought vacancy rates for industrial properties to an all-time low in 2021. This means there will likely be more development and expansion opportunities in this market for real estate investors.

**2. Longer Rental Terms**

Industrial leases are often longer than residential and self-storage contracts since many of these properties are highly specialized to meet the tenant's needs. Moving to new locations can be logistically challenging and costly for them. Industrial real estate lets you focus on dealing with businesses instead of individual people, so you may end up with a lease that extends for 10 years or more. For real estate investors, this potentially means more predictable and consistent passive income and fewer landlord responsibilities than short-term lease terms.

**3. E-Commerce**

Because the warehouse and e-commerce demand are interconnected, real estate investors can take advantage of the fact that e-commerce has grown by over 50% between 2019 and 2021. Online purchases have flourished, and with them, the need for more manufacturing, shipping, and distribution properties. With these numbers rising, many businesses may need to turn to industrial real estate to opt for fulfillment centers over traditional retail locations.

**4. Lower Maintenance**

Industrial properties don't always require as much upkeep as some commercial property types. It's common in industrial real estate to use triple-net leases, which means the maintenance of the property is the tenant's responsibility. Likewise, these properties generally have longer lease terms, so real estate investors will likely have lower tenant turnover. They also won't need to renovate or do much with the properties as often as they might with an apartment or office building.

**5. Variety**

One of the top benefits of industrial real estate is the variety of property types available to investors. When it comes to large, open spaces like flex warehouses, these properties tend to be leased plain and empty, which means you can open up your property to many different kinds of tenants who have various equipment, production, and storage needs. Compared with some commercial real estate types, industrial properties can often be used for many different purposes. Real estate investors looking to invest in industrial properties may have more diverse tenants, from manufacturing companies to logistics businesses.

**6. Potential for Stability**

All investments have risks, but due to the consistent demand for industrial real estate, these properties may hold value or even appreciate over time. If you're a real estate investor, industrial properties may be worth looking into as the need for warehousing, fulfillment, distribution, and sales centers continue to grow. As mentioned above, industrial real estate also offers plenty of diversity, which means it may be easier to find one that can perform well even with market fluctuations and produce a steady income.

### CONS

As with any investment, it's crucial to remember that industrial properties come with their fair share of potential pitfalls. The following are some of the drawbacks of investing in industrial real estate:

**1. Tenant Risk**

While having a consistent tenant for several years or decades can be beneficial, it can also present a downside. If your tenant struggles to pay rent due to financial trouble, the responsibility will fall on you to resolve the issue, which could result in costly litigation or other legal fees. Essentially, single-tenant occupied warehouses and industrial spaces can work very well or become a headache. It's critical to choose the right tenants for your space, whether it's single or multitenant, to try to avoid these issues in the future.

**2. Long-Term Vacancy Risk**

Long-term leases have their benefits because they can potentially provide more income stability, but it can sometimes be difficult to find a new tenant after a completed lease. For instance, if your tenant of 10 years vacates your industrial property that was built to accommodate their specific manufacturing needs, you might have to invest a significant amount of capital to make the space compatible with other types of tenants and their unique business specifications.

**3. Oversupply Risk**

In any market, there is always the risk of demand decreasing due to many factors. Though the current and future demand for warehouse space appears to be quite strong, this doesn't mean it will always remain this way. For example, suppose many real estate investors build the same type of facility to support e-commerce, such as fulfillment centers. This can cause the market to soften and significantly impact rental and occupancy rates, thus reducing property values. Tenants could opt to move their operation to a different location altogether, such as a state with a lower tax rate.

**4. Less "Flipping"**

With the long-term nature of industrial real estate, there tends to be less opportunity to gain quick profits through flips. Flipping generally refers to the practice of purchasing a revenue-generating asset and reselling it for a profit in a short amount of time. When it comes to industrial real estate, this term often describes how quickly property owners can "resell" their property to a business by way of a lease agreement after vacating the previous tenant.

As some industrial spaces have specific build-outs, it means longer potential holdovers as the space is remodeled to undo the previous tenant's alterations and meet the next tenant's needs. This can lead to several months without a tenant and, therefore, without income.

**5. Less Availability**

Though the industrial real estate sector has tons of variety, there are fewer industrial buildings to choose from compared to other commercial buildings. In the U.S., there are approximately 5.5 million other commercial buildings, while there are only about 350,000 industrial buildings. Granted, industrial buildings usually take up much more space, but this could mean that real estate investors have fewer to choose from in this market.

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## 1031 RISK DISCLOSURE

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- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions; Impact of fees/expenses
- Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits


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