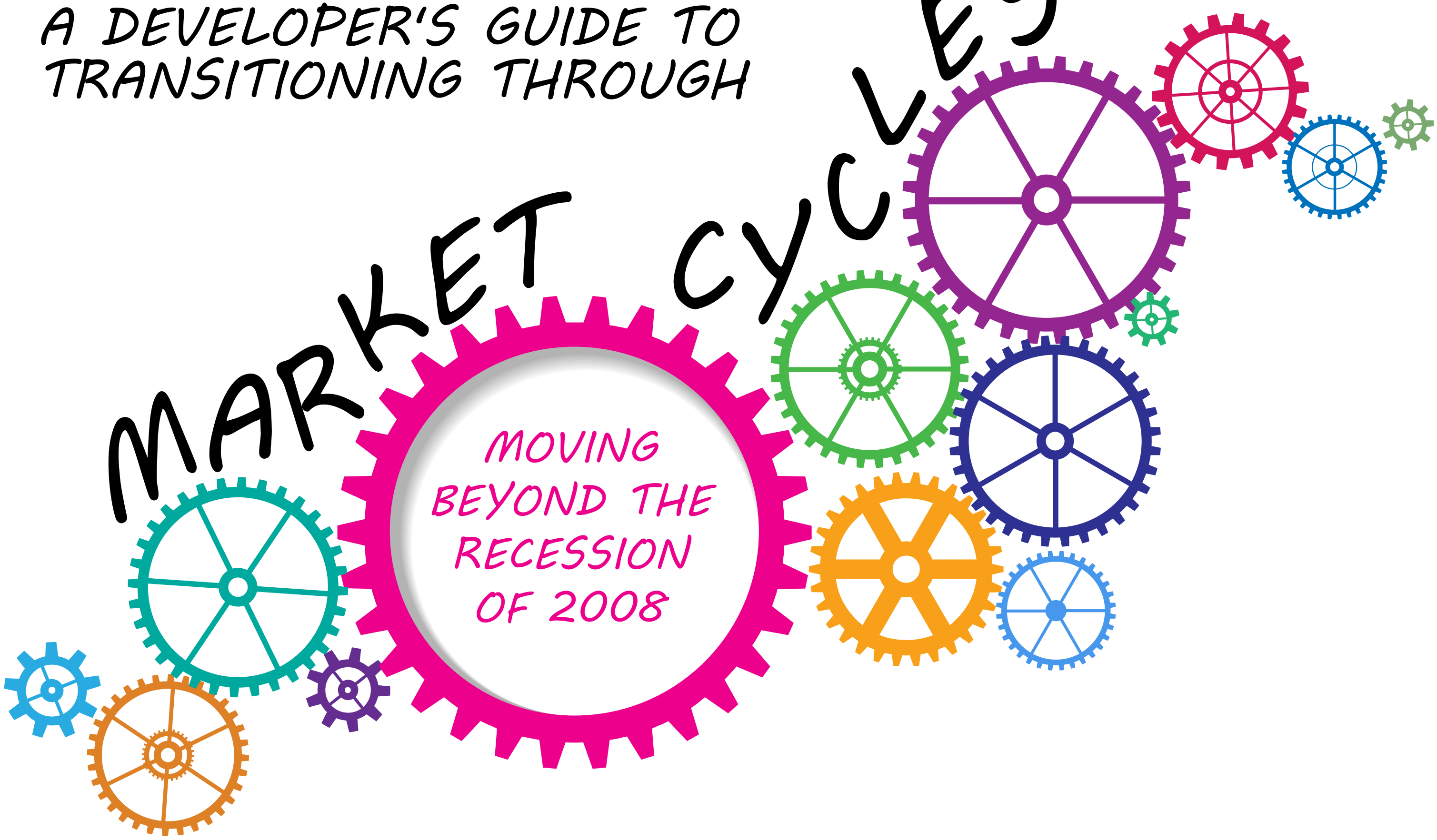
A DEVELOPER'S GUIDE TO TRANSITIONING THROUGH MARKET CYCLES

MOVING BEYOND THE RECESSION OF 2008



By Douglas A. Kiersey, Jr., SIOR

The Great Recession hit every industry hard, but the combination of rapid constriction of demand and the convulsion of the capital markets had a devastating impact on the industrial real estate sector. Moving past the downturn of 2008 has been challenging for industrial developers, both private and public. However, investor appetite for high-quality real estate is healthy, and customer demand for industrial product — while still not at peak levels — has returned.

Over the past two years, Dermody Properties has experienced a burst of activity. I can tell you that we would not be in this position if we hadn't adequately prepared for the recovering economy, beginning our planning even during the most challenging times of the Recession. Anticipating economic changes in order to smoothly transition through different points in the market cycle has been key to our recent success.

GETTING THROUGH THE RECESSION AND PREPARING FOR THE RECOVERY

In 2007, Dermody Properties, in partnership with the California State Teachers Retirement Fund (CalSTRS), sold its 25-million-square-foot portfolio to Prologis for $1.85 billion. The deal made national news in the industrial real estate world because of its scale and market timing. The sale was the culmination of more than two decades of development, strategic investment, and a strong sense of fiduciary obligation to our partners. It was also the result of excellent relationships with brokers, leaders, and customers.

During the Recession, Dermody Properties stayed active in a struggling industrial real estate market through build-to-suits for companies such as Penn Jersey Paper and Urban Outfitters; with opportunistic acquisitions in key markets including Chicago, Central Pennsylvania, and New Jersey. For all of Dermody Properties' success, our CEO, Michael Dermody, would tell you he is most proud of the fact that even during the darkest days of the Recession we made every mortgage payment on time and never "gave the keys back" to any of our lenders. We took the long view to protect and enhance our brand. As a result, our relationships with lenders, partners, customers, and brokers are stronger than ever.

When I joined Dermody Properties in 2011, we began working to determine how to strategically position the company for a rebounding economy. We knew we had to focus on multiple initiatives simultaneously to prepare for growth: our team, our partners, our customers, and our portfolio.

BUILDING STRONG TEAMS AND STRATEGIC PARTNERSHIPS

Our goal at Dermody Properties has never been to be the biggest, but we always want to be the best. As we all know, the people, companies, brokers, and partners you choose to work with have a great impact on your success. As a long-time SIOR, and clearly a broker in my previous life, I knew the importance of attracting and retaining a best-in-class team across our five regional markets. We looked for experienced deal-makers with strong track records of success and excellent reputations in their markets.

Today, we have a team of regional partners that are broker-friendly, responsive and woven into the fabric of their communities. We've built an experienced team that is able to move quickly to take advantage of market opportunities and position us to grow our national platform.

Just as important as our internal team, are the capital partners with whom we co-invest. Dermody Properties has historically created exceptional strategic alliances with capital partners. In 1990, we partnered with the California Public Employees' Retirement System (CalPERS), the largest public pension plan in America. To broaden that financial model, we formed additional alliances with other major partners, including Lazard and Frères & Co. In 2003 the entire portfolio was rolled up into a new partnership with the CalSTRS; partnerships like these supported sustained growth for Dermody Properties.

Following the events of 2008, we followed a different strategy: sourcing and developing relationships with multiple capital partners. This allowed us to acquire and develop in many different markets across the country, giving us flexibility and providing strong returns to our partners. Each capital partner has a unique investment strategy and different return expectations; working with several has allowed us to match the right partner to each opportunity.

ANTICIPATING CUSTOMERS' NEEDS

A major key to success in real estate development — industrial or otherwise — is anticipating the current and future needs of customers. E-commerce has had a significant impact on building design. Companies that are engaged in e-commerce fulfillment, such as Urban Outfitters, require more clear height (a minimum of 36 feet) and more auto parking for employees (1 auto space per 1,000 square feet). Many of these customers also require enhanced electrical capacity and a more robust structural design to accommodate their sophisticated material handling equipment design, as well as a fully conditioned warehouse, which in turn, requires upgraded building insulation.

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The design changes have the aggregate effect of lowering building FAR and increasing construction costs. However, we know that the e-commerce share of U.S. retail sales is rising, which, in turn, will drive e-commerce fulfillment demand for warehouse space. In fact, it is estimated that 30 percent of overall warehouse demand in the U.S. is related to e-commerce. The influence of e-commerce demand on the industrial real estate market is of such a scale that it threatens to prematurely render obsolete a large percentage of the existing rental stock.

Just as our customers have evolved, so must developers. In 2004, Dermody Properties created the "LogistiCenter" concept, a national trademarked brand. The concept involves developing industrial parks and facilities that are innovative, efficient, strategically located, and cost effective. Recognizing these changing customer needs, we have adjusted the LogistiCenter design to remain e-commerce compliant, and we continue to stay close to our customers to anticipate future needs.

STRENGTHENING THE BALANCE SHEET

Nothing good ever happened in this business until a customer signed a lease. Like most other industrial developers, we were long on speculative development when the music stopped in late 2008. Even as the market began to recover, we had some lingering vacancy issues that, in a few cases, weren't fully resolved until 2011.

Once our wholly owned Class A buildings were fully stabilized, we began to execute a capital recycling strategy by contributing these assets to partnerships with both institutional and private partners, all while maintaining a minority ownership interest and the ability to earn current fee revenue and a future promotion. Simultaneously, we identified wholly owned assets that we considered non-core by virtue of their location, size, and/or function. As the market has recovered, we have been able to recapture our equity by selling these assets to third parties.

Some, but not all, of these sales resulted in a profit, but in every instance we made the calculation that redeploying our equity into our core development business would be accretive to our overall return on equity. Selling these non-core assets was also important because it freed up the team to undertake more profitable activities.

READY FOR THE RECOVERY

When I first joined Dermody Properties, we were just barely starting to see the economic up-tick. But steadily, over the past few years, the recovery has gained traction. Demand is rebounding and construction of new industrial product supply remains low by historical

In June 2014, construction began on this 750,000-square-foot facility in Berks Park 78, an industrial park in Bethel Township, Penn.

standards — especially in a few very strategic markets. The recovery was led by the expansion of e-commerce and other large corporations seeking to maximize efficiencies in their supply chains. At the same time, regional and local companies were struggling due to weakened customer demand and lack of access to working capital. As a result, in many markets there was an inversion, whereby market fundamentals were stronger for 500,000-square-foot spaces than they were for 25,000-square-foot spaces. About a year ago, we started to see the return of sustained demand from small and medium sized customers. With a more broad-based recovery underway, we are confident that the development of traditional multi-tenant industrial park projects will be supported by significant rent growth and improved overall fundamentals.

Having the right team and capital solution in place gave us an early mover advantage in our target markets. Today, Dermody Properties is invested, through development and acquisition, in ten U.S. markets. Our plan is to increase our investment in these strategic markets while targeting an additional five markets for future investment. These markets have common attributes (sustainable demand drivers, barriers to entry, and liquidity) but, just as importantly, we are investing in markets where our regional partners and executive team have strong personal relationships with brokers and customers. We believe these relationships are the key to our past and future successes.

LOOKING TO THE FUTURE

Our goal is not to be the biggest. It's not to be everywhere. Our goal is to be the high-quality developer and operator in the most attractive industrial real estate markets. We want to continue to expand our geographic breadth, and to move selectively into new markets with our capital partners. To that end, we recently opened an office in Seattle to better serve the Northwest market, and our team members continue to identify the emerging markets to evaluate and potentially develop.

Ultimately, we expanded our platform by staying true to our values and the strong reputation this company was built on. The task for us now is to continue expanding the same way we have been: with experienced, knowledgeable team members and the support of key stakeholders such as our capital partners and the industrial real estate brokers who help us grow our business.

The work we've done to grow Dermody Properties post-Recession has been demanding but extremely rewarding. Put the right people, in the right place, with the right tools, and opportunities and success will follow. The strategy sounds simple, but the execution is easier said than done. As the song goes, "it's a long way to the top if you want to rock n' roll."

ABOUT THE AUTHOR: *DOUGLAS A. KIERSEY, JR., SIOR, is President of Dermody Properties, a national industrial development firm headquartered in Reno, Nev. He has over 30 years of experience in capital formation, development, acquisition, management and marketing of distribution properties, with extensive experience in more than 20 U.S. markets.*