THE PROPERTY REPORT

Industrial REITs Get a Lift

Growth in online shopping bolsters need for warehouses and distribution centers

By Peter Grant

DUKE REALTY

A Weber-Stephen warehouse and distribution center. Industrial REITs have climbed 17% this year.

Investors in recent years have been ho-hum about online shopping's potential as a growth engine for companies that own warehouses and distribution centers.

Now Wall Street is giving that a rethink.

Shares of real-estate investment trusts that own industrial space have soared 17% this year, compared with 6% for all equity REITs and 1.7% for the S&P 500, according to Green Street Advisors.

In 2015 and 2014, by comparison, industrial REITs underperformed the real-estate market by 0.6% and 9.1%, respectively, Green Street Advisors says.

Analysts believe that internet retail accounts for much of the increase in demand for industrial space. At the end of 2015, tenants in the top 47 markets occupied 101.7 million more square feet than they did at the beginning of the year, according to data firm Reis Inc. That is up from 93 million in 2014.

This year's exuberance partly reflects the strong first-quarter earnings posted by industrial REITs such as **Prologis** Inc. and **Duke Realty** Corp. But the rally also is a sign that investors are recognizing that online retail is going to have a deeper and longer lasting impact on demand for industrial space than previously expected.

One big reason: Processing goods for online distribution is proving to be more complicated and requires more space than processing goods for bricks-and-mortar stores. Prologis, the country's largest industrial REIT, estimates that every dollar of online sales needs three times more distribution-and-warehouse space than one dollar of bricks-and-mortar sales.

"Even if retail sales in the economy stay constant, just a shift from stores to e-commerce is going to grow industrial demand," said Hamid Moghadam, chief executive of Prologis, which controls 667 million square feet of industrial space world-wide.

The growing appeal of industrial REITs contrasts sharply with the pain that online shopping is inflicting on other parts of the retail world. Major retail companies such as **Macy's** Inc. and **Sears Holding** Corp. are getting hammered as consumers increasingly shop online.

Last year, 7% of U.S. retail sales were online, compared with 3.9% in 2009, according to a Green Street Advisors analysis of U.S. Census Bureau data.

Meanwhile, an April report on the industrial sector by Green Street Advisors pointed out that U.S. inventory levels have been rising faster than sales since 2011.

Analyst Eric Frankel said that is partly because e-retailers have needed to keep more inventory on hand as they promised customers shorter delivery times.

> Investors realize that e-retail will have a deeper effect than once thought.

E-retailers also require more inventory space because moving their goods tends to be less efficient than moving inventory for stores. "If you look at major retailers like **Wal-Mart**, warehouses are set up to send truckloads of goods to individual stores," said James Connor, chief executive of Duke Realty. On the other hand, online distribution centers "are set up exactly the opposite," he said. "Everything goes out in onesies and twosies."

As online retail has grown, few expected industrial REITs to be hurt. But it hasn't been clear how much they would benefit.

Many believed retailers would be able to store both online and bricks-and-mortar inventory in existing distribution facilities.

Also, the industrial sector suffered a severe space glut in the aftermath of the 2008 crash. Investors became painfully aware of how easy it was for new space to be built, and many remained wary of industrial REITs during the current recovery.

But so far in this cycle, many industrial REITs have restrained their urge to develop a lot more new space.

Vornado Looks Toward A Final Cut: Washington

By Eliot Brown

For six years, real-estate giant **Vornado Realty Trust** has been lopping off chunks of its empire in a bid to slim down from a sprawling property conglomerate to one more svelte and focused.

Now it appears to be nearing a final excision: Washington, D.C.

Vornado Chairman and Chief Executive Steven Roth in recent months has mentioned with increasing frequency the possibility that the company will spin its chunk of Washington-area offices and apartments—estimated by analysts to be worth about $6 billion—into its own company, separate from Vornado.

"We think each company, if separated, would thrive and would do better than if combined," Mr. Roth said at an industry conference last week, cautioning that no final decision has been made. "It's sort of deconglomerating—if that is a word."

That word, deconglomeration, has been increasingly employed in the lexicon of corporate America in recent years as investors in sprawling companies from General Electric Co. to Viacom Inc. have successfully pushed for more specialization. The overarching theory, particularly in real estate, is that if investors want to be diversified in many sectors, they can do it themselves by buying separate stocks.

Much as GE has dropped its finance and appliance arms, Vornado has been trimming since 2012, when Mr. Roth grew tired of a lagging stock price.

A brash and razor-sharp executive raised in the Bronx, Mr. Roth built Vornado up from a set of New Jersey strip malls into one of Manhattan's largest landlords with top-quality towers like Bloomberg LP's headquarters. But investors had grown weary of the company's lack of focus, including the landlord's ill-fated 2010 bet on J.C. Penney Co., in which Vornado lost an estimated $250 million.

Since the simplification drive was announced, Vornado has sold more than $4.7 billion of property and other businesses, and in 2015 it split off its strip-mall business into a $3.7 billion retail company, Urban Edge Properties. Today, Vornado's portfolio is estimated to be worth more than $30 billion.

The culling has left Vornado focused on New York and Washington, D.C., office and high-end retail space. But there has been a nagging problem: The stock price is still lagging.

Vornado is trading at a large discount to the estimated underlying value of its properties. Its performance has trailed competitors—a fact that helped spur Mr. Roth to embark on the simplification in the first place. Back when the simplification was announced, Vornado's stock traded at a level equal to the estimated value of its properties, according to real-estate tracker Green Street Advisors. At the time, **Boston Properties** Inc.—one of Vornado's main competitors—traded at a 7% premium, while the office sector overall traded at a 1% discount.

By June 1 of this year, Vornado traded at a 13% discount compared with an average 8% for both the sector and for Boston Properties.

Analysts say the reasons are numerous. Mr. Roth, while respected in the industry for his intellect, is renowned for being slow to make big decisions.

And Mr. Roth, 74 years old, has been slow to identify a successor for when he retires, making investors nervous about the direction of the company.

Mr. Roth declined to comment through a spokesman.