CapRock Partners

The industrial pure play

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Jon Pharris,** co-founder and president of CapRock Partners, about the firm's approach to the industrial sector. Following is an excerpt of that conversation.

Tell us about CapRock Partners and its history.

Pat Daniels and I started the company in 2009 during the global financial crisis [GFC], and we recently celebrated our 15th anniversary. When we started the company, the United States was in the midst of the GFC, so our initial investment thesis centered around buying nonperforming notes secured by industrial buildings throughout California. As the economy recovered, we focused on traditional industrial value-added opportunities in California and neighboring states. In 2015, we launched our development platform and are now one of the more prominent developers in the Western United States. Three years ago, I moved my family from Southern California to the Dallas–Fort Worth area and opened our Central Region office, which is focused on investing and developing in the major Texas markets, as well as Colorado.

To date, between both our flagship value-added series and our development platform, we have raised eight funds comprised of university endowments, sovereign wealth funds, life insurance companies, domestic pension funds, hospital systems, family offices and other institutional investors. We have $2.934 billion in gross assets under advisement with more than 50 team members in three offices: company headquarters in Southern California, an office in Phoenix, and our Central Region headquarters in Dallas–Fort Worth. CapRock is a vertically integrated fund manager focused solely on industrial real estate in the Western and Central United States.

What markets, specifically, are you focused on right now?

We are regional sharpshooters focused on investing and developing high-quality industrial real estate in high-barrier infill markets within the Central and Western United States. We have never drifted from our pure-play industrial strategy. Our roots started in California, and over time we methodically and strategically expanded into Arizona, Nevada, Utah and the Pacific Northwest. In 2021, when I moved to Texas, we launched our Central Region, which is focused on investing and developing in the major markets throughout Texas and Colorado.

The industrial sector is resilient, and provided leasing fundamentals maintain near pre-COVID absorption levels, industrial will probably have the least amount of distress of any major real estate product. That being said, some distress is inevitable, given the frothy pricing in 2021 and beginning of 2022. But, unless there is a significant recession, I don't anticipate the distress will be anything like what the industry experienced during the GFC. In my view, the lower middle market, which often consists of less sophisticated investors with smaller balance sheets, will have the greatest concentrations of distress. These investors typically do not have the staying power of larger firms and may not have the resources to re-margin a loan or buy a new interest rate cap when their existing one matures – if they even bought one originally – nor have sufficient capital to pay for leasing costs, let alone carry a vacant or partially occupied building. As a result, these types of investors may be forced to sell, and if rental rates have not grown sufficiently to offset the loss of value due to cap rate expansion, these investors – and in some cases, lenders – may suffer losses.

Are those the types of assets you are acquiring?

We believe the buying window is emerging, and we are focused on prudently deploying capital in our core markets. In our value-added series, we specialize in acquiring assets less than $100 million, with a specific focus on investing between $15 million to $35 million of equity per investment. The properties within our value-added platform are typically between 100,000 to 500,000 square feet and located in major infill markets throughout the Western and Central United States. These are usually shorter-term business plans with the goal to create value and sell within three to five years from our initial acquisition. Given the experience of our team, we can pursue a variety of value-added opportunities, such as redevelopment, mark-to-market with short-term leases, traditional repositioning of older buildings, acquiring nonperforming loans, and developing shallow bay properties, among other value-creation strategies.

Our development platform has a longer investment horizon and focuses on large-scale build-to-core properties that are typically greater than 500,000 square feet with design features to accommodate the needs of *Fortune* 1000 caliber tenants. These build-to-core buildings are designed to be future-proof with 40-foot clear heights, excess trailer parking, truck-first traffic circulation that minimizes vehicular and truck interaction, oversized power capabilities, and parking that can accommodate manufacturing uses. Given the overall macroeconomic environment, our pace of new construction has been muted compared with the past couple of years, when we delivered millions of square feet.

Across our platform, we anticipate approximately 65 percent of our investment will be in the West, with the balance in the Central Region, primarily Texas. We have been active buyers over the past year, and each acquisition has a unique story, with many of them either off-market or distressed or, in some cases, both.

How has CapRock dealt with slowing activity in the past two years, and what strategies are you implementing to move forward?

During COVID-19, because of many well-publicized reasons, the industrial real estate market experienced a couple of years of unprecedented rental rate growth, record-high net-lease absorption and a flurry of construction starts. These factors created a sensation of irrational exuberance, and many market participants seemed to ignore traditional risk premiums and expected the unprecedented growth to last indefinitely. In my opinion, many market participants began underwriting the unprecedented growth as normal and essentially expected trees to grow to the sky.

On the other hand, during these periods of froth, CapRock Partners took a different approach: We were net sellers across our platform and exploited the artificially induced record-low cap rates, we slowed our capital deployment, and we fixed or hedged our loans to take advantage of the lowest interest rates in modern history. In short, we were focused on taking profits and derisking our portfolio so, when the music slowed, CapRock would be well positioned for growth in the next market cycle. As a result of this contrarian and conservative approach, we have a resilient

3200 USA Parkway, which CapRock Partners recently acquired in Reno, Nev.

portfolio with low leverage and do not have legacy headaches from buying at the market peak.

The next market cycle is emerging, with appropriate risk premiums returning for the first time in years. Today, most market participants are underwriting pre-COVID absorption pacing, more realistic rental rates and rental growth assumptions, and higher reversion capitalization rates. While we were intentionally on the sidelines during the market peak, we are now selectively deploying capital, as this may be one of the best entry points for industrial real estate since the GFC. Barring a recession or exogenous shock to the economy, we believe that 2024 may be the bottom for industrial real estate.

What kinds of deals have you passed on, and why?

Our investment philosophy is centered around mitigating risk and protecting the downside. If we underwrite appropriately to protect the downside and acquire institutional-quality assets in infill locations at a discount to replacement cost, then our portfolio will be well positioned to generate the returns our investors desire. Since we are both value-added investors and industrial developers, our DNA is about creating value, buying below replacement cost and protecting capital. If there is no clear path to creating value or not a sufficient risk premium, then we will pass on the opportunity. Maintaining prudent underwriting standards is the reason we have a resilient portfolio today and why we generate strong returns for our investors.

During the market froth, it was nearly impossible to acquire assets below replacement cost, so we slowed our investment activity. Today, some markets and building sizes are oversupplied, so we are avoiding those submarkets and size ranges. In many markets, land pricing has yet to decline, but we do anticipate some softening in land values during the next year or so.

And, while we have a background in entitling complex projects, we are very cognizant of the difficulty of entitling projects in certain municipalities, and so we avoid sites if the city either has an industrial moratorium or has plans to institute one. Development is difficult enough even with a pro-development community, so in our view, it's not worth focusing our time, energy and capital in communities that are anti-growth or where our vision does not match the community's goals.

The buying window is emerging, but it is imperative to maintain disciplined underwriting standards with an eye to mitigating risk, especially given the uncertain economy amid a volatile geopolitical environment.

Tell me about CapRock's philosophy.

Simply put, our investment philosophy is that you make money on the buy, and if you need to use financial engineering to artificially create returns, then you are probably overpaying for the asset. We believe CapRock Partners has the best chance of generating the returns our investors are seeking by acquiring infill properties below replacement cost in growth markets with high barriers to entry. This investment philosophy is paired with our modest use of leverage, which aims to maintain a portfolio goal of 55 percent loan-to-value or less at stabilization.

We are industrial sharpshooters with a regional focus, which has been the secret to our success. CapRock Partners has become one of the larger developers in the Southwest, and we will continue expanding our development capabilities into the Central Region. Given our ability to both acquire existing properties and develop new class A facilities, we often have more tools in our tool belt than some similarly sized peers. These two platforms allow us to be flexible and adjust to market conditions quickly. Our intentionality during the market peak allows us to take advantage of the emerging buying opportunities with the view that 2024 just might be the market bottom.

CapRock Partners is just at the beginning of our story. We recently celebrated our 15-year anniversary and are blessed with great partners and a fantastic team. We have never strayed from our core conviction — the industrial pure play. We are experts in our field. We know what we are and what we do, and that allows us to provide excellent returns for our investors.

CONTRIBUTOR

Jon Pharris

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CapRock Partners

Jon Pharris is co-founder and president of CapRock Partners, where he oversees all facets of the firm's investment activity, equity and debt across the firm's platforms. Pharris also co-manages CapRock's investment committee. Prior to co-founding CapRock in 2009, Pharris worked in acquisitions and development of industrial real estate across Southern California. He currently manages CapRock's Dallas–Fort Worth office and resides in Fort Worth, with his wife and four children.

COMPANY OVERVIEW

Founded in 2009 in Newport Beach, Calif., **CapRock Partners** is a fully integrated, privately owned investor and developer of industrial real estate in the Western and Central United States. Since its inception, CapRock has acquired, developed or entitled more than 32 million square feet of industrial real estate. As of Dec. 31, 2023, CapRock has gross assets under advisement of $2.9 billion with a team of more than 50 professionals across three offices in Southern California, Phoenix and Dallas/Fort Worth. CapRock manages a series of private funds with multiple targeted investment objectives. CapRock's investors include domestic pension plans, university endowments, sovereign wealth funds, life insurance companies, family offices and other global investors.

CAPROCK PARTNERS

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