Logistics & the Industrial Sector

Industrial real estate is having a fantastic year, with third quarter numbers revealing the best performance since pre-recession, according to Ryan Severino, Senior Economist with REIS.

"The warehouse and distribution subsector vacancy rates are at 11.3% and falling, with rents rising faster than 2.0%. For flex R&D, vacancies are down to 13.1%, and rents accelerating by 0.6%. And numbers are still coming in for Q3."

Right now, Ryan told me, the larger properties and class-A space out-perform the market as a whole, and this pattern is expected to continue into 2015. But that rising tide is raising all boats.

See the USA

Looking across the country, warehouse distribution is thriving as retail and manufacturing expand. American consumers want their goods, and distribution centers must be near the consumer to meet demand. Manufacturing is on an upswing, notably in southern 'right-to-work' states, where larger companies are planning and building new facilities.

Port cities are traditionally high performers, but cities like Dallas, Kansas City & Memphis also have thriving warehouse markets due to strong airfreight facilities. Flex R&D space is hot in tech-centered areas like northern California.

Where are the opportunities? East coast ports are gearing up for widening of Panama Canal, which opens in 2016. Another interesting trend is the million+ sf 'monster' warehouses cropping up in markets off the beaten path. We can count on this trend to persist as long as ecommerce is hot.

What's New

New construction for warehouse distribution is at 65 million square feet this year, with 55 million anticipated next year. Flex R&D is not as big of a market at 3.5 – 5.0 million, up from 1.5 to 2.0 million sf, a great improvement over the past few years. That's all good news for the industrial market, the economy and jobs.

In active and gateway markets a significant percentage of building *is* speculative; this varies market-to-market; more so than other property sectors. Industrial construction is beginning to push pre-recession highs. Over next few years we may begin to develop some oversupply.

A Rising Star for Investors

Compared to the other sectors, industrial is making a move for the top position. Multifamily is beginning to fade, and industrial's strong fundamentals are causing investors to take a closer look. This recovery began with apartments, and it took a while for the business economy, and thus industrial real estate, to get moving. Now we can see growth in value as well as the yields that investors want.

Sales volume is strong compared to last several years, on track to meet or exceed last year. If the rumored sale of the $8 billion InCor portfolio goes through, that will be very strong signal that industrial is the rising star going forward. *(Note: At air time the outcome of the Blackstone sale was unknown. The deal with Singaporean wealth fund GIC Pte. LTD was confirmed 12/1.)*

Cap rates continue to compress; the sector averages in the 7s, with lower caps in better markets for better properties. Cap rates will continue to drift downward, perhaps 30-50 bp lower over the next few years. Increased NOI growth and minor cap compression will bring increasing valuation.

For owners, now is a good time to hold. Investors, we're still in the early stages of a recovery, but the boat is leaving the dock.

What's in store for 2015?

Looking ahead, REIS predicts that warehouse distribution vacancy will fall another 150 basis points with rent growth of 2.5 to 3.0%, and flex R&D vacancy will drop 170 bp with rent growth of 2 to 2.5% next year. That's growth over the rate of inflation, so owners and investors can be quite comfortable.

What happens if interest rates begin to rise? Here's what Ryan had to say:

"As long as the economy is improving, industrial doesn't care what channel the goods are sold through. Industrial real estate will benefit from any improvement in consumption and sales. If economy begins to slow, then investor sentiment will cool, and cap rates will begin to rise. Short term or long term hold, you're good. Medium term, three to five years; sharpen your pencils and make sure the deal is right for you."

"We Want our Stuff, Now!"

Logistics, or supply-chain management, is the key to the industrial real estate. The way goods are moved is a bottom line factor for business, and well designed and located facilities are critical. The costs of what we buy includes this cost of moving stuff from place to place.

To get a better understanding of this I spoke to Annie Baxter of the Georgia Department of Economic Development and Page Siplon, Executive Director of the Georgia Center of Innovations.

"On average, logistics adds at least 10% to the cost of goods," said Siplon. "It can run 40% or higher for pharmaceutical or refrigerated items, and 50% to 60% of that can be fuel alone."

Online sales are completely reshaping logistics, says Siplon. Retailers are competing in speed of fulfillment. We want instant delivery. We want customization. The term "just in time" used to be an automotive industry term that has become widespread.

Retailers know your preferences; they try to anticipate your needs and stock items regionally. Large companies like Wal-Mart and Amazon are developing predictable logistics. If you order a hammer, will you order nails?

Ecommerce fulfillment firms handle three times the number of SKUs (item bar codes) items that retail used to juggle, which explains the trend in 'monster' distribution facilities. But it's tough to find those large, flat parcels of land near population centers, so developers have to get creative.

Community Participation is Key

One developer acquired a large enclosed mall, empty for some time, to repurpose for a distribution center. At first community leaders were resistant; they wanted to restore the retail presence as it had been.

"The truth is, that just isn't coming back," said Baxter. "The job potential is what won them over. Now they have a 1.1 million sf distribution facility, and more jobs in the community."

States have to compete with incentive packages to attract businesses, but it takes more than that, according to Anne Baxter, who has helped municipalities develop workforce training for incoming firms.

"The most successful states act like a business to support a business, working to meet the clients' needs. Bonuses like corporate tax offsets, sales and use tax breaks, and workforce development programs are essential, but it's the community that goes the extra mile to help a relocating company hit the ground running will always have the advantage."

States are competing aggressively to give tax incentives and provide workforce, but the logistics must sense. How can you control your biggest costs? The cheapest location is not always the best location long term, if you don't balance the logistics costs against the immediate incentives.

Don't overlook the power of public private partnerships, says Siplon. In-town opportunities are there, but require patience, planning and creative cooperation among multiple partners.

"It's a challenge for companies to pre-negotiate incentives, for locales to market the real benefits, short and long term, of a given community. But in the long run it's in everybody's best interests. The company wants long term incentives to reduce the bottom line, and the state wants the company to succeed."

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