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REAL ESTATE

Discovering opportunities in a dynamic industrial market

KEY TAKEAWAYS

- The number of new construction projects has already dropped, and further declines are expected as interest rate hikes take effect.
- Despite the demand/supply trends being in flux, the sector remains healthy, buoyed by regional-specific opportunities.

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Since the end of the Global Financial Crisis (GFC), the industrial sector has been the best-performing core property type, producing robust returns during an extended period of falling vacancy and strong rental growth.[1]

The COVID-19 pandemic accelerated these trends, leading to record-high demand and record-low vacancy rates starting in 2021 and early 2022.[2]

WAREHOUSE DEMAND IS MODERATING BUT LIKELY TO HOLD

The initial shock of the pandemic led to a spike in e-commerce demand as most consumers avoided traditional retail stores either voluntarily or involuntarily to curb the spread of the virus. The pandemic also caused significant supply chain disruptions, rendering many retailers and manufacturers incapable of meeting demand.

In response, companies scrambled to lease additional warehousing space either to upgrade their e-commerce fulfillment capabilities to meet consumer spending patterns or to modernize their supply chains to insulate themselves from future supply chain disruptions.

The sector has experienced unprecedented demand over the past two years, with over 500 million sq. ft. (MSF) of net new demand in 2021 followed by over 400 MSF in 2022.[2] This was enough to push vacancy rates in the sector below 4% for the first time on record and spur double-digit rent growth. Investors and developers in the sector soon took notice, leading to a surge in industrial transactions

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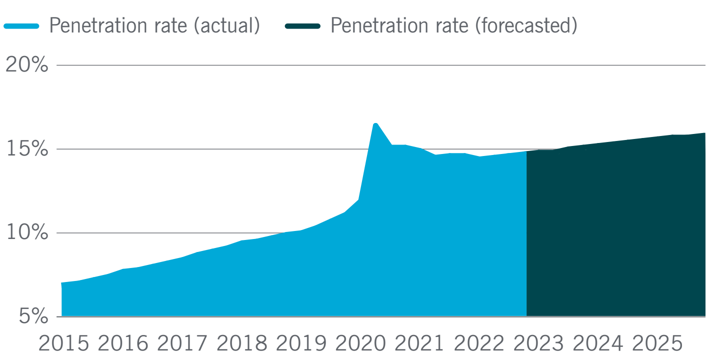
in capital markets and nearly a billion sq. ft. of new industrial space under construction across all U.S. markets.

Demand has remained healthy by historical standards, but sector performance remains tied in part to the performance of the macroeconomy. Demand for new industrial space has decelerated in recent quarters[2] as U.S. economic growth slowed and will likely slow further with the economy expected to flirt with recession in 2023.[3]

However, the structural tailwinds from e-commerce and supply chain modernization will likely prevent net new demand from turning negative. Packaging and shipping individual orders to doorsteps requires more warehouse space than shipping pallets to a store, resulting in 2-3x more industrial space required per dollar spent to support e-commerce compared to brick-and-mortar retail.[4] This continually rising e-commerce penetration rate could help offset a slowdown in consumer demand, but the pace of demand growth is likely to be below 2021 and 2022's levels (Figure 1).

Figure 1: E-commerce penetration rate

% of total retail sales



Source: US Census Bureau/Moody's Analytics

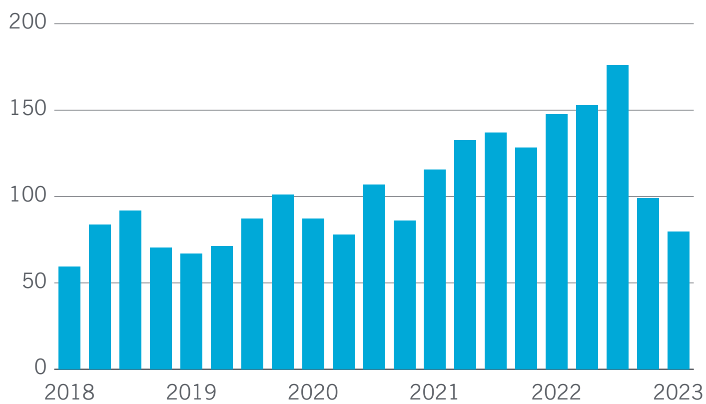
NEW SUPPLY IS SURGING BUT WILL EASE NEXT YEAR

On the supply side, we are starting to see a large amount of construction projects delivered in 2023 amidst tapering demand, causing vacancy rates to moderately elevate from historic lows. Despite vacancy increases in each of the last two quarters, the 4.3% national vacancy level in Q1 is still 290 basis points (bps) below the sector's long-term average and nearly 100 bps below the vacancy level before the pandemic.[2]

New construction starts have already pulled back dramatically, with starts in Q1 2023 just half of the peak starts in Q3 2022. Starts will likely continue to weaken in upcoming quarters, as high-interest rates and tighter lending standards have made commercial real estate development more costly. Industrial projects currently take around five quarters to complete, which suggests that the pace of new deliveries is likely to slow noticeably in 2024 and 2025 (Figure 2).

Figure 2: Starts continuing to weaken

New industrial starts (million sq. ft.)



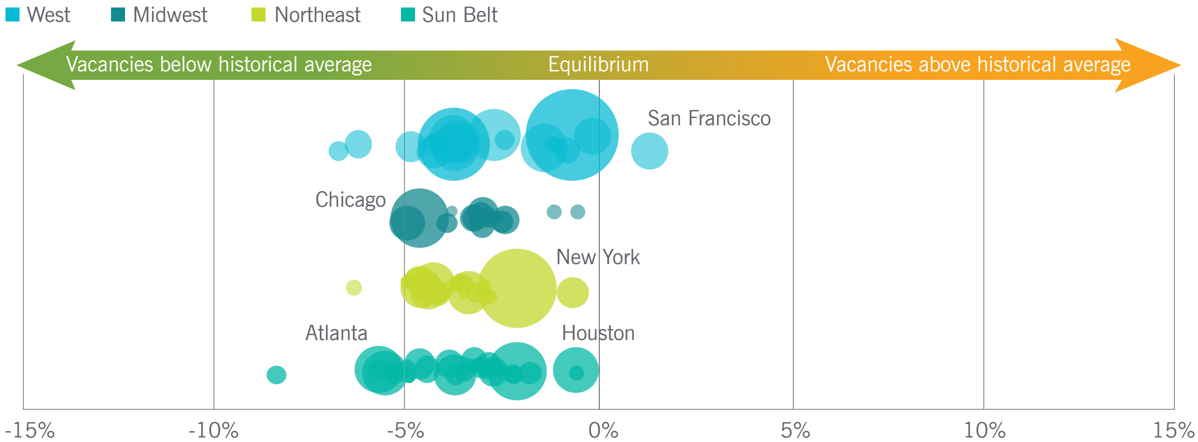
Source: Costar as of Q1 2023

REGIONAL CHALLENGES EMERGING ALONG WITH NEW OPPORTUNITIES

Despite shifting supply/demand trends within the sector, industrial fundamentals are likely to remain strong by historical standards even if the sector softens from record performance in 2021 and early 2022. Of the top 80 largest industrial markets, only San Francisco has a vacancy rate higher than its historical average (Figure 3).

Over 850 MSF of industrial space is currently under construction across all U.S. markets, of which nearly 300 MSF is already pre-leased. Current vacancy rates are so low that even if all speculative space under construction is delivered completely vacant, vacancy rates in the sector overall would

Figure 3: Current vacancies relative to pre-pandemic average vacancy



Source: Costar as of Q1 2023
Pre-pandemic average vacancy is calculated from 2000–2019 where data allows.
Bubble size represents the relative industrial asset value in the market

only rise to 6.4%, still below the historical average vacancy of 7.2%. This is an encouraging sign for asset managers and investors in the sector, as overall rent growth seems to have exceeded historical norms in every period where vacancy falls below historical averages.

While a record amount of space is set to deliver in the sector over the next several quarters, there are still markets and locations within markets that will be less affected by oncoming supply. Coastal markets typically have less land available for development and typically have far less under construction, particularly in Mid-Atlantic and Northeast markets like Baltimore and Northern New Jersey. Even markets that are experiencing a wave of new supply, there are infill locations and submarkets that have far less competing supply under construction and are likely to continue experiencing low vacancies and high rent in the near and long-term.

BIGGER DOES NOT MEAN BETTER

There are also noticeable differences in the supply/demand dynamic when looking at size ranges within the industrial sector. Demand over recent years has increasingly been focused on larger building sizes, reflecting a focus by companies to hold more inventory outside of large population centers.

To meet this surging demand, most new deliveries in the sector have been of buildings that are 250k sq. ft. or larger, and under construction square footage is also mostly in larger size ranges.[2] With demand beginning to ease at the end of 2022, the pace of new deliveries as a percent of inventory (completion rate) is higher than the pace of new demand as a percent of inventory (absorption rate) for buildings larger than 500k sq. ft., indicating that conditions in this size segment are loosening. Because the supply pipeline is also larger in this size cohort, vacancy is likely to rise despite higher demand for larger spaces.

By contrast, the completion rate for spaces under 250k sq. ft. has slowed in recent quarters and continues to fall short of demand in this size range.[2] The supply pipeline is far smaller in this reduced size range, particularly in buildings under 75k sq. ft. where less than 1% of the current stock is under construction (Figure 4).

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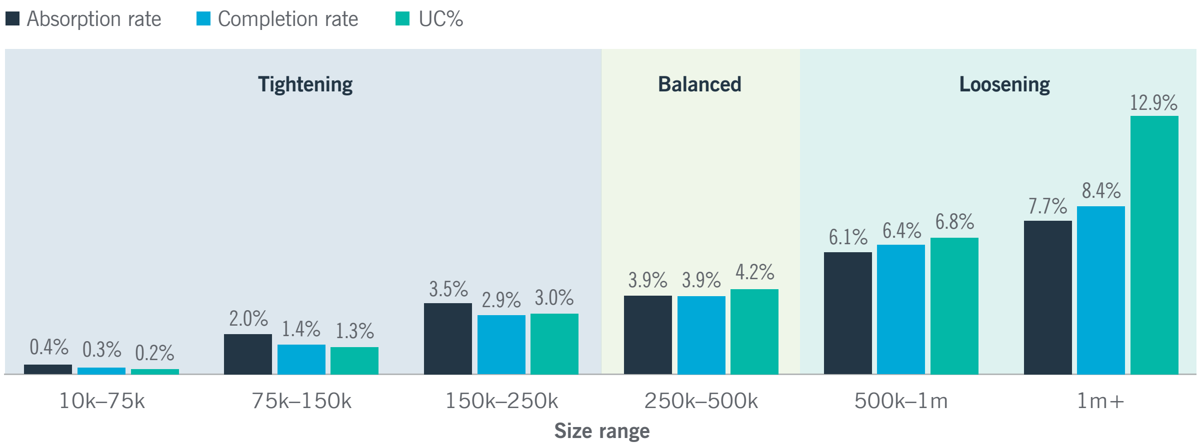
Overall rent growth seems to have exceeded historical norms in every period where vacancy falls below historical averages.

Figure 4: Absorption, completion and construction rate



Source: Costar as of Q4 2022

Further, there are noticeable differences when looking at the dynamics of the industrial sector by age. It is worth remembering that approximately half of all existing warehouse space in the U.S. is over 35 years old.[2] Often these older buildings have lower clear heights or insufficient parking facilities, making them less ideal for modern supply chain operations.

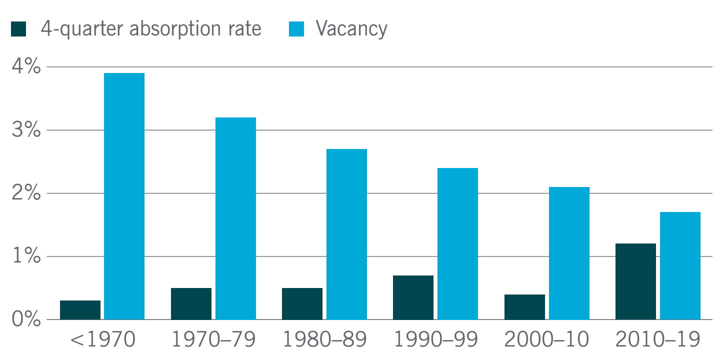
Except for new buildings (<3 years old) which often are delivered vacant, older warehouses tend to experience higher vacancy rates than newer ones. In addition, absorption trends tend to improve among newer cohorts of warehousing space. These differences among age ranges are likely to widen in upcoming quarters, as loosening conditions in the sector provide an opportunity for tenants to trade up for newer space. Newer buildings, particularly smaller light industrial-sized properties, are likely to continue to experience solid demand and face less upcoming competition in the form of new supply (Figure 5).

INDUSTRIAL REMAINS ATTRACTIVE DESPITE CHANGING DYNAMICS

The changing dynamics of the industrial sector are creating numerous key themes that are likely to influence performance in 2023 and beyond. The first is the combination of a weaker macroeconomy and accelerating supply that is likely to translate to some weakening in the sector from an extraordinarily strong position in the near term. Long-run tailwinds from e-commerce and supply chain diversification should continue to drive strong demand for industrial space, and the recent slowdown in new industrial starts suggests the pace of new supply will slow in 2024 and 2025.

There are also noticeable differences in terms of age, size and location when thinking about the performance outlook. Coastal markets and infill locations typically have high barriers to new supply and should continue to experience low vacancies despite conditions loosening in the sector overall.[5] Much of the construction in the industrial space has been concentrated in larger building sizes as well, while newer light industrial spaces should continue to experience low vacancies and solid demand (Figure 5).

Figure 5:Warehouse and light industrial vacancy and absorption by year built



Source: Costar as of Q4 2022

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Endnotes

Sources

1 NCREIF 2023
2 Costar 2023
3 Moody's Analytics 2023
4 Prologis Global Insights 2020
5 Green Street 2023

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