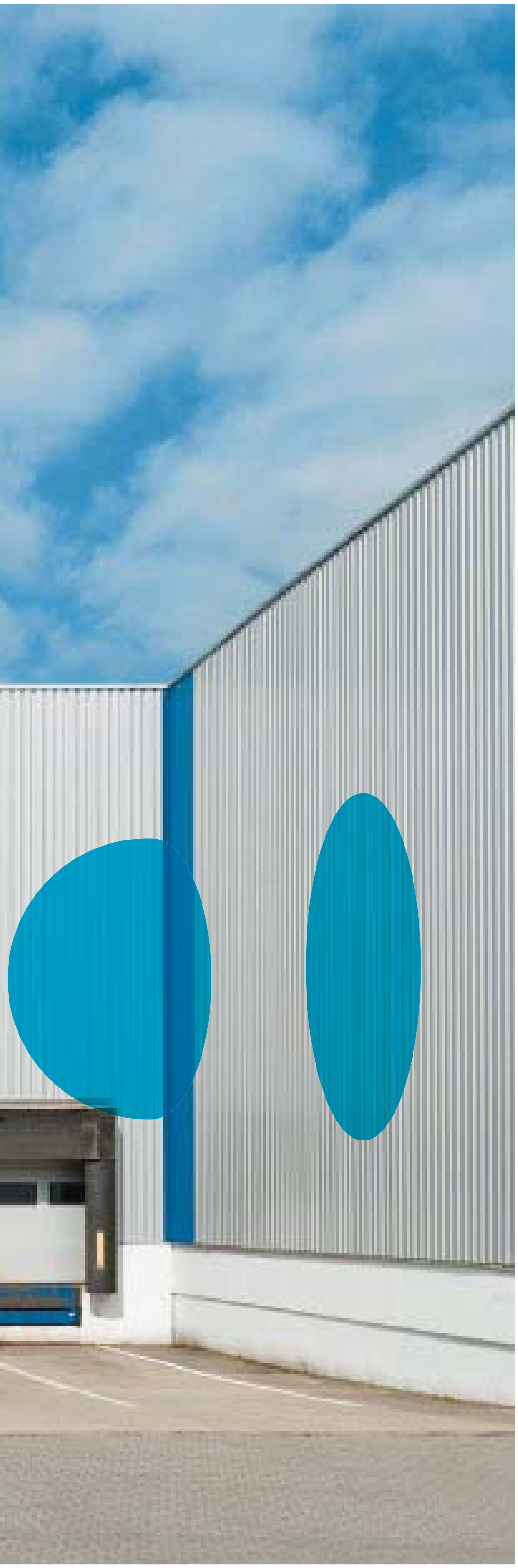
COMPANIES GOBBLE UP EXCESS WAREHOUSE SPACE AND SEARCH FOR MORE.



by Beth Mattson-Teig

Industrial brokers across the country have something in common these days. They are busy again. A steady demand for space and a hot investment market are driving transaction activity across the board, ranging from land and building sales to leasing transactions and development.

"I think the national industrial market has improved pretty dramatically," says Terry E. Smith, CCIM, SIOR, executive vice president and partner at Colliers International in Nashville. That improvement is evident across the country from major metros to smaller secondary and tertiary markets. "In some markets there is a lot of optimism, while in others there is more cautious optimism. But, I think everybody feels pretty strong about the market coming back and improving," says Smith.

Bolstered by the improving economy, expansion is picking up across a wide variety of industries ranging from auto manufacturing and energy to food processing and third-party logistics. Nationally, the warehouse and distribution vacancy rate fell to 11.3 percent in second quarter, according to data from Reis Inc. Vacancy has declined by more than 50 basis points in the past year and is now 290 basis points below the cyclical peak of 14.2 percent that occurred in third quarter 2010, according to Reis.

"The industrial market is right on the cusp of a recovery cycle. I think we are going to continue to see increased demand for space driven by manufacturing, but also distribution requirements including the very strong e-commerce market," says James Barry III, CCIM, president of Cassidy Turley Barry in Milwaukee, Wis. In southeastern Wisconsin, where the industrial market spans some 270 million square feet, the vacancy rate is hovering near 6 percent. The growing demand for space coupled with very little speculative development has accelerated the recovery. "We have had about four years of sustained, positive absorption of industrial space in the southeastern Wisconsin market," says Barry.

In tertiary markets such as Bend, Ore., the surplus supply of space disappeared quickly once the demand for space returned. The Bend market spans a little more than 4.5 million sf of industrial space, and in 2012 more than one fourth of that space — 1.2 million sf — was vacant. Over the past 18 months there has been a huge increase in demand for industrial space for lease and industrial buildings for sale, notes Brian E. Fratzke, CCIM, principal broker at Fratzke Commercial Real Estate Advisor in Bend.

The demand for space spans all types of users across manufacturing, distribution, and warehouse space. "We are virtually out of industrial space, and we really don't have any new industrial inventory coming on the market any time soon," Fratzke says. That demand has caused rental rates to surge back to near pre-recession levels. On the leasing side, rental rates have increased more than 140 percent from February 2012 to May 2014, Fratzke says. Rates have gone from 25 cents per sf per month triple net in 2012 to 60 cents psf per month currently.

Construction Pipeline Grows

The steady absorption of available space is sparking a tentative return of new development. Reis expects the new supply of industrial space to reach nearly 50 million sf this year, which is up from the 36.5 million sf completed in 2013. Although that volume is still well below pre-recession levels, construction appears to be gaining momentum.

The North/Central New Jersey market has shown strong signs of increased demand for space during the last 12 months. The industrial market spans roughly 300 million sf of space, and the vacancy rate has dipped to 9.1 percent, according to CoStar. The growing demand for space has sparked a number of new speculative development projects, most notably along the New Jersey Turnpike between Exits 10 and 13.

Due to the shrinking supply of space, the North/Central New Jersey market has reached a point where functionally obsolete buildings are being purchased and demolished to make way for the construction of new, modern class A distribution facilities, notes Ian M. Grusd, CCIM, SIOR, a principal at GreenGate Capital in Tinton Falls, N.J. "We are actually seeing a building boom," he says. For example, Clarion Partners and

Trammell Crow are co-developing nearly 800,000 sf of speculative industrial space in Piscataway, N.J.

The greatest demand is for spaces that are 100,000 sf and greater with ceiling heights in excess of 30 feet and trailer parking. E-commerce distribution companies and third-party logistics providers in particular need modern "big box cubes" and they are willing to pay the price for new space, Grusd says. The growth in e-commerce and a shift to create more regional distribution centers for those goods sold online is driving leasing activity in markets around the country. "New Jersey continues to benefit due to its strategic location between Boston and Washington, D.C.," he says.

Amazon.com is building large, 1 million-sf distribution centers in multiple markets across the country. That same phenomenon also is occurring at a smaller scale among the middle market companies. Grusd recently leased 25,000 sf of warehouse/distribution space to a company that sells custom-built furniture online. The firm is a retail partner with Amazon, and the business has expanded dramatically due to e-commerce sales, he says. The company relocated from Brooklyn to New Jersey in a space that allows them to triple their size and also provides better logistics for shipping and more competitive occupancy costs.

In the Midwest, major metros such as Chicago, Indianapolis, and Kansas City have seen developers come in and build large speculative industrial buildings. That activity is beginning to trickle down

INDUSTRIAL SALES

Buyer demand pushes prices higher in secondary markets.

by Beth Mattson-Teig

Buyers that have been steadily returning to the industrial arena put the foot on the gas at the beginning of 2014. Led by robust sales activity occurring in secondary markets, national transaction volume surged higher in first quarter.

Year-over-year sales rose 50 percent to reach $11.3 billion in first quarter, according to Real Capital Analytics. The increase marks the strongest beginning to a year since 2006 with sales that span a wide variety of geographic markets and most property subtypes. What is notable is that secondary markets experienced the biggest increase, with a 53 percent YOY gain — more than double the volume gains in either primary or tertiary markets, according to RCA.

Sales activity has been buoyed by improving vacancies and rents, as well as the continued push from investors to find better values in secondary markets such as Indianapolis, Charlotte, N.C., and Tampa, Fla. For example, 2013 was a banner year for industrial investment sales in Nashville. "There is probably not one week that goes by that an investor does not call looking for opportunities to enter our market," says Terry E. Smith, CCIM, SIOR, executive vice president and partner at Colliers International in Nashville. Last year, 14 class A facilities totaling more than 5.4 million square feet sold for $244 million. That is the highest level of industrial investment sales that Smith has seen across his 33-year career in the industry.

"Investment sales are white hot and trading at historic low cap rates," says Kevin McGrath, SIOR, CCIM, a senior associate, Brokerage Services at CBRE in Columbus, Ohio. Pricing is back to pre-2007 levels, and Columbus has seen new institutional investors enter the market for the first time with the purchase of multi-property portfolios. "Lease term does not seem to be much of a factor in pricing as investors are not shying away from terms as short as 36 months, especially if there is opportunity for rent growth," McGrath says.

In Columbus, the shorter term deals are trading at capitalization rates between 7.5 and 8 percent, while deals with longer lease terms and investment grade tenants are trading at cap rates between 6.5 and 7 percent, he adds. Nationally, cap rates on industrial property sales were relatively flat in 2013, according to RCA. However, cap rates dropped slightly in first quarter 2014 with cap rates on warehouse properties dipping 20 basis points and cap rates on flex buildings remaining unchanged. Overall, the cap rate on industrial properties averaged 7.4 percent during first quarter, according to RCA.

"It is a hot market," agrees Todd Garrett, CCIM, SIOR, principal, Investment & Industrial Services at Avison Young in Mount Pleasant, S.C. "About 10 months ago there was a shift in momentum where we started getting calls from all over the nation from institutional investors," he says. That demand is pushing prices higher.

In many cases, properties are still trading below replacement costs. However, growing buyer demand and a limited supply of property in secondary markets is beginning to impact cap rates. In Charleston, cap rates that were solidly in the mid-8 percent range have now dipped into the 7-plus percent range. "A year ago, we were still getting sale prices at levels as if the land were free. Now we are getting closer to replacement value again," he says.

Previous Spread: hansenn/Thinkstock

to smaller metros. In southeastern Wisconsin, for example, local developers have completed some speculative development in the 100,000-sf to 150,000-sf range. “All of that space has been almost immediately absorbed,” Barry says. Now the regional and national players are starting to move forward on spec projects. For example, Liberty Property Trust has announced a 170,000-sf spec industrial facility on the south side of Milwaukee.

Developers Still Cautious

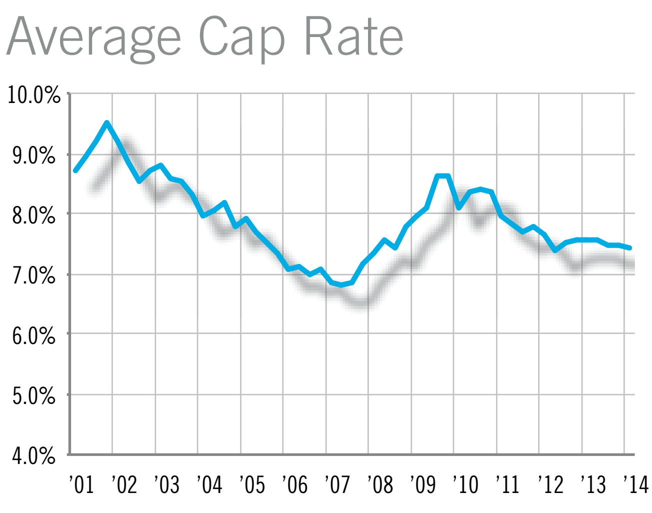
Although the national pipeline of industrial development is continuing to expand, there are a number of factors that have slowed the return of spec construction. Despite improving fundamentals, developers and lenders alike remain cautious. “Most of the people who would be doing development now also owned property in September 2008. So that can’t help but to influence the decisions that are being made today,” says Todd Garrett, CCIM, SIOR, principal, Investment & Industrial Services at Avison Young in Mount Pleasant, S.C.

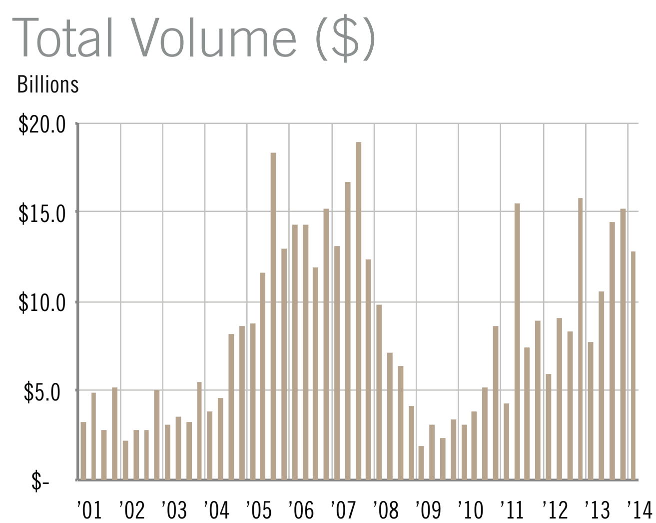
A lack of available financing in some markets, such as Michigan, has curtailed spec industrial development. Another common theme across the country is that rental rates still have not risen to the level that can justify new construction.

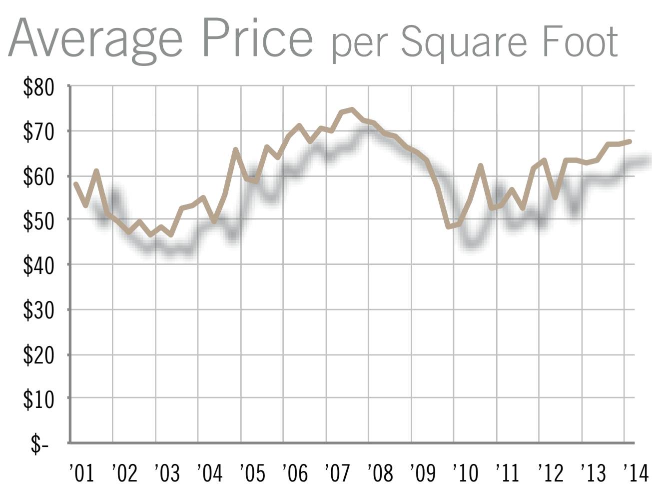
“New industrial development does not pencil because the cost of construction is so high,” Fratzke says. Even though industrial rental rates have increased dramatically in Bend during the past two years, the rents are not high enough for developers to achieve an acceptable return on investment, he says. One concern for Bend is that the lack of supply of space will push rates even higher, which could prompt some businesses to relocate to other communities. “We are already seeing that migration happen where some of the businesses in Bend are moving to outlying cities, because their lease rates are less and they are willing to make the commute,” he adds.

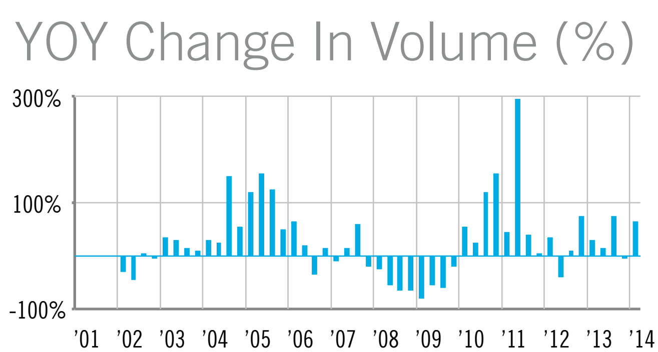
In Charleston, S.C., lease rates are still 15 percent to 20 percent

Industrial Stats









Source: Real Capital Analytics

below where they need to be in most cases in order to justify new construction, Garrett notes. Yet the argument for speculative construction is getting stronger with more projects lining up to break ground in 2015. "Vacancy is at the tipping point. If we have new entrants to the market, they're going to need to build more space to house them. That will push leasing rates back to the levels needed to require new construction," he says. The vacancy rate for Charleston's tri-county area reached 7.9 percent in second quarter 2014, according to Avison Young. Several class A projects are pad-ready and developers are saying they are ready to build even though there is no steel is in the air yet, he adds.

Build-to-Suit Boom

Build-to-suits rather than spec development continue to dominate new construction activity. "This shortage of available space and the fact that we haven't had speculative construction during the last six years has created a very active build-to-suit market," Smith says. During the last year and a half, the Nashville industrial market has added nearly 5 million sf of build-to-suit projects. For example, Panattoni Development recently completed a 240,000-sf bulk facility for Hollister Inc. on the east side of Nashville.

Much of that build-to-suit activity has been driven by the fact that users had very large or specialized space requirements. Facilities larger than 500,000 sf are in short supply in Nashville. Today, there are two options for 500,000 sf and only one option bigger at 700,000 sf. "We have seen an awful lot of build-to-suits over the last two years, but we also are starting to see some people talk about spec development," Smith says. That spec construction is gearing up to be more active in 2015 as vacancies and rental rates continue to improve.

Developers and investors also are taking advantage of opportunities to buy older, obsolete properties at below replacement cost and renovate or redevelop projects to meet modern requirements of today's companies. Today's space users typically demand buildings with high ceilings, improved utilities, HVAC, and early suppression fast response sprinkler systems, more dock doors, and additional land for truck and employee parking.

Ultimately, the growing appetite for industrial space bodes well for owners, investors, and developers, and that momentum shows no signs of slowing. "We are seeing increased demand, and I don't think supply is going to catch up with demand very quickly, because we are behind the curve on that," Barry says. "So, I think we are going to see some gradual upward movement in lease rates and price per square foot, but it is a very positive scenario for the industrial market going forward into the remainder of 2014 and 2015."

Beth Mattson-Teig is a freelance writer in Minneapolis, Minn.