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Outside the box

Rebounding demand prompts a shift in thinking

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KEYNOTE INTERVIEW

Industrial remains hot amid macro shifts

Supply crunch, e-commerce growth keep real estate in high demand, say Crow Holdings Capital's Matthew Colter, Michael Balcom and Kelsea Alexander

While other commercial real estate property types drag, macro shifts in consumer habits and logistics practices have the industrial sector charging ahead. Investors want to know if the rapid growth of the industrial sector could cool or if it is still running hot.

Supply and demand of new construction may be rebalancing, but Crow Holdings Capital's Matthew Colter, senior managing director, industrial; Michael Balcom, managing director, industrial; and Kelsea Alexander, director, industrial, believe it is a fortuitous time for development amid continued growth as major players invest heavily in modern logistics.

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Q What is behind the growing flight to quality trend in the industrial real estate sector?

Matthew Colter: The stock of industrial space in the US is pushing upwards of 40 years old, on average. Those older buildings are becoming obsolete, with shallow building depths, auto and truck traffic that blend together, and lower clear heights. In the past, 18-foot clear heights were the norm, but newer buildings today offer standard clear heights of 36-foot plus. If you have a newer Class A building, you are going to be able to attract more tenants to occupy that space.

Michael Balcom: Some industry observers may wonder why Class A and B are priced so differently. Rent is a relatively small share of logistics spend, around 5 percent. If you contrast that with multifamily, renters on average are spending 30 percent of their income on rent, which makes them more sensitive to price fluctuations. A 10 percent increase will not blow the budget of an industrial user. More dock doors, more parking, more utility, it just makes

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>
> **MICHAEL BALCOM**

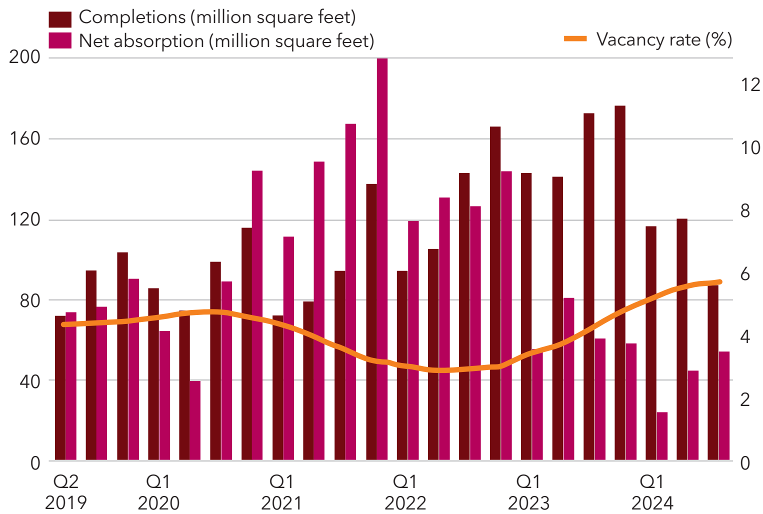
What are some of the key factors contributing to the current supply/demand imbalance in the industrial sector?

MC: We are seeing a dramatic fall-off in construction starts. We had upwards of 700 million square feet of construction going on across the US; that is a tremendously high amount. Now we are below 300 million square feet under construction nationally. Vacancy is still sitting close to 6 percent, which is still right in line with the 15-year average. We see rent growth numbers ticking up as the amount of product being delivered ebbs backwards.

KA: The chart shows this playing out. Pre-leasing is up 3 percent year-over-year as tenants navigate a leasing environment with fewer options due to the supply drop-off, combined with steady demand.

MB: On the demand side, CBRE noted we are on pace for the third-best leasing year on record. We feel like the leasing demand side of the equation is resilient. Contrast that with the significant dip in the amount of construction, and forecasts show that it is going to be a favorable fundamentals environment for owners over the next couple of years.

Industrial completions have fallen as net absorption rebounded in Q3 2024



Source: CBRE Research

sense for tenants to pay a small increase to get that extra functionality, and it's relatively affordable.

How does the demand for modern, functional industrial spaces impact the renovation and retrofitting of older properties?

Kelsea Alexander: We are seeing tenants with more sophisticated buildouts, more automation and AI, and needing more power for various reasons. Some tenants place importance on sustainable building features, and those are significantly more difficult to implement in older buildings. Some aspects of this have resulted in negative absorption in building vintages constructed before 2020.

MB: It's also true that Class B and C cannot easily be renovated into Class A in the industrial sector. If you consider what makes a building Class A, it is a handful of things like clear height, the number of dock doors, column spacing, and trailer and auto parking. It is very expensive, if not economically unfeasible, to change those characteristics on a Class B or C building. For example, it is difficult to add land for parking or raise the clear heights on a building or add dock doors to a load-bearing wall, so we see some of this older product becoming functionally obsolete.

MC: On spaces above 100,000 square feet, 65 percent of all leasing year-to-date is occurring in 13 percent of the inventory, in buildings that were completed after 2020.

In Chicago, around O'Hare, we have had instances where we bought Class B, and then the rents are such a premium for a new building that we are knocking down the existing structure to build efficient new buildings. The math is there to make it pencil out, and we have done it a few times now.

Despite a decrease in supply, why is there still a steady demand for industrial real estate?

KA: Overall, we have seen the broader macro secular trends that have been driving industrial for the better part of the last five to 10 years continue to persist. E-commerce, nearshoring and onshoring and a flight to quality continue to drive the need for additional industrial space.

MC: People need to appreciate that e-commerce has been, and will continue to be, a tailwind driver in the industrial space. Compared to other countries, we have a lot of room to grow. Right now, we are seeing 23.1 percent of all retail sales online, and forecasts show that climbing to 30.3 percent by 2030.

We are seeing nearshoring or onshoring play out with moves like an Asia-plus-one strategy or a full relocation from Asia. We are seeing that heavily on the US/Mexico border as well. On top of that, there is electric vehicle manufacturing and chip manufacturing in the US Sun Belt and across the country. Demand is not going anywhere.

Q Can you expand on how macro trends like e-commerce growth and onshoring are influencing the real estate development pipeline?

MB: Since Mexico replaced China as the US's largest trade partner last year, we have seen outsized demand in those Texas and California border markets and regional distribution markets like Dallas-Fort Worth. We think a lot about the production happening in Mexico being shipped north on Interstate-35.

KA: If you look at e-commerce, traditionally those players need about three times more industrial space than brick and mortar retail. There is a real need for more space as e-commerce becomes a bigger piece of the overall pie. For tenants, industrial used to be an afterthought in their overall operations. That thought process has changed. Now it is a central part of how tenants run their businesses and it is an opportunity for them to become more efficient and to grow their business. They are getting more sophisticated in the build-out of industrial space, and with that, they are willing to commit more capital and more resources to industrial.

Q What are the top US markets and why are they attractive for investors right now?

KA: Some of the top-performing markets in the US for absorption have been DFW, Houston, Chicago and Atlanta.

MC: We like the depth of liquidity in these top markets. You are always going to have someone who wants to purchase. Own your asset where the demand is most active and where you are seeing the highest tenant velocity. Infill product typically has high barriers to entry, but the challenge to find sites like that can sometimes bear fruit.

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> **KELSEA ALEXANDER**

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> **MATTHEW COLTER**

Q What role do infill submarkets play in the performance of the overall industrial real estate market?

MB: Look at DFW: as a whole, it is about 9 percent vacant, but if you go through the exercise of separating the infill submarkets from the peripheral submarkets, you see a big discrepancy in the vacancy rates. You see vacancy rates as high as 16 percent and as low as 6. We see infill markets continuing to outperform. They have higher barriers to entry, more constraints on new supply, and generally tighter vacancy – and, therefore, have more potential for both rent and value appreciation.

Q Amid all this optimism, what are some speed bumps investors should be looking for over the next two years?

MB: Entitlements are challenging. As the industry has delivered a lot of warehouse stock over the past several years in response to the demand, we have seen that in most counties and states it has become more challenging to get permits to build. In some markets, litigation is a growing concern, because municipalities are denying site plan applications for zoned sites and forcing developers to go to court to get permits and entitlements. That is a risk developers will have to understand and be wary of.

MC: NIMBYism is making entitlements tougher. There is a lot of local pushback to industrial use, but at the same time, everyone wants their packages quicker. Leasing is the machine that keeps it all going.

KA: Despite entitlements posing a potential speed bump and an aspect developers and investors pay thorough attention to, these challenges can also represent an opportunity when successfully navigating those barriers to entry. ■