Commentary from Cohen Asset Management

Demand for industrial real estate is booming – thanks in large part to the growth of e-commerce – with net absorption exceeding new supply nationwide for the 35^{th} consecutive quarter. With online sales predicted to grow to 32% of total retail sales by 2030 from only 12% in 2017, the continued growth of e-commerce is expected to drive demand into the foreseeable future. As logistics service providers develop new technologies to automate processes and maximize the utility of warehouse space, industrial developers are constructing buildings to accommodate the future of logistics, including clear heights that now can reach 60 feet.

US: Raising the roof

By Christopher O'Dea | March-April 2019

In December 2018, Lincoln Property Company delivered Lincoln Logistics 40 in Phoenix's West Valley, a 901,000 square foot speculative development with the city's first ever 40' clear height.

Logistics property is raising the roof for institutional investors, literally and figuratively speaking. Demand for property to serve the logistics industry is booming, reflecting strong economic growth, healthy US import trade, robust consumer spending online and in store, business spending on inventory and durable goods, and favorable supply and demand.

"The logistics industry is a rapidly growing force in the US economy, and that is driving extraordinary demand for industrial warehouse property," says Tim Wang, managing director and head of research at Clarion Partners, a $47.8bn (€41.7bn) real estate fund manager that leases 17m square feet of industrial space to Amazon. "Ultimately, warehouse property serves US consumption demand, and the main drivers of demand, total retail sales, imports and business inventory spending, have been very strong." On the supply side, Wang notes, "vacancy is trending lower and effective rent is going higher".

In fact, the vacancy rate for US industrial and logistics sector stood at 4.3% at the end of 2018, maintaining its lowest level since CBRE began tracking the metric in 2002. Net absorption exceeded new supply for the 35th consecutive quarter, CBRE says. It was the longest streak since before 2001, "demonstrating both extremely strong demand for class-A logistics space and the difficulty of building such space, especially in the strategic supply chain markets".

With demand exceeding new supply, net asking rents increased 2.2% in the fourth quarter, reaching the highest level since the firm began tracking the metric in 1989. Rents increased 7.4% year-over-year, according to CBRE, one of the largest growth rates in this cycle and exceeding the average annual growth rate of 4.3% since 2012.

Those conditions have fueled strong returns for investors in the sector. The annualized total return on US industrial property as tracked by the NCREIF Property index has far exceeded the total return on office, multifamily and retail property over the past one-year, three-year, and five-year periods ending in the third quarter of 2018, with industrial property returning 14%, 13% and 13%, respectively.

Attracted by this performance, institutional allocations to industrial property have climbed steadily recently. "There's been a structural shift towards industrial assets," says Avery Robinson, senior vice-president and co-manager of Callan's Real Assets Consulting Group. Just a few years ago, the average allocation to industrial property in an open-end diversified core fund was below 14%, compared with about 18% today.

As a result, Robinson notes, industrial property has been delivering the highest income return and the highest price appreciation relative to the other three major property sectors. "We continue to see some cap-rate compression in the industrial sector," Robinson says, with price gains last year accounting for about 70% of total return compared with 30% or less on a long-term basis in NCREIF data.

Despite the long run of strong relative performance, market participants do not expect a slowdown any time soon. For starters, there is a looming need to replace obsolete assets in many of the country's major logistics centers. To accommodate the new warehouse technologies being devised by logistics services providers, developers and asset owners are literally raising the roof, constructing buildings with ever-higher ceilings that can tower 50 or even 60 feet over the shop floor, with 36-38ft ceilings – once the state-of-the-art for only the largest occupiers – having become the new standard.

Demand for buildings that meet that new standard in turn reflects "a structural shift in the way consumers are accessing goods through online channels", says Robinson. "The e-commerce story has been a strong driver of demand for industrial product."

According to Wang, e-commerce sales have grown 15% to 20% annually over the past five and 10 years, respectively, based on US Census Bureau data, and now represent about 12% of core retail sales as of 2017. Amazon is the largest e-commerce company by far, capturing about 24% of online sales in 2018, according to e-Marketer.

Rapid as the adoption of e-commerce has been, logistics analysts predict further growth. Consultancy AT Kearney predicts that by 2030 total online sales will grow to $1trn (€875bn), or about 32% of total retail sales. The upshot for investors is that the sector will require substantial capital: according to AT Kearney, a typical e-commerce order can require three times more warehouse space than a traditional retail transaction. With every $1bn in new e-commerce sales equating to 1.25m square feet of new warehouse demand, CBRE estimates that logistics service providers and retailers will need 240m square feet of new space over the five years from 2019 to 2023 just to accommodate e-commerce transactions. “This means the e-commerce boom is less than halfway finished,” says Wang. “This will be a very strong demand driver for industrial property.”

There is little indication that the demand for warehouse property will decrease. “It’s been a very strong market, and there’s just no sign of things slowing down,” says Steve Schutte, GLP global COO and president of GLP US. “In the past year, we signed 1,100 leases covering 40m square feet in the US, and we have been seeing double-digit effective rental rate growth and strong NOI growth. We fully expect that to continue through this year as well.”

One of the largest logistics property investors and operators in the world, GLP develops properties for logistics providers and corporations, as well as managing more than $60bn in logistics funds for institutional investors. Given the strong demand for logistics property, Schutte says GLP views the sector as a growth industry. Accordingly, the company aims to focus on cities and submarkets with high demand and limited supply, and seeking to opportunistically acquire land in off-market transactions that preserve its development margin as competition increases.

In addition to stimulating overall demand for logistics property, the spread of e-commerce has “changed the landscape in terms of our business, and in terms of how our customers look at their entire supply chain”, Schutte says. Change starts with consumer behavior. “Demographics are affecting the entire logistics supply chain,” he says. “Millennials are the world’s largest population cohort, and they spend an average of an hour a day shopping online.”

The main change is the demand for quick delivery. For many products in cities, same-day delivery is now the norm, and “that has really changed the speed at which things have to happen”, Schutte says.

To keep up, space-starved logistics service providers and manufacturers are making the most of the space they have. “The logistics sector is having a very hard time keeping up with the demand,” Schutte says. “This often necessitates retrofitting existing facilities or modified build-out of existing space, but it’s being used in a different capacity.”

An e-commerce center may have higher labor than a traditional warehouse, for example, with employees taking delivery of rapidly arriving returns. While the functions employees are performing may be limited, “their turn-around time is extremely fast, and so it’s necessary to change the entire configuration”, Schutte says.

The high degree of returned merchandise ordered online is a major factor in the need for space at e-commerce facilities, Wang says. Brick-and-mortar retailers require about 400,000 square feet of warehouse space to support every $1bn of sales, he says. E-commerce retailers require three times as much warehouse space.

"The reason is the returns," says Wang. "Brick-and-mortar sales are supplied by one-way, outbound bulk shipments to stores, and returns take place at stores, across a range of locations. In e-commerce, each item is shipped to a consumer, and returns all come back to the warehouse – generating a constant ebb and flow of packages. The e-commerce sector must also accommodate higher rates of return from consumers who order the same item in multiple sizes or colors and return those they do not want. "All that requires warehouse space."

Another possible innovation for those in need of warehousing space is to raise the roof. "We are starting to see some newer facilities being constructed with higher clear-heights," Schutte says. "The idea is to create flexibility depending on how high we think customers might need to go to accommodate automation and robotics," Schutte says. "It is highly conceivable that a higher clear-height, at some point, will be more common in the future," he adds. That generation of buildings might require different metrics as well: "To the extent we see that solution to accommodate more automation, you're really focused on cubic volume, as opposed to just linear feet."

But such considerations are still in the early stages. "What we're seeing is people trying to use current technology, or new technology and automation, to work within existing or traditionally-designed facilities and to create greater efficiency there to meet the rising demand and expectations of today's consumer," Schutte says.

UBS Asset Management sees cause for caution. Driven by the repurposing of supply chains to facilitate e-commerce, industrial property has performed well in most countries, and UBS believes the sector will continue outperforming through to 2021. But in its 2018 fourth-quarter review of global property markets, UBS warns: growth in net rents is strong but decelerating as supply increases – rents rose by 5.4% in the year ending September 2018 compared with 7.5% in the year ending September 2017. For the time being "we expect the outperformance of industrial to continue as strong demand drives rental growth". However, "in a period of strong demand, purchasers must do thorough due diligence on assets they are considering purchasing and ensure they do not factor in excessive rental growth expectations".

Another factor that could bring the roof crashing down on industrial growth is that rents are rising off low levels and are a relatively low share of logistics companies' costs, whereas tight labor markets are making labor costs more of an issue for industrial space occupiers.

Disruption to the online distribution model, such as changing consumer preferences, regulatory intervention on the basis of environmental protection or traffic congestion, or government efforts to protect traditional retailers, could also be a problem. Online retailers in the US have already been forced to collect sales taxes applicable in the jurisdictions where consumers make e-commerce purchases, UBS notes, and "calls for such moves to level the playing field look set to only get louder".

Source: IPE Real Assets

Who We Are

Cohen Asset Management is a private real estate investment firm that is headquartered in Southern California with a regional office in Northern New Jersey. With a primary focus being the industrial sector, Cohen Asset Management has an established history as an active owner-operator that is comprised of a team of seasoned real estate professionals who create value for our investors by establishing mutually rewarding relationships within the industrial real estate community in each of our Target Markets, particularly with tenants (our customers), brokers, sellers and ultimately the buyers of our real estate when we monetize investments.