FEATURED ARTICLE

population GROWTH Driving Development Costs to New Heights

By Michael Hoban

While there is no denying the impact that e-commerce is having on the U.S. industrial market, the rise of online retail and same-day delivery is not the entire story of the consumer-driven demand for the hottest of the CRE asset classes. The other half of the equation is the ongoing trend toward urbanization.

The move to cities is fueling the construction of multifamily and office properties in all major metros, placing additional pressure on the supply chain and driving up land costs, sales prices, and rental rates for industrial product.

"We're seeing demand across all sectors of the industrial space in the different industries," says Steve Schnur, senior regional executive vice president with Duke Realty. "The projects that we have in development right now span everything from e-commerce, to omnichannel distribution for traditional retailers, to tires, shoes, and the food business...and we're developing in nearly all of our 21 markets, so it's not just concentrated on the coasts and it's not just e-commerce."

A recent report by the Urban Land Institute finds that for the first time in decades, population growth rate in urban neighborhoods of the nation's 50 largest metropolitan statistical areas are approaching that of the suburbs (3.4 percent to 3.7 percent). This is in sharp contrast to 2000-2015, when suburban growth outpaced the cities by a 13-1 margin. Cities also accounted for 36 percent of the new job growth in the U.S. between 2005 and 2015.

Nationally, industrial occupancy is over 95 percent and rent growth has been exceeding five percent for the past two years. While that may be ideal for landlords and investors, it is presenting huge challenges for developers and brokers.

"Industrial is the hot thing right now, from an investment standpoint, and rents are higher than we've ever seen," says Greg Klemmer, SIOR and senior vice president with Colliers International in Boston. "But what I think is really

going on is that it's not just e-commerce – there are more and more people and companies that want to be in the Boston area and other cities than ever before, so there's just more and more industrial space that's required to service all of their needs."

Greater Boston has seen significant population growth in the past decade, adding more than 225,000 jobs between 2009 and 2015 – mostly in the inner-core. Since 2015, Boston and Cambridge have been magnets for tech and life science companies, seeing massive in-migration from national and local suburban firms seeking access to the tech-savvy millennial workforce. With land in Boston at a premium, former industrial sites in the city are being converted into the proverbial "higher and better uses", i.e., office and life science space, which commands upwards of $85-$90 per square foot for Class A product, putting enormous pressure on land prices for industrial uses.

An acquisition by life science titan, Alexandria, is a prime example of the ripple effect of escalating land prices in all markets. In 2017, the REIT acquired a 75,000 square foot building (since demolished) on a 3.63-acre site in life science mecca Cambridge for $80.25 million from plumbing supply company Metropolitan Pipe. The site, which is permitted for 163,399 square feet of office/lab, is adjacent to One Kendall, the 644,000 square foot office/lab/retail campus that Alexandria acquired in 2016 for $725 million.

This deal left Metropolitan Pipe without a home, but flush with cash. They purchased and moved into a 195,000 square foot warehouse/distribution building (built in 1968) in Somerville, an inner suburb of Boston, spending $35.75 million ($184 per square foot) – a price equivalent to some Greater Boston Class A suburban office properties. In another 2017 deal, National Development purchased a seven-acre site in the industrial section of Chelsea, a suburb adjacent to Boston, for $10 million, to construct a (non-e-commerce) 100,000 square foot build-to-suit for specialty food distributor, Baldor, who signed a 20-year lease prior to construction. The project will establish a new high-water mark for warehouse construction costs in the area, according to National Development.

On the other side of the country, Seattle looks a lot like Boston, with a thriving tech sector, numerous cranes in the air, and even more robust population growth (114,000 new residents in the last decade). Vanessa Herzog, SIOR, and senior vice president at Lee & Associates, reports that there is continued growth in rent and asset pricing, but the biggest challenge for brokers is finding industrial land for developers.

"In the Seattle core, land is practically nonexistent, so you have to buy, rip down, and then rebuild," she says, adding that any available land is now in the $80+ per square foot range. "We've never seen prices like this before." Elevated pricing is now spreading south of Seattle, with some areas doubling in cost over the past 12 months.

As high construction, land, and entitlement costs eat away at margins, local developers are being squeezed out, says Herzog. "They're saying, 'It's too risky. We just don't know what's going to happen in this market. And if we get caught paying high prices for land while anticipating continued rent growth, and we're in the permitting process for another year and the market changes – we're in trouble.'"

It is a story being told in many of the major metros, leaving a significant portion of the development to industrial REITs, who, despite having a greater capacity to absorb risk, are facing the same development issues as local operators. Schnur says that with the Great Recession still fresh in their minds, Duke Realty is "very cognizant of our pre-leasing percentage in our development pipeline, and we've committed to keep that north of 50 percent pre-leased on a gross dollars invested basis." Rent growth in all markets for the firm remains strong, with approximately 10 percent cash rent growth for the last year, while gap rents (changes from one lease to the next) are up 20-22 percent, he adds.

The formula allows them to build on spec in high-barrier-to-entry, tier one markets such as South Florida, Eastern Pennsylvania, and Southern California, as well as Cincinnati, where they broke ground on a pure spec 285,000 square foot bulk warehouse in June. Duke Realty's rent growth was "north of 30 percent" for their nearly 10 million square foot Cincinnati portfolio last year, says Schnur.

Kim Snyder, president of the West Region for Prologis, says "it costs a fortune to operate" in the core markets like Seattle, San Francisco, and Los Angeles, but "if that's what your customer needs, that's where you have to be." The firm's development volume has been double that of acquisitions for the past year, because "it's just so hard to buy things...we're past peak values in pricing on everything," says Snyder, who reports that cap rates in the best global markets are now in the 4.0-4.25 range, previously unheard of figures for industrial.

As a result, Prologis has been pursuing a covered land play strategy for redevelopment, purchasing well-located assets that will eventually be demolished, but still have tenants in place. "It really only works if you've got some time on the leasehold to collect rent while you're going through that planning and entitlement effort – which in California can be two to five years – but not everybody is built for that," explains Snyder. "You might be getting a three percent return while you're waiting, which is not exactly anything to write home about; but on the other hand, if it buys you that time you need to do things properly, it's well worth it."

With the economy at virtual full employment, and few indicators of a severe economic slowdown on the horizon, there does not appear to be any easing of pricing or rent growth for industrial space. In fact, a recent Supreme Court ruling, South Dakota v. Wayfair Inc., may further increase demand for urban assets. In short, the court ruled that companies no longer need a physical presence in a state to be liable for sales tax, just an "economic and virtual presence."

That decision should radically affect the site selection decision-making process, given that much of the analysis is usually based on sales tax savings vs. transportation costs, says Steve Kapp, SIOR, and executive managing director with Newmark Knight Frank in Oakland.

"Since there's no savings on sales tax, shipping costs may be reduced, and the way to reduce your pick costs is to get the product as close to the consumer as you can," says Kapp. "So what you're going to see is even more e-commerce operators coming in, and they won't be looking for 500,000 square foot requirements, they'll be looking for six 25,000 square foot spaces. So as an investment broker, I think we're going to see even more demand coming our way."

All of which will present even greater challenges for developers and brokers - and a nightmare for tenants.

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