Tim D'Angelo, SIOR, Senior Managing Director for Newmark Grubb Knight Frank, has been actively engaged in the Denver market for more than two decades. His market and client expertise in Industrial investment and user sales, leasing, build-to-suits, industrial park development and vacant land sales is a testament of his 29-year industry track record.

Mike Wafer, SIOR, a veteran in the Commercial Real Estate Industry and a Denver native, is an Executive Managing Director for Newmark Grubb Knight Frank. Mr. Wafer focuses the majority of his efforts within the Denver metropolitan industrial market specializing in acquisitions, dispositions, leasing, build-to-suits and vacant land sales.

From Equilibrium to Undersupply Overnight

Tightening Secondary Markets Approaching a Stall

By Tim D'Angelo, SIOR, and Mike Wafer, SIOR

For Denver and other second-tier markets, speculative construction has been minimal to non-existent over the past five years. The most recent downcycle as a result of the "Great Recession" as we all have experienced, created deeper fundamental changes to the development industry and our collective market behavior. The lower populated, mainly inland, markets are the last to recover from the distressed economic environment of the past few years. As they return to a healthy supply cycle with continued recovery and industrial space demand on the rise, we are running out of space and an aging real estate asset stock.

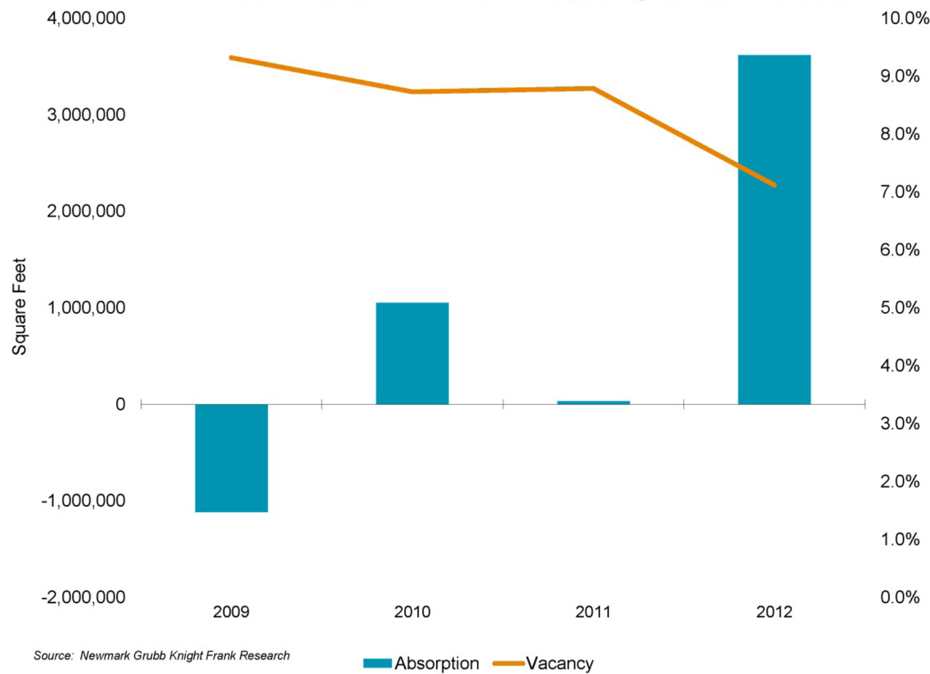
The Sky is Falling

During the Great Recession, many tenants renewed at a voracious pace, pouncing on rate reduction fueled by market conditions and fear that the sky was falling. Tenants seized this opportunity by extending lease terms prematurely as many landlords chose to reduce rent under the terms of a lease renewal rather than risk losing the tenant later should the economy worsen.

Markets experienced a rewriting of rental rates and a flight-to-quality while little space was given back. This had the net effect of essentially creating artificially low rental rates, leaving a bitter taste in the mouths of many landlords. While some owners weathered the storm, down only 10 percent from pre-recession levels, there is lingering evidence of rental comps, estimated 25 percent below rates, needed to justify new construction due to tenants locking in low rates. As it turned out, the small businesses were much more affected than corporate America when it came to industrial space, the true vacancies occurred in the smaller blocks of space.

So this was our experience, but in looking at historical reality, the sky never did fall. The market activity continued while construction all but ceased during the economic crisis. The demand for class "A" modern buildings continued as tenants locked in less than normal economic rents. Now we are out of product—unless you are seeking an older, nearly functionally obsolete building.

This low rental-rate environment is about to change as rates adapt to the market conditions upon lease renewal. In the Denver market, we are beginning to see elements foreshadowing a stalled market: existing price levels, rates rising 10-25 percent upon renewals to reach market levels, continued absorption and a constrained market with little to no supply-new or old. Without any new product, market conditions will likely progress to a level where the underserved market moves beyond equilibrium, resulting in a stalled market.



Where is the New Supply?

Developer experience post 2008 has been varied. Limited development financing tempered speculative construction, and national developers with land holdings hunkered down and finished out projects in progress with in-place loans. This new inventory was eventually absorbed as the regional and local developers for the most part disappeared. Land assets went to financial partners and development plans were shelved. With the ongoing economic uncertainty, REITS quickly got out of the game and focused on portfolio occupancy. While this efficient behavior prevented an overbuilt environment, there is now a lack of a critical mass of functional inventory.

Amplified Tenant Demand

A further implication of the market improvement and constrained supply is the development pipeline. With demand exceeding supply and rents high enough to justify new construction, replacement cost has reached a point where tenants will be willing to pay perceived premiums for brand new space. In secondary markets, specifically Denver, too few available choices led to a spike of owner user construction activity in 2012. Approximately 1.38 million square feet of industrial space was completed or under construction in 2012—100 percent of which is built-to-suit and owner-built. As rents continue to rise across the market, this build-to-suit trend is expected to continue into the foreseeable future until the market once again reaches equilibrium with adequate, functional supply.

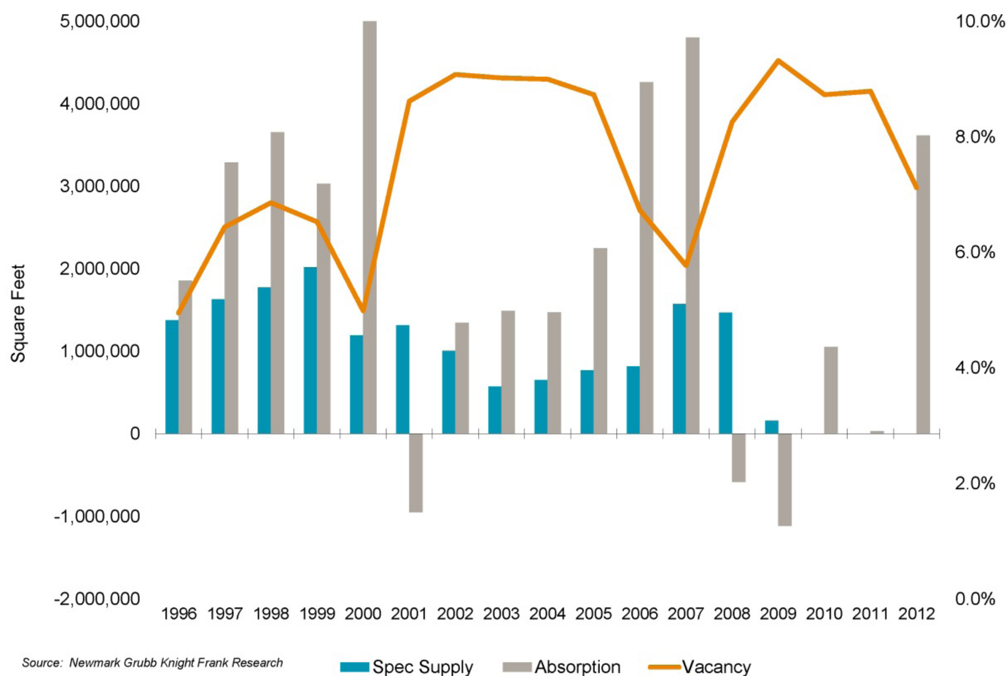
" Inland, markets are the last to recover from the distressed economic environment of the past few years."

The class "A" construction era in Denver began in earnest in 1996. Majestic Realty and The Pauls Corp. each purchased 1,000 plus acre business parks east of Stapleton towards the newly built Denver International Airport. By the late 90s names such as Catellus (Prologis), Birtcher, IDI, Trammel Crow, Lauth, Pannattoni, Koll, Lowe Enterprises, CMC Group, Opus and others had purchased infill sites and were providing a wide variety of product types and sizes.

Over a 17 year period, from 1996-2012, the market recorded 30 million square feet absorption in contrast to 16 million square feet of construction. This 17 year total would represent only a modest year in southern California's Inland Empire. Our overall market absorption meanwhile chugged along starting at 1.8 million square feet, reaching a high of 5.5 million square feet with only a few recessionary years of negative numbers. This stability is why industrial product has become the "darling" asset class for institutional investors.

Secondary Market Constraints: Denver is a Case Study for Needed Supply

As you will see in the chart (next page), a 13-year cycle of speculative construction in this market averaged an addition of 1.25 million square feet annually. In the last three years, the market posted zero. The overall vacancy during this span started at a low of 4.95 percent and reached a zenith at 9 percent several times. Due to the fact that Denver never experienced an overbuilt environment, vacancy never reached 10 percent. Vacancy peaked during the Great Recession at 9.32 percent recorded in 2009 with a negligible addition of 156,350 square feet of speculative space. In the ensuing three years, tenants absorbed approximately 4.7 million square feet of space with no new speculative development.



The Trigger

So where are we now? Denver just experienced an above average absorption year—3.6 million square feet recorded—matching many pre-recessionary record years. And, as such, vacancy declined to a better than healthy 7.1 percent. Vacancy below the 8.5 percent range generally signals a balanced market, and is historically the hinge point for speculative development. This is spurring upward rent pressure justifying the cost of new construction, resulting in 1,384,000 square feet of user or build-to-suit construction over the past two years.

In Denver a grand total of five vacant class "A" spaces over 100,000 square feet are available, however, deals are circling on two of these buildings. Yes, that's it. Essentially, availability consists of three Class "A" spaces over 100,000. With no new speculative product since 2008, the market is simply running out of space. Additionally, there has been a slight occupancy gain from removals as obsolete buildings are refurbished or are removed from the market as the product adapts use and redevelops as mixed-use or demolished for light-rail construction. It would be a severe understatement to say that the market is constrained.

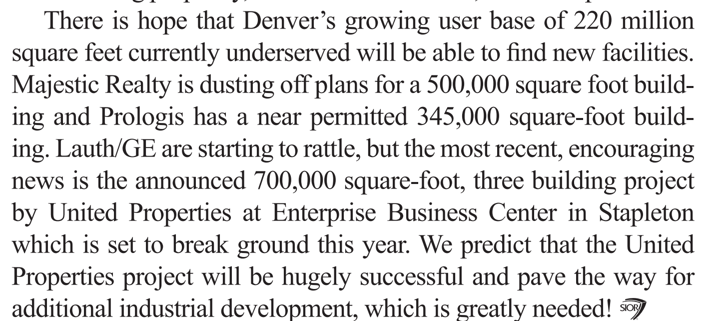
"This stability is why industrial product has become the 'darling' asset class for institutional investors."

A Stalled Market

Currently, healthy pricing of both leasing and investment deals today combined with continued demand and lack of product create an environment ripe for speculative development like many other inland secondary markets. Assuming a continued economic recovery in 2013 and 2014, albeit slow, new deliveries will easily pick-up for both build-to-suit and speculative space. As rental rates stabilize and vacancy levels fall in many markets, users, developers, and lenders are slowly becoming more comfortable with ground-up development. However, conservative lending for the next 24 months requiring large equity commitment will all but shut out the local and regional developer.

Turn on the Spec Spigot!

In order to be competitive, a market must offer critical mass of product and variety. Currently, the user and build-to-suit market is growing because there are simply not any viable options for space. The Denver market is almost stalled. "Build it and they will come" is a self-fulfilling prophecy, or in Denver's market, more of a prediction.



There is hope that Denver's growing user base of 220 million square feet currently underserved will be able to find new facilities. Majestic Realty is dusting off plans for a 500,000 square foot building and Prologis has a near permitted 345,000 square-foot building. Lauth/GE are starting to rattle, but the most recent, encouraging news is the announced 700,000 square-foot, three building project by United Properties at Enterprise Business Center in Stapleton which is set to break ground this year. We predict that the United Properties project will be hugely successful and pave the way for additional industrial development, which is greatly needed!