Industrial in Crisis

Despite low vacancies and higher rents, industrial construction fails to meet demand.

by Eric Rehn, CCIM

An industrial housing crisis is affecting the U.S commercial real estate markets and will have a major impact on the ability for our economy to grow.

Across the nation, industrial vacancy rates have dropped to their lowest point in decades, at approximately 4.7 percent at the end of the second quarter of 2018. Contrast that against a 10.3 percent vacancy rate for office and a 6.4 percent rate for multifamily, according to CoStar. Even more alarming is the lack of entry-level, light industrial incubator product type in the 1,500-square foot to 3,000-sf unit size range. Most vacant industrial space is found in large blocks of high-cube warehouse product produced over the last few years to support demand for companies like Amazon, rather than smaller, multitenant buildings. In 2017, CoStar reported that 87 percent of construction starts across the nation were for logistics buildings.

The news is worse for California, as the booming economy has driven industrial vacancy rates down to 3.3 percent from their five-year average of 4.4 percent, according to Kennedy Wilson and CoStar Analytics. Even more interesting is the speed of the market. The time frame to lease industrial product in California dropped more than 50 percent; it now takes three and a half months to lease, compared to the seven-to-eight-month historical average. This has driven rents up from a $0.59 average to $0.82 psf per month today. With few incubator projects pending, little relief is expected.

These factors typically would indicate accelerated construction, but 12-month construction starts in California during 2017 are only slightly above the five-year average of 35 million sf at $38 million. Very little of the construction was on light industrial, incubator projects, further skewing the available space to much larger blocks with at least 100,000 sf. Drilling down to the regional level puts the issue into sharp focus. For instance, Contra Costa County in Northern California has enjoyed a strong industrial market that historically ran at about a 7.1 percent vacancy rate. The hot economy has driven vacancy down to 3.1 percent for the first quarter of 2018. But when small industrial spaces of 2,500 sf or less are isolated, it's an incredibly tight market, at 1.7 percent vacant. That means 20 spaces across the county are left to support a historical deal velocity of 23 deals per month in this size range. Additionally, the average age of an industrial building in the area is 45 years old, so small startups have to vie for expensive, old space.

While low vacancy and rent growth should have lenders eager to invest in industrial development projects, they are taking a cautious approach to the market. Here's why. Loan-to-value ratio for construction projects remains nearly at 65 percent. Actual rents now are the focus rather than pro forma optimistic projections, as lenders are keenly aware of the potential impact of rising construction costs on the bottom line.

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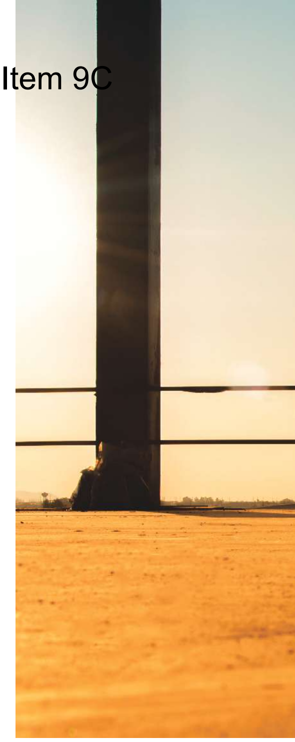

Contributing Factors

No single culprit, but rather a perfect storm of factors, is driving this situation.

Although rent growth is strong, the growth of construction costs is outpacing any gains. A recent light incubator industrial project in Contra Costa County utilizing concrete tilt-up construction requires rents of $1.28 psf per month just to cover the construction and soft costs, while the land cost pushes rents to $1.50 psf per month to achieve an 8 percent return.

Approvals take longer, cost more, and face "not in my backyard" (NIMBY) opposition. Hearing that although rents are skyrocketing, the value of their land has not changed due to the higher development costs, owners are not eager to part with their land.

Local non-governmental organizations extract expensive concessions to allow development in their area.

Demand from emerging markets like cannabis drive up pricing in areas with the proper zoning, virtually eliminating vacant space in that area.

Finally, the conversion of industrial to residential land further reduces the supply of land for industrial development.

Finding Resolution

Possible solutions to ease pressures include municipalities streamlining the approval process to reduce time frames, plus looking at sewer and water fixture fees. Smaller multitenant projects are vulnerable to these types of fees due to the higher number of individual units/restrooms for a given size compared to a single tenant unit. Protection of existing industrial-zoned sites from conversion to non-industrial uses is another option. For example, in 2014, Contra Costa County enacted a Northern Waterfront Economic Development Initiative to protect existing industrial-zoned land, but had limited success.

Ultimately, the industrial housing crisis across the nation is a critical factor in continuing economic growth. It's important to facilitate the development of smaller, incubator-style projects to ensure an adequate supply of space for industrial startups and help balance the need for industrial housing with the rest of our needs for real estate.

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