The Industrial Age

The industrial sector is once again the darling of property investors. For the second year in a row, industrial has ranked as the top sector for both investment and development prospects in *Emerging Trends in Real Estate*, the Urban Land Institute's widely-followed annual industry survey. This year the industrial sector posted its highest preference scores in over a decade. Not bad for the "Rodney Dangerfield" of property sectors – never getting any respect.

Demand Drivers All Firing Strongly

Its rising stature reflects both compelling capital and property market fundamentals within the sector, as well as declining or weaker prospects for the other major property types. To start with the positives: Demand for warehouse and distribution space is soaring as the whole chain of moving goods from producer to consumer is being upended by consumer shifts toward e-commerce, to the advantage of wholesalers and warehouse space generally.

Other demand drivers are also firing strongly, in concert with the continuing economic recovery. As with the other property sectors, demand for space naturally rises with GDP growth and especially job growth. But industrial demand especially depends on two factors, in addition to retail demand: trade and housing construction. Warehouses benefit from housing construction as homebuilders need large spaces in which to store their materials. Housing starts are not nearly at the level of the mid 2000s, which is probably a good thing – as a nation we were building too many houses that families could not afford. But volumes have recovered nicely since the recession, with the annual rate now up to 1.1 million units, twice the rate at the depth of the recession and finally approaching the levels of the mid 1990s prior to the housing boom.

And trade is up, building on a long upward trend for both imports and exports dating back at least 50 years due to greater trade liberalization. Exports and imports combined have tripled their share of our nation's Gross Domestic Product, from less than 10% in the 1960s to almost 30% now. It must be noted that services account for a significant share of imports (18%) and especially exports (33%), meaning that much of what we trade with other nations does not involve any physical goods. Nonetheless, our growing trade means that an increasing share of the products we buy and sell end up in warehouses at some point in their journey from producer to consumer. Putting all these factors together – rising trade, increasing housing construction, and the shift to e-commerce, all in the context of at least moderate economic growth – provide the fuel for strong tenant demand for warehouse space.

Warehouse Markets Are Thriving

So far tenants have been fairly indiscriminate in their space demands, as relatively little new supply has been brought to market, leaving tenants with few options. In the last five years of the economic expansion through year-end 2014, the nation's warehouse base has risen less than 2.5% — on average only 0.5% per year. By contrast, supply rose by almost 1% annually in the expansion from 2002-07, and 1.3% a year during 1990s expansion.

Thus, tenants cannot be choosy with their leasing – this despite sharp changes in ideal location and configurations of warehouse space. With consumers increasingly demanding next day and even same day delivery, an increasing share of warehouses will need to be closer to where people live, as opposed to near ports and major distribution hubs. And modern, robot-driven logistics requires buildings with taller clear heights than traditionally found in warehouses. For now, however, the shortage of this best-in-class space means that almost all markets and products are benefiting from the demand surge, almost without regard to quality. (Higher finish "flex space" is one exception to the broad recovery, but this product typically performs more like office, which has been a relative underperformer.)

With leasing strong and construction only moderate, at least up to now, existing buildings have seen their occupancy soar to levels not seen since the late 1990s. We estimate that only 6.6% of our industrial stock is now vacant, down 20 basis points (bps) to 6.6% in 3Q15 and the 22nd straight quarter of rising industrial demand. Industrial vacancy rates have steadily declined since peaking at 11.2% in early 2010, a drop of almost 500 bps in all, the biggest improvement of any sector. As a direct result, rents have risen sharply, nearly reaching their prior peaks.

Warehouse Owners Benefit

In turn, warehouse owners have benefited as the strong occupancy and rents have translated into financial outperformance for the sector. And while the supply pipeline has been expanding recently with deliveries expected to finally reach levels typical for an expansion, demand is anticipated to nearly keep pace with this new supply, limiting the hit to rents and occupancies.

Given all these positive trends, it's not hard to understand the sector's new-found attraction to investors. But the industrial resurgence reflects not only the positive market dynamics within the sector, but also industrial's strong performance and prospects relative to the other major property sectors. Apartments were the first sector to recover after the recession and already boast record high prices, rents, and occupancy in many markets; prospects for significant further gains gains seem limited.

Meanwhile, the office sector continues its moderate pace of recovery, but leasing has not reached the levels typical of a late-stage economic expansion, despite exceptionally strong office job growth. Firms are more focused now on controlling operating costs through alternative work arrangements and efficient space planning than they are in capturing the best space. So vacancies remain elevated and occupancy may not reach prior highs before the next downturn hits.

Finally, the retail sector has suffered since the recession as it struggles to counter the growing completion from e-commerce as well as its legacy of overbuilding. Clearly many retail markets and shopping centers are thriving, with historic occupancies and eye-popping rents. But these winners are increasingly separating from the losers, so the rising economic tide is not lifting all boats, at least not equally.

Real estate markets are nothing if not cyclical, and the various sectors each take the lead at different points in the cycle and in different cycles. And now it's the industrial sector's turn to shine. Who knew the humble industrial sector could be so sexy?

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