Ares Management

Industrial's low vacancies, high rental-rate growth likely to continue

Recently, **Chase McWhorter,** Institutional Real Estate, Inc.'s managing director, Americas, spoke with **Tom McGonagle,** a managing director of Ares Management's Real Estate Group, about supply-and-demand drivers in today's port and gateway-city markets. Following is an excerpt of that conversation.

What are some of the current trends that are influencing the industrial sector?

I will start with a little bit of background because I think industrial has proven to be a durable asset class through market cycles. Industrial has always been impacted by two main demand drivers: real gross domestic product (GDP) growth and trade growth — the flow of products manufactured overseas and shipped here, or manufactured here and shipped overseas. This growth is particularly profound in the port markets, and that hasn't changed from a fundamental standpoint. What has changed over the past five, maybe even 10 years, is how much ecommerce has become a driving factor for industrial demand. Pre-2020, ecommerce had been growing at a pace of 10 percent to 15 percent each year, but in 2020, online sales skyrocketed, increasing 34 percent from 2019. While this growth may have been an anomaly because of the pandemic, I believe that ecommerce will continue to evolve and that, over the next five years, online sales could grow to 25 percent to 30 percent of total retail sales from a little more than 15 percent today. Ecommerce is not going to go away. I have three daughters and, trust me, they are not going to stop ordering online.

Another key aspect of ecommerce that I don't believe is discussed enough, unless it is the holiday season, is reverse logistics. This is where people will order multiple products to try at home and then return all but one or two. What some people don't know is that those returned products do not go right back into the stores. Rather, they are sent to a completely different warehouse, where they are then processed for return. Those brand new, never-been-used products need to get back into the supply-chain network and are a huge economic factor for retailer and consumer-goods manufacturers.

Additionally, rising ecommerce and the pandemic have impacted the industrial sector through the supply-chain shortages that we have seen across a number of different product categories. With many companies running on low inventories, we are now seeing customers shift from just-in-time inventory to just-in-case inventory. By keeping more inventory on hand, tenants are less likely to be impacted by delayed supply chains, and more inventory translates to an increased need for industrial space. Will people continue to operate in this model? We are not sure, and it may not be quite as permanent of a driver as ecommerce, but it definitely will be a very strong driver during the next couple of years.

Together with supply-chain delays, and again partly driven by COVID-19, we are seeing more companies consider onshoring or nearshoring their manufacturing facilities to bring operations or other facilities from Asia and other overseas locations to North America locations. This trend is a little bit longer term, as you can't just pick up and move manufacturing facilities tomorrow, but we do expect to see an increased demand for warehouse space, especially in markets such as Southern California and South Texas, due to their proximity to cross-border commerce with Mexico.

How are you seeing the industrial sector respond to these trends?

Because of the growing demand for industrial during the last several years, driven by ecommerce growth and combined with the impacts of the pandemic, we are seeing vacancy rates in the United States at an all-time low, dipping below 4 percent nationally. In most of the port and gateway markets that have high population growth — Seattle, Houston, South Florida, Pennsylvania, Chicago, Atlanta and Dallas — we are even seeing vacancy rates below the national average; and good luck finding vacancy in parts of New Jersey and Southern California. This demand has led to annual highs as it relates to rental-rate growth across the country. While it does vary market by market, we have historically seen average annual rental-rate lease bumps of 2.5 percent to 3.0 percent, but we are now seeing 3.0 percent to 4.0 percent in many of our new leases. In some key markets where there is no vacancy, we are seeing annual rental growth in the low double digits to mid-teens. There just isn't enough space available to meet the warehouse demand that is being driven by the factors I discussed in the first question.

How are tenants reacting to these trends?

With vacancy rates so low and space hard to find, we are seeing more renewals from our tenants. Typically, we expect 70 percent to 75 percent of our tenants to renew, and we saw well over that percentage this past year. Not only are more tenants renewing, but many of them are asking for longer lease terms.

Another really important factor about the industrial sector is that, while most ecommerce and omnichannel tenants are looking for brand new, state-of-the-art space, they are also looking for infill space, meaning space that allows them to make deliveries faster and get closer to their customers. These infill spaces tend to be older, smaller buildings that are close to city centers. What is interesting to me about these buildings is that they are every bit as functional today as they were 30 to 40 years ago, as long as the landlord has been keeping the roof and parking lots in good shape.

We are seeing that the larger ecommerce tenants want more parking for their employees — they can be very people-intensive operations, especially on a seasonal basis — and more trailer storage and car and truck parking since they are providing a number of ways to deliver products faster to the customer.

The supply-chain crisis seems to have impacted the demand for industrial space. Do you anticipate demand for industrial to level out as these issues resolve?

I would say normalize versus level out. Ecommerce is a great example of this. We saw more than 30 percent growth in ecommerce sales in 2020, but we believe that will normalize to more like 10 percent to 15 percent annualized growth over the next several years. So, ecommerce growth is not leveling out, it is just going to become more normalized and will still have long-lasting effects.

As it relates to the supply-chain shortages, you can see that demand continues to grow for industrial space since people are building up inventories. In certain top-tier markets, we are seeing stronger tenant activity in our key target markets than even what it has been during the past two to three years. However, I believe that the last-mile/last-hour delivery concepts are not going anywhere, and will be long-lasting and sustainable drivers of industrial demand. We are also watching the demand/supply balance within these markets, and while we are seeing that it is in balance for the most part, some of the dense markets remain undersupplied. In those dense markets, it tends to be harder to find land to develop, not to mention the entitlements, rising costs of labor and construction materials, and supply-chain shortages — all of which are factors that are helping to keep the demand/supply balance.

Do you think the industrial sector will continue to experience the same amount of growth it is now, or are there headwinds that you are worried about?

We have been in this business for a long time — over 30 years — and I am optimistic that this growth can continue. Since GDP and trade growth are drivers of commercial real estate, if there is a downturn or an economic recession, it will obviously impact all real estate asset classes. Historically, though, industrial tends to be less volatile and quicker to come out the other side.

As I mentioned previously, we are generally seeing very low vacancies with balanced supply and demand, which demonstrates strong fundamentals for the industrial sector. Because we are a national company, we have real-time insight into almost every major industrial market, investing in 25 to 30 markets at any given point.

How has the current environment affected the investment landscape for industrial assets?

Price increases for industrial assets is an understatement. I mean, if you think about valuations at flat cap rates with rental rates growing at high single digits or low double digits, right away you can see valuation increases being very strong. Couple that with cap-rate compression, and you are seeing outsized price increases over the past three to five years. The flip side of that, though, is that, while you may have been able to buy something at a higher cap rate five years ago, the strong rental-rate growth has made it possible to get back to that original cap rate over the next couple of years, which is attractive to a long-term holder of industrial.

In this environment, we are seeing a good portion of industrial under development being pre-leased, which hasn't always been the case. Additionally, we are also seeing our value-add product lease up much faster than what we anticipated.

As an active industrial developer, how have you navigated recent construction issues, such as rising costs and labor shortages?

There is no question that today's considerations take into account situations that weren't necessarily considered 24 to 36 months ago, such as rising material costs, increased labor costs and longer delivery times. Since the firm has been an active developer over our careers, we have a lot of deep, long-term relationships that have been essential as we navigate today's landscape. If we know that we are going to need certain structures, such as roof membranes or materials that have a 12-month lead-time in that particular market, we can seek to lock in at today's prices and cut down our construction costs. We also tend to be very concentrated in where we build, so we know counties and townships very well, and we try to work with them all the time to navigate the development process with our tenants. Entitlements in some of the large dense markets, such as Southern California and New Jersey, are taking longer than they did three years ago, so having our people in those markets helps us to navigate the process much faster.

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Based in Denver, Thomas McGonagle is a managing director in the Ares Real Estate Group, where he focuses on U.S. industrial real estate equity portfolio management. McGonagle is also senior portfolio manager for a fund managed by the Ares Real Estate Group and serves on the Ares Real Estate Group's Combined Industrial Advisors Committee.

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CORPORATE OVERVIEW

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