

THE JOURNAL OF COMMERCE

Stacking Up the Empties

The warehouse building boom of recent years came to a crashing halt, so how much of the downturn can DCs absorb?

By David Biederman
June 22, 2009

The U.S. industrial real estate market is in the midst of an unprecedented downturn. Vacancy rates are rising, sales, leasing and new construction have tanked and many developers are barely hanging on, trying to conserve cash and survive the recession as they wait for the market to hit bottom.

"We haven't seen this kind of deep freeze in capital markets and such a fast drop in demand all at one time," said Will Friedman, vice president for ports and logistics at Duke Realty, an Indianapolis-based national industrial developer.

Nationwide, construction of new distribution facilities has ground to a halt in what Jim Dieter, executive managing director for the Americas at real estate services firm CB Richard Ellis said are the worst market conditions he's seen in a 35-year career in the industry.

"Rents have been discounted so dramatically in the existing building market that it would be very difficult for rents of new buildings to match," he said.

The average U.S. industrial vacancy rate stood at 9.5 percent at the end of the first quarter, according to real estate services firm Grubb & Ellis. Leasing activity declined an astronomical 41 percent from the same period a year earlier.

Net absorption — the amount of newly occupied space — dropped to negative 40 million square feet in the quarter, the largest quarterly decline of the decade. Average lease terms of 44.2 months and an average lease size of 23,260 square feet also represented the decade's lowest figures.

The national industrial market was flooded with 75 million square feet of available sublease space in the first quarter as scores of companies downsized or went out of business. The huge increase indicates extreme weakness in the drivers of demand for industrial space, including consumer and business spending, falling inventories and shrinking global trade.

No one in the industry has been spared, including top-tier developers such as AMB Property, First Industrial Realty Trust and ProLogis, all of which suffered huge losses and implemented drastic cost-cutting measures.

In February Denver-based ProLogis, the world's largest industrial owner and developer, announced it would sell more than 33 million square feet of industrial properties in 14 states and Washington, D.C., including more than 9 million square feet in Texas, 3.5 million square feet in Atlanta, 3.3 million in Chicago and 3 million in the Northeast.

The move follows a tough year in which the company lost \$887.1 million as its common stock price collapsed. Jeffrey H. Schwartz resigned as chairman and CEO last November, and the company announced steps to reduce its debt by \$2 billion by the end of 2009.

The moves include a halt to development activity other than previously committed projects, plans to cut expenses by 20 to 25 percent and the sale of its China operations and property fund interests in Japan for \$1.35 billion.

The company said its efforts are starting to pay off. "We have accomplished a great deal in the first part of 2009, making significant progress on our objectives to de-leverage and de-risk the company," ProLogis CEO Walter C. Rakowich said.

Industrial real estate pricing probably hasn't hit bottom, making it difficult for cash-strapped developers to sell properties, said Tim Feemster, senior vice president and director of global logistics for Grubb & Ellis.

Whether individual developers make it through the recession depends on factors including occupancy rates and lending terms. A common industry practice, which could doom some of the big companies, was short-term borrowing to develop and sell a high volume of buildings.

"It depends on how leveraged they are," Feemster said. "If they have short-term money, there are real problems."

Every region is going through the same economic cycle right now, said Faith Ramsour, a research director with real estate services firm Cushman & Wakefield. The number of industrial markets with vacancy rates over 10 percent has doubled in the past year.

Frozen finance markets have led to a stunning decline in projects under construction. There was 32 million square feet of new space under construction in the first quarter compared to 98 million square feet a year earlier.

In addition to the steep decline in leasing activity, sales of every type of industrial building have virtually stopped, with REITs and other institutional sellers not receiving any offers for buildings out for bid.

"Financing is just not there even for buyers who have interest," Ramsour said.

The rapid increase in vacancy rates is especially troubling because the industrial market is a lagging indicator — slow to decline *and* recover — and tends to change slowly over time. But the current meltdown has hit with stunning speed.

For example, California's Inland Empire went from being one of the nation's hottest industrial markets to one of the slower markets in only two quarters, said Lance Ryan, vice president of marketing and leasing for Watson Land Co., a West Coast developer with approximately 12 million square feet of industrial and commercial properties in Los Angeles County and the Inland Empire.

In Inland Empire East, the submarket of the Inland Empire farthest from the Port of Los Angeles, lease rates have fallen as much as 40 percent and occupancy rates have dipped as low as 80 percent. Across the Inland Empire, which has 430 million total square feet of industrial space, buildings under construction have been shuttered and new projects postponed indefinitely. The 2.2 million square feet of industrial space that were in the construction phase in the first quarter represent an 81 percent decrease since the first quarter of 2008.

In the South Bay submarket of Los Angeles, where Watson operates some 10 million square feet of industrial properties, the vacancy rate is still a healthy 2.4 percent even though sales and leasing activity dropped by 41 percent in the first quarter from a year earlier. About 80 percent of

Watson's industrial space in South Bay is occupied by 3PLs or privately operated logistics operations.

Overall, Los Angeles has the nation's lowest industrial vacancy rate of 2.7 percent but the market, with a total of 986 million square feet, is showing other troubling signs. The market posted 3.5 million square feet of negative absorption in the first quarter, while sales and leasing activity dropped 43 percent from a year earlier. Average asking rates were down 11 percent. Available sublease space jumped 44 percent for the period.

Industrial markets are in free fall nationwide. The five markets with the highest increases in vacancies in the past year are in states hammered by the housing slump; Phoenix; Orlando; Las Vegas and Reno, Nev.; and California's Inland Empire.

In North/Central New Jersey, one of the nation's biggest industrial markets, net absorption plummeted to negative 7.34 million square feet in the first quarter, a staggering increase of 8.47 million square feet from a year earlier. The availability rate reached 10.3 percent, up three percentage points.

The hardest hit submarkets in terms of new availability were Exit 8A (16.7 percent) and the Morris Region (14.2 percent).

Metro Atlanta's 11 submarkets, with a combined 592 million square feet of space have been hit especially hard by the downturn in construction and retail. At the end of the first quarter there were more than 8 million square feet of available industrial sublease space in the market, up 25 percent since the end of 2008.

The Dallas-Fort Worth industrial market recorded negative absorption in the first quarter for the first time since mid-2003. Industrial vacancy increased for the fifth consecutive quarter to 11.3 percent, the highest level in 10 years. In 2008, more than 20 million square feet of space was added to the market, contributing to the high vacancy rates. No new developments are up for completion in 2009.

In the first three months of 2009 the Houston industrial market posted almost 510,000 square feet of negative net absorption, the first negative report since 2003. Although strong demand for oil exploration equipment insulated Houston's economy from the recession for most of 2008, the sector has cooled considerably, leading to rising vacancy rates.

Tenants are taking advantage of the sputtering industrial market to renegotiate lease terms, and desperate owners are eager to comply. A mantra among landlords is "blend and extend," which means offering lower rates in exchange for extending lease terms. Duke has modified the concept to "blend, extend and don't spend" — meaning property improvements and upgrades such as new lighting are pretty much off the table.

"Right now it's hard for any landlord to make those sorts of investments," Friedman said.

With new construction at a standstill, Duke and other developers are focused on balance sheets and the management of existing assets. Duke owns and operates a high percentage of its properties and is pulling out all the stops to retain tenants and lease empty space. Meanwhile, top executives are working overtime to strengthen liquidity.

The growing corporate focus on maximizing efficiencies could have long-range implications for supply chain design and by extension industrial markets throughout the country. Dieter has spent the past nine months talking with corporate leaders and heads of national development firms and industrial real estate investment trusts. One emerging trend is that several companies in the process of redesigning their supply chains are turning from big box distribution centers to smaller regional DCs closer to consumers and various modes of transportation.

“Logistics and supply chain consultants are in the planning stages with a lot of companies right now to do that,” Dieter said.

Feemster has seen owners of big box DCs buy out 18-month leases in order to attract tenants. “That is a desperate landlord,” he said.

Despite the downturn, industry experts are confident mega-markets such as Chicago, Dallas, New Jersey and Los Angeles will always sustain a baseline level of industrial activity as companies expand, contract or renew leases. Dieter believes markets that developed more recently in response to rising global trade such as Savannah, Charleston, Norfolk and Oakland will bear the brunt of collapsing import/export volumes.

“Absorption in those markets is almost totally reliant on business coming from outside and not on local populations,” he said.

But Duke’s 6 million square foot portfolio in Savannah — about 25 percent of the city’s total industrial space — is holding up pretty well in terms of occupancy, Friedman said. For the port cities, that suggests their success of recent years may bring them something they had not seen in several decades — a freeze in new construction.
