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## Industrial Absorption Creeps Up

By: Matt Hudgins

The cautious pace of rebuilding inventories of warehoused goods may frustrate some landlords eager for a fast gain in occupancy in 2011. U.S. companies seem to be relying less on warehousing and more heavily on just-in-time supply chains, researchers say. Owners of distribution centers are seeing a more rapid absorption of space in their portfolios, however. "What we're seeing from our customers is optimism," says Lance Ryan, vice president of marketing and leasing at Watson Land Co.

Based in Carson, Calif., Watson owns and manages about 15 million sq. ft. of industrial properties in Southern California, mainly near the busy ports of Los Angeles and Long Beach. Since the summer, growing numbers of companies have leased distribution and warehouse space from Watson and its competitors on short terms of six months or less, says Ryan. He attributes the surge to retailers gearing up for the holiday season. That was an improvement over 2009, when the usual pre-holiday inventory buildup just didn't happen. Tenants now are renewing many of those short-term leases as multi-year deals. Japanese logistics carrier NYK rented 250,000 sq. ft. and 8.5 acres of land from Watson for a few months earlier this year. In November, the firm signed a three-year lease for the same space. What isn't yet clear, says Ryan, is how much of this year's signed leases stem from companies rebuilding inventories that were depleted in 2009, and how much is driven by business growth. "Part of it could be the seeds of a recovery," he says. "We just have to wait and see."

### Pain lingers

Researchers say the devastating contraction in demand for industrial space that reached a crisis in 2009 is about over. Negative absorption this year is expected to total 3.5 million sq. ft., a fraction of the record 72.7 million sq. ft. of negative absorption in 2009, reports Reis. Excess space is weighing down lease rates. Average annual effective rent fell 6.5% in 2009 to \$4.35 per sq. ft., and will fall 3.7% this year to \$4.19, predicts Reis. Those weakened rents, coupled with nearly three years of quarterly vacancy increases, explain why returns for industrial real estate investment trusts (REITs) lag other commercial sectors. The FTSE NAREIT U.S. Real Estate Index showed an 8.95% year-to-date return for industrial REITs in November, compared with 15% for office and 31.23% for retail REITs in the same period. Even so, with industrial users expected to absorb more than 45 million sq. ft. in 2011, the current recovery is outpacing market performance following the recovery nearly a decade ago, says Victor Calanog, chief economist at Reis. In 2001 and 2002, tenants vacated 36.6 million sq. ft. and 3.7 million sq. ft., respectively, but the recovery in 2003 only produced 29.6 million sq. ft. of absorption. "Given how devastating 2009 turned out to be, industrial properties are essentially climbing out of a deeper hole faster than they did relative to the last downturn," says Calanog.

### Demand grows in niches

Foreign trade volume is rising. U.S. imports through the first three quarters of 2010 totaled \$1.4 trillion, up 27% from \$1.1 trillion over the same period a year ago, according to Census data. Exports increased in the first nine months of this year to nearly \$937 billion, up 22% from \$769 billion a year ago. Shipping those goods helps distribution centers lease space, but retailers are wary of restocking warehouses until consumer demand improves, says Luciana Suran, economist in the Boston office of CBRE Econometric Advisors. Many retailers now rely more on air freight to ship goods on an as-needed basis. That explains why industrial vacancy has declined since the beginning of the recession within five miles of Los Angeles

International Airport, says Suran. These factors translate to a slow and fitful recovery. In the third quarter of 2010, U.S. industrial vacancy dipped to 14% from its historical high of 14.1%, marking the reversal of a three-year trend of swelling vacancy, according to CBRE Econometric Advisors. Rents are still declining, but should flatten next year. Unfortunately for investors, the slow pace of economic growth and industrial absorption expected in 2011 suggest rent is unlikely to increase until 2012. Reis projects the average effective rent to rise by a slight margin by the end of 2011 from the current \$4.19 per sq. ft. to \$4.20. "We're not expecting massive changes in availability [of space] that will really affect rates," concludes Suran. "It's going to be a choppy, up-and-down recovery."