Moody's, Others Say Industrial Sector Starting to Soften

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Many metros are seeing lower or even negative absorption rates.

By Richard Berger | Originally featured on GlobeSt.com

Despite elevated manufacturing and consumer goods production through 2022, the industrial sector is reflecting the start of a softening period, according to Ermengarde Jabir, senior economist at Moody's Analytics, in a report published on the Scotsman.

Jabir said this is occurring across distribution and warehouse properties, as well as flex spaces for research and development purposes.

"Many U.S. metros are seeing lower or even negative absorption rates, although last year also featured more completions as developers and investors sought to capitalize on the booming sector," she said.

Jabir is not suggesting a sense of urgency but notes that the industrial sector is showing early signs of moving away from roaring growth and toward stabilization, citing the vacancy rate for distribution and warehouse space.

It stabilized at 4% throughout the second half of 2022 as the subsector recalibrated to accommodate an influx of new supply coupled with moderating demand, she reported.

"Industrial properties remain healthy from a capital-markets perspective, as Moody's Analytics data found that the share of all industrial property loans that are at least 60 days delinquent is at a 14-year low of 0.51% as of November 2022."

Widespread Reassessment of Where to Manufacture

Like so many aspects of commercial real estate, rising interest rates increase the cost of borrowing, so the goods trade is likely to face downward pressure in 2023, not to mention lingering supply chain issues and reshoring and nearshoring efforts.

"There also is the chance of a domino effect as manufacturing, and the subsequent warehousing and distribution needs for these goods, might shrink and thereby lower demand for industrial properties," Jabir said. "Supply chain pressures have caused widespread reassessment throughout

the manufacturing industry about where goods should be produced."

She anticipates that property subtypes across the industrial sector are likely to benefit due to the increased domestic need for space to house research, production, assembly, storage, and distribution facilities.

Industrial properties have performed "spectacularly well," Jabir said, supported by industrial production numbers for both manufacturing and consumer goods. The Institute for Supply Management's Purchasing Managers Index (PMI), a key indicator, is shrinking.

An index reading above 50 represents expansion within the manufacturing sector compared to the prior month, while a reading below 50 represents contraction, the PMI has steadily trended lower during the past two years even as manufacturing activity has grown. It fell to 48.4 in December following a reading of 49 in November.

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Risk Being Assessed Differently & Slobalization

Adam Roth, executive vice president, Industrial Services, NAI Hiffman, tells GlobeSt.com that as supply chains catch up, "we somewhat suddenly find ourselves re-entering more traditional trade flow patterns.

"Corporations' mid-pandemic reaction was ordering additional product for just-in-case stockpiles to prevent lost sales that occurred earlier in the outbreak. I would expect some correction in 'footprint' as better reliability and pricing returns to the transportation sector and retailers burn through their inventory.

"However, in our recent experience there are long-term supply chain shifts occurring. Risk is being assessed differently. Selective decoupling from China will continue to pick up pace."

He said the age of cost-driven, blind globalization is being replaced by 'slowbalization' and a movement towards bilateral trading blocs with like-minded nations as well as production locally – supply chain to be replaced by supply web and international regionalization.

"While we will experience near-term lower transportation pricing as another bullwhip effect coming out of the pandemic, in the long run, corporations will be forced to combat their length of

haul and reduce their time to market," Roth said.

"Real estate is an ideal solution for this. I remain bullish on the industrial real estate sector for North America, particularly in areas that offer access to power, population and transportation infrastructure."

Retailers Slowing Their Need to Add Distribution Space

Adrian Ponsen, national director of U.S. industrial analytics at CoStar Group, tells GlobeSt.com that, when adjusted for inflation, retail goods sales are still coming in at a healthy level as they've yet to fall significantly from the "incredibly" elevated levels reached during the pandemic.

"The problem is that the number of physical goods Americans are buying has essentially flat-lined at this high level for more than 12 months," Ponsen said. "As the impact of stimulus checks and excess savings has been fading from the picture, households haven't been able to push their spending on goods much higher.

"With households still frazzled from last year's inflation, and now coming under pressure from the recent spike in credit card rates, retailers aren't expecting a significant acceleration in sales, and so some are slowing down their leasing of additional distribution space, particularly if their business is tied to home sales, which are currently in the doldrums."

But the picture is definitely not the same across markets.

"We are tracking more than 25 very large semiconductor, electric vehicle, and electric vehicle battery plants planning to begin production in the U.S. before the end of 2025," Ponsen said.

"It is very difficult to be bearish on the outlook for industrial leasing if you are sitting in a state like Arizona, Georgia, or North Carolina, knowing numerous large-scale high-tech manufacturers are opening facilities in your market within the next two years, and you're seeing examples of future suppliers to these plants leasing space nearby on an almost weekly basis."

Owners Benefiting from When Leases Expire

Doug Ressler, Commercial Edge, tells GlobeSt.com that demand for industrial space has remained elevated since the pandemic started, and owners are benefiting when leases expire, according to Yardi Market Insight.

Yardi Market Insight found that leasing spreads—the difference between a new lease signed over the past six months and the prior rate for the same space—are up substantially.

Of the 63 markets covered by Insight, 44 have a lease spread greater than 10%, and 16 are higher than 20%. The largest spreads are generally found in port markets and logistics hubs, although some tertiary and emerging markets have seen outsize spreads, as well."

With such substantial lease spreads, properties with leases that expire soon will be more attractive on the transaction market. Given the current interest rate environment and economic uncertainty, leasing expiration schedules could be the difference between a deal penciling or not.

Rent growth has been slowest in the Midwest. St. Louis (with a 2.1% increase in rents over the last 12 months), the Twin Cities (3.3%), and Chicago (3.5%) saw some of the lowest gains for in-place rents. Even in-demand markets with low vacancy rates such as Indianapolis (3.4% rent growth) and Columbus (3.5%) have not seen much rent movement over the last 12 months. New supply is easier to build in these locales than in the port markets, giving tenants more of an upper hand in rent negotiations than they would have in Southern California or along the East Coast.

'So Little Vacancy and Scarce Availability'

Julian Freeman, Partner, Cox Castle, tells GlobeSt.com, "Based on discussions with my industrial owner clients, the industrial market is softening relative to the incredibly strong growth of the past two years.

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"Despite slowing momentum, some predict that 2023 will still be a strong year, with growth similar to growth in 2019, which was a relatively strong year in the industrial sector. Vacancies may rise slightly nationally, primarily due to new supply in the market.

"Nonetheless, since there is still so little vacancy and scarce availability, many predict that 2023 will see continuing growth in industrial rents, particularly in port markets.

Industrial Still a 'Darling' of Institutional Investors

Stephen Evans, managing director with Miami-based Black Salmon, tells GlobeSt.com that despite the headwinds it is important to note that the market overall is approximately 3.5% vacant, and e-commerce continues to grow, albeit at a slower pace.

“Even with a higher vacancy and lower demand, the industrial market (vacancy) is at a good starting place entering a recessionary environment,” Evans said.

“Industrial is the darling of institutional investors as the appetite for office and certain retail assets has waned. Regarding the supply, the average age of the U.S. warehouse stock is more than 40 years old. As a result, large and smaller warehouse users are demanding modern design, higher clear heights, truck and trailer storage, and other modern features for lighting, safety, and efficiency.

“These factors support newly constructed warehouse facilities, and while we are cautious about our investment decisions, we remain bullish on the industrial sector in the long term.”

Evans said from a national perspective, the market has softened; however, not all markets demonstrate the same state of demand, nor is the demand for a particular property size the same.

“Size matters in markets such as the Inland Empire, where supply is constrained for large buildings in high demand, while in Dallas, there is a significant supply of large buildings where the demand has slowed,” according to Evans.

“Other markets are experiencing added risk due to substantial new supply delivered (or soon-to-be) while absorption and leasing activity slows. A large percentage of the new industrial stock in Austin will be delivered vacant. Conversely, some markets, such as Savannah, have rapidly increased supply, and most of the new construction is pre-leased or on a build-to-suit basis.

Black Salmon is selective about where we invest and spends significant time understanding the local market trends to mitigate investment risk. Today, we are very active in the industrial sector, with several investments under development while underwriting an active pipeline.”

BKM Capital Partners Hasn’t Seen Pullback

Brett Turner, Senior Managing Director, Acquisitions & Dispositions, BKM Capital Partners, tells GlobeSt.com, “After years of heavy double-digit rent growth and ultra-tight vacancy, we expect to see some softening.

“Despite this, BKM has not seen any type of pullback. Our portfolio has never been more occupied, our leasing spreads have never been higher, and our credit loss has never been lower. Fundamentals remain strong.

Two-Thirds of SoCal Developers Have At least One New Project

Seth Garrett, Partner at Allen Matkins, tells GlobeSt.com that demand in the industrial sector is

beginning to normalize. In fact, the latest Allen Matkins/UCLA Anderson Forecast predicts that while demand will remain strong, it will not increase at the rates seen in 2020 and 2021 in the coming years.

“Industrial real estate experienced heightened demand during the pandemic, outperforming expectations, as the already flourishing market was spurred by a rapid shift toward e-commerce shopping and last-mile delivery,” Garrett said.

“The sector was always expected to cool down after performing so well for so long. As supply begins to catch up with demand, vacancy rates will increase, and rental rates will decrease, and the overheated industrial sector will begin to cool down.

“Right now, the market’s biggest challenge is the continued rising interest rates, leading to uncertainty in the industrial sector. With the Fed’s plans to remain bullish on rate increases, the rising cost of capital will lead to the postponement of new development and investment in industrial assets. What’s more, with a looming recession and continued inflation impacting consumers’ budgets, ultimately hindering sales, industrial developers are likely to cut back on speculative construction.”

However, despite rising rates and market uncertainty, developers are still planning industrial projects, Garrett said.

The Allen Matkins/UCLA Anderson survey shows that two-thirds of developers in Southern California have at least one new project in the works. “A cooling in the industrial sector will not deter future growth,” he said.

San Diego, Phoenix Healthy Markets

Josh Tracy, vice president of real estate development at Ryan Companies in Phoenix, tells GlobeSt.com, “We have yet to see a softening of the industrial market in Phoenix, real estate development at Ryan Companies. Vacancy decreased by 13 basis points in Q4 2022 and is currently at 3%.

“We continue to see companies relocating from California, vendors supporting the massive semiconductor expansions (TSMC & Intel), and automotive suppliers for the new auto plants south of Phoenix.”

Ryan Grove, vice president of real estate development at Ryan Companies, tells GlobeSt.com that industrial demand is still healthy in San Diego due to strong rent growth, a diverse tenant pool, and a lack of large blocks of land for new industrial development.

"We have seen a slight uptick in industrial vacancy over the last year, but the overall vacancy rate still hovers at historic lows under 3%," Grove said.

Top Companies Modernizing Their Supply Chain Facilities

Brian Netzky, principal at Glenstar Properties, tells GlobeSt.com that there's been a fundamental shift in the industry over the last several years, which will continue to create growth within the sector.

"Reshoring and onshoring have become top priorities for both government and corporations alike due to geopolitical shifts away from globalization," Netzky said.

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"Additionally, companies are reexamining how to distribute their goods across the country resulting in a radical shift away from the antiquated Long Beach (west to east) and New Jersey (east to west) centric ports to southern ports, leading to greater demand in the South.

"Data in the Sunbelt Region shows increased demand and record low vacancy for the foreseeable future. When you combine macro elements, like historical population growth and pro-business governments, with multiple demand drivers in a market, such as skilled labor, advanced manufacturing, and port and transportation access, it's a recipe for demand to continue to exceed supply."

Netzky said when looking at the absorption numbers, "you must also examine the corresponding delivery numbers. In years when more space is delivered, there will likely be less absorption as a percentage.

"That doesn't mean more supply than demand. It's still an extremely healthy growth environment.

In many high-growth markets, there's still a great demand pipeline that exceeds the supply pipeline. Additionally, over the next several years there will likely be a shortage of space delivered, due to a reduced allocation of capital, creating pent-up demand."

Lenders Applying the Brakes

Robert Smietana, vice chairman and CEO of HSA Commercial Real Estate, tells GlobeSt.com that the increase in short-term interest rates from near 0% to levels over 4.5% is starting to slow the economy as designed.

"Lenders have put the brakes on lending as well because of rising rates, so we're seeing fewer new construction starts," Smietana said.

"While manufacturers and other warehouse tenants have somewhat reduced their needs, there will also be fewer new buildings delivering in 2024, which will create a tighter market for tenants and keep absorption rates from falling."