The Next Big Trend in Industrial

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IRVINE, CA—Multi-story warehouse **development** hasn't caught on quite yet in the US, but it's a big trend in some Asian countries that would require an overhaul of 18-wheelers to be fully realized here, says **Mike Kendall**, executive managing director in **Colliers International**'s Irvine, CA, office. Kendall oversees Colliers' institutional **industrial** investment platform for the West Coast, teaming with local experts in various markets in that region. We sat down with him for a chat about the top industrial **capital-markets** trends he's noticing and anticipating to grow in 2018.

GlobeSt.com: What are the top industrial capital-markets trends you're anticipating for 2018?

Kendall: One of the trends is the desirability of the **logistics** sector in the US and worldwide, but first we need to define the term logistics. In the US, everyone refers to the category as industrial or warehouse, but globally it's referred to as logistics. Right now, logistics—or modern warehouse buildings—is the number-one desired product type in the world. One of the reasons for that is the stability everyone has associated with industrial, which has much less volatility than **office** and **retail**.

E-commerce has been a net positive for the industrial sector. When you talk about global capital, five years ago there was very little interest outside of the US to invest in US industrial properties. Foreign investors were much more interested in trophy hotels and high-profile office, but that has changed. There's a limit to these industrial transactions in that they have to buy scale to make it worth their while, so they focus on transactions that are $100 million and greater. These investors have been most active in large **Amazon-leased** warehouses along with some large national logistics portfolios. There have been several large transactions recently with capital originating from Singapore, Korea, Germany and Canada to name a few.

Because it's the number one product type, everyone is under-allocated in industrial. There's been a flood of capital in the space, but there's very little product on the market. Cap rates are at historic lows, values are at historic highs and the fundamentals are amazing, with vacancy rates at all-time lows. There's a lot more capital chasing this real estate, so there are lots of green lights now in industrial.

Another trend that's early on here is **multi-story warehouse**, which is alive and well in Asia. The only developer that has a multi-story warehouse project under **construction** in the US is Prologis, one of largest industrial owners in Japan and China, and it's using that know-how and expertise to bring this product into the US. Their first multi-story warehouse project is in Seattle, and there is another that's nearing commencement of construction in San Francisco by the airport. Those are the only two I know of that are actually happening. There are probably six to eight projects in L.A. where developers have architects working on plans for multi-story warehouse facilities, but they're not greenlighted yet.

A big reason why multi-story warehouse work in Japan and China so well but hasn't worked here is that they have a large network of smaller trucks. The standard delivery truck in Japan can navigate a multi-level warehouse without a problem, but the 18-wheelers we use here are not designed to go up and down ramps, etc. The **infrastructure** doesn't exist in the US and the high construction costs only pencil when land values exceed $60-70 per land square foot, so these projects only really work in the most infill locations in markets like Seattle, San Francisco, Los Angeles, New York, New Jersey and South Florida, where land prices are reaching or exceeding those pricing levels.

One buzz phrase you hear is "last mile," which is a big topic of discussion in logistics circles. If you ask five people to define what qualifies as last mile, you will get five different answers. This term has only come about in the last 12 to 18 months, and we will see limited winners in that space. The users that actually fill these buildings have a narrower definition of last mile, so that definition will be driven by the tenants.

Another trend is the insatiable demand and wall of capital targeting logistics property. We're starting to see a lot of activity in some strong secondary markets, whereas it used to be that core industrial developers would only look at primary, tier-one gateway markets. But now, they're being priced out of some of those markets, and because cap rates have gotten so low, a lot of them are looking at the characteristics of secondary markets. One of these is San Diego—which is not a gateway market from an industrial standpoint because it doesn't have the size of the industrial base to qualify, but it exhibits a lot of the fundamentals that attract others to that market, including its physical limitations and great demographics. Because of this, people are looking at San Diego now, that two years ago weren't considering investing there. Las Vegas is another market that has increased in demand, and Phoenix is also getting a lot of looks today. These markets are driven by competition in California.

GlobeSt.com: What are investors' financing strategies as interest rates creep up?

Kendall: Industrial is probably the least debt-dependent sector right now in CRE. Probably 60% to 70% of industrial sales that I'm involved in are cash transactions. A lot of this is driven by the intense competition to buy: when all bidders are offering the same price, sellers use other factors to select a buyer, including how quickly they can complete the transaction. All cash is one way. Because of that, industrial doesn't have the same link to debt as, say, suburban office, and the recent rise in interest rates has not impacted industrial trades. It hasn't changed cap rates yet or decreased demand from the capital side.

As rates continue to increase, however, this has to have an impact on cap rates at some point. We're just not sure when that will happen. Some buying groups will buy for cash and put portfolio debt on other properties in their portfolio, which spreads the risk over a wider base. They can get more-attractive long-term debt this way and use their pricing power, so it's still accretive. One of the bigger stories to watch is how much more interest rates can increase before it starts to impact cap rates.

GlobeSt.com: How will the federal tax plan influence investors' capital-markets strategies this year?

Kendall: This has yet to be seen. The real estate markets are not nearly as efficient or liquid as the equities markets, and what I'm hearing is that we're not going to see significant changes in capital flows because of the tax plan in the near term. There are some advantages in the tax plan on a net basis, but it's essentially neutral to slightly positive regarding CRE. Commercial real estate still represents a great tax-efficient investment vehicle, and I don't see that changing.

The other thing to keep in mind is that there have been some changes in how **leases** have to be accounted for by corporate users. It used to be that a lease was not a capital item on a balance sheet, but now a lease of greater than five years has to be shown as a capital liability. Will this push more corporations to own real estate? I don't think so. Capital is still a precious commodity to users, and even though they will lose some tax efficiencies, they would rather invest capital in their business than in real estate itself. Owning real estate is a capital-intensive proposition, so we not seeing a flood of companies wanting to own rather than lease real estate.

GlobeSt.com: What else should our readers know about industrial CRE capital markets in 2018?

Kendall: Everyone is wondering where we are in the cycle. We're pretty deep into this recovery, if you're looking at it from a timing/real estate standpoint. Are we at risk for overbuilding? Not in California, where the fundamentals are still really strong. We're seeing incredible demand for land for new development. The reason we're not overbuilding here is that there are so many impediments to new construction. It's very time consuming to get entitlements, so we've kept a lid on new supply. When you don't see a flood of new product, it keeps the cycle going longer since there's no oversupply. We believe that will continue for at least the next several years.

Another interesting trend people are talking about is what happens when we get driverless trucks. Obviously, we're very close to getting driverless car, and everyone believes trucks will follow. That will be a hot topic of discussion over the next several years: how does that change the supply chain in industrial?
