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Why industrial rents are going up: It all depends on the type of property owner - by David Skinner

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Industrial rents are going way up. The days of buildings on I-495 that rent for $3.00-$5.00 per s/f are gone, probably forever. Why is that happening, and what should we expect moving into the future? The way to understand where rents are going is to understand what kinds of landlords own the real estate and how they operate.

There are two main categories of real estate owners, and both are motivated very differently. On one hand are the local investors, developers, or owner operators, and on the other hand are institutional fund managers, portfolio managers, or otherwise deep pocketed investors.

1. Local investors, developers, or operators. This first group is primarily interested in profit, and secondarily interested in saving money. Historically, the Boston market has been slow to see institutional buyers with billion dollar funds purchasing industrial real estate as is much more prevalent in other Tier 1 markets around the country. In Boston, local investors and developers own and have owned and managed most of the real estate, especially industrial real estate. These landlords are cash-driven. They may run a local business and have excess real estate as a by-product of their business, maybe they are a local landlord with a small bank account, or they may be simply very conservative and sensitive about spending money on their real estate. This type of landlord is going to be motivated by little to no tenant improvement work, working for as close to an “as-is” deal as they can get. These landlords also may not have their own property manager, and so they will be more motivated by tenants with good local credit rather than maximizing on every penny of the lease because they will likely want to minimize the chance that they personally need to run around collecting rent checks. In some cases a landlord like this may execute a deal that does not maximize the return if there is no hassle and no cash needed to get the deal done and may compromise on rental rate and term length in order to do the deal. These local landlords are not focused on squeezing every penny out of the deal, because they would rather a lower rent and even a marginally lower return if it meant that they did not need to come out of pocket for tenant improvement, even if it meant they could justify a higher rental rate.

2. Institutional owners. The second group of landlords are not cash-strapped at all. They may have a billion dollars (or more) in a fund earmarked to be deployed in commercial real estate. They are not afraid to pay up to buy a building, and they will really push rents as they can afford to keep a building vacant at a higher rental rate for longer. This landlord may manage a fund of some kind or is in the buy, invest, and flip business. They are motivated by maximizing the Net Operating Income which is simply Total Revenue - Operating Expenses. This means that term and net revenue are the most valuable factors to a lease and things that do not affect the base rent number are the most easily given up. For example, landlords like this would rather compromise by writing a larger check for tenant improvements at the beginning of the lease term than lowering the base rental rate. Another typical concession by a landlord like this would be a period of free rent at the beginning of the lease term in lieu of lower base rent so that when the building is fully leased they can flip the property at a multiple of value of the leases or for the purpose of refinancing.

We are seeing a mass consolidation of commercial real estate and an aggregation of ownership by buyers / landlords in the second category. Get ready to continue to see rising rental rates, higher tenant improvement allowances across the board, and higher purchase prices for well-located industrial buildings over the next year or more.

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