Industrial markets – What are they telling us? by William Pastuszek

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The era of free money being over, and with post-COVID inflation eroding purchasing power and making everything more expensive, markets are adjusting to the higher cost of acquiring and holding real estate. Plus, everyone is kept on edge by what is going on inside and outside the borders of the nation. And in New England, we are eyeing what is going on in the rest of the country. The economic landscape has dramatically changed.

The faces of commercial real estate (CRE) have changed. The long run up of real estate assets – perceived as safe long term but management intensive - has been over for the better part of a year. There are many who are still operating as if not much has changed. Commercial real estate has become more adaptable – and more nimble – today due to better information access and greater ease in financing. As far as asset classes are concerned, multi-family adapts relatively easily due to the short-term nature of tenancies, as does self-storage. Office, due to long lease horizons and what appear to be more permanent COVID aftereffects, is encountering some headwinds.

Industrial has been the darling investment class. This sector is highly diversified, ranging from the “Amazons” to “Main Street” industrial. The Boston market is a small market but has experienced very dramatic price and rent increases.

In 2022 CoStar said, “Boston’s industrial market doesn’t yet show the macro burdens of peak rents, pricing, or development …Anecdotally, though, players across the area see growing strain on lease negotiations, pro formas, and construction supply chains.” The most recent overview tells us, “One quarter does not make a trend, but the breadcrumbs of a slowdown in Boston’s industrial market were far more visible in 23Q1. After absorption finished negative for the second time in three quarters, 12-month net absorption in the metro area fell below 2 million s/f for the first time in 18 months. Vacancy increased 50 basis points … Asking rents, while still increasing at outsized rates, saw their annualized increases fall below 8% for the first time in over a year.”

With availability at 7% with an average of 7.9 months on market, both indicators represent an increase over 2022, but still show the Boston market outperforming national trends. Boston’s average price per s/f of $195 per s/f is higher than that of 2022. When contrasted to the national average of $164 per s/f , Boston represents a high per s/f value market, with an average price nearly 10% higher. A Boston market cap rate of 5.9% (down from 6% in 2022) is marginally lower than the reported national cap rate of 6%.

Of concern is absorption, which has gone negative, slower leasing volume, and delivery of new space. Could it be that Boston has made progress in overcoming the shortage of product over the past 5 years or so? (Worth noting also, is the outsized influence of Amazon on the statistics in this market.)

Another investor survey notes that recent cap rates for warehouse/industrials, nationally and regionally have shifted up “at larger-than-usual amounts.” Cap rate shifts average +/-40 basis points which represents one of the largest quarterly “jumps” over the past decade. This is a trend worth tracking and bears what had been anecdotal previously. (Different surveys produce different results and it’s always important to understand what underlying data and methodologies is relied upon to ably interpret the conclusions of the survey.)

So, while investors remain optimistic about warehousing, there are concerns underscoring the need for additional due diligence and patience in making investment-related decisions to better understand the evolution of this sector.

What drives the industrial market in Eastern Massachusetts? CoStar indicates that the Boston market has logistics as the predominant subtype. Flex is significant too, accounting for nearly one third of inventory. Warehouse and distribution assets show lower vacancy than flex buildings.

While volumes will be down, prospective – though less robust – rent growth entices investors, and buyers are still out there, even though buyers and lenders both have become more selective of late. (How much of the drop in demand is in response to higher interest rates is a fair question. Thus, if rates begin to drop at the end of 2023, will demand be stimulated?)

In terms of investment activity, any source consulted notes dramatic drops in commercial real estate investment volume locally, nationally, and globally. More recently, the fallout from recent bank failures will result in much more conservative lending by larger lenders and opportunities for smaller lenders to finance projects that may represent a greater level of risk than smaller banks are able to absorb.

The Boston industrial market is a sophisticated one, located a dense, diverse, affluent area with a skilled consumer pool and work force. There is a strong mix of industrial users ranging from logistics to life science. (Life sciences is an important and pricy demand driver: that market should be considered separately at another time.) While there are storm clouds, and signs that demand is peaking in this cycle, the sector continues to represent a viable, long-term arena for investment. In terms of valuation, as always, care should be taken to not rely overly on averages and broad bush indexes. A property needs to be in the context of its specific market niche.

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