Colony Industrial

Light industrial is the new heavyweight

Jonathan A. Schein, senior vice president and managing director of global business development for Institutional Real Estate, Inc., recently spoke with **Lew Friedland,** managing director at Colony Capital, Inc., and head of Colony Industrial, about current trends in the light industrial sector. Following is an excerpt of that conversation.

What trends are driving the light industrial sector right now?

The biggest trend we are seeing is strong demand for last-mile warehouse logistics, coupled with relatively limited new supply. There are very diverse drivers of demand for smaller infill buildings. It's not only retail e-commerce — many of the materials and supplies that support construction and factories have to be stored in the local market and quickly distributed locally. Construction demand by both the residential and commercial sectors is very strong. Manufacturing is also doing extremely well, helped by the push to have more production performed in the United States.

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Retail, of course, is a big demand driver, with the surge in e-commerce in the last 10 years. Everyone is now experiencing the "Amazon effect." Their delivery innovation is the market's bellwether. Amazon hasn't stopped with one- or two-day service, delivered from large, million-square-foot fulfillment centers via FedEx or UPS. Their Amazon Prime Now service, rolled out a few years ago, with one- or two-hour delivery, could become the new standard every retailer from Walmart on down has to match.

What does that mean for Colony Industrial?

The vast majority of our tenants are wholesale B2B distributors and almost all of them are trying to improve their logistics networks to deliver products more quickly. Reconfiguring their networks requires more, smaller distribution nodes located closer to customers. In a large population market with relatively limited new supply, it means plenty of demand for our well-located warehouse properties. This is attractive for us because the business-to-business market for quick delivery is estimated to be more than twice the size of the business-to-consumer market.

What differentiates light industrial warehouse from bulk warehouse or flex and R&D properties?

The light industrial market is the largest segment of the U.S. logistics market, accounting for half of the 9.2 billion-square-foot total U.S. industrial market. At one end of the spectrum are bulk industrial buildings, accounting for about 28 percent of the total square footage of the sector. When I started in the business 30 years ago, a large bulk industrial building was 300,000 square feet in size. Today, developers are building spec buildings that are 800,000 square feet, 1 million square feet or even larger. They tend to be used for national distribution of product and are generally clustered in the top five industrial bulk markets, which are Los Angeles, Chicago, Dallas, Atlanta and Northern New Jersey.

The logistics chain flows from these bulk buildings to the smaller, infill, light industrial buildings, and finally to the end consumer, whether it's a retailer, another wholesaler, a factory, a construction site or your home or mine. These light industrial buildings need to be located close to the population centers and have good transportation options.

And at the other end of the spectrum?

At the other end are flex or R&D buildings. These are smaller in size, have lower clear heights and have a very high-office finish — sometimes they are 100 percent built out as office space. They are designed for companies that want to incorporate both office and lab or R&D uses in the same building. They represent about 21 percent of the market. We don't invest at either end of the spectrum — bulk or R&D.

The biggest sector, 51 percent of the industrial square footage, is light industrial buildings, which are generally 250,000 square feet in size or smaller, primarily multi-tenanted with low-office finish. They are not flex product. The real differentiating factor is their prime, infill locations close to the center of major metropolitan areas.

Colony Industrial's portfolio totals more than 47 million square feet of light industrial product as of June 30, 2018, with an average building size of about 120,000 square feet, at an average tenant space of 46,000 square feet. Seventy-seven percent of our space is leased to international or national companies, many of which may have one or two large bulk buildings, maybe one in Los Angeles and one in Northern New Jersey, but they may have 50, 100 or 300 infill distribution warehouse spaces in the 25,000-square-foot to 75,000-square-foot range. Since 2001, about 96 percent of all industrial lease transactions done in the United States are for spaces 75,000 square feet or smaller, our sweet spot.

What can you tell me about light industrial's supply side?

The strong demand for infill spaces runs up against the very constrained supply of new construction, unlike in the bulk market, where there is a lot of new supply. It's relatively easy to permit and build bulk industrial buildings — 800,000-square-foot buildings don't need to be close to the center of the city, and their cost per foot of construction is a lot lower from economies of scale than smaller infill facilities. Our typical infill, multi-tenanted building might be 120,000 square feet with three or four tenant spaces, and every tenant has their own heating/air conditioning system, plumbing, electrical, kitchen, and bathrooms, making it very expensive to build.

On top of that, light-industrial land sites are costly and in short supply. It's difficult to find an infill site that is zoned for industrial space. Where there is a potential infill site, generally a multifamily, office or mixed-use developer can often pay more for the land. It can be a struggle to rezone for more industrial land — a new warehouse is the last thing someone wants built next to their apartment. As a result, annual construction deliveries of light industrial space account for only about 1.3 percent of total existing light industrial inventory, versus 5.4 percent for bulk.

Do you think existing infill warehouse properties are becoming too expensive?

Values are definitely increasing and so are rents. Tenants are willing to pay premium rents for infill locations near their customers to reduce delivery time and cost. In the logistics business in general, the cost of the space, the rent that the tenant pays, is a relatively small percentage of their total cost chain — around 5 percent — while their biggest costs are transportation and labor.

Which markets do you focus on, and why?

We focus on markets with large population centers, a growing population and strong job growth, because the strength of the local economy is what drives the demand for last-mile distribution. We want a market large enough so that we can gain scale and have multiple buildings and many opportunities for tenants to grow. There are roughly 28 markets that we are targeting, and we are already in 20 of them.

Who are your tenants and what are their businesses?

We have roughly 1,000 tenants, and they are extremely diverse. We have tenants that are in the medical distribution business, paper goods, plumbing supplies and automotive supplies. In addition, we have several large e-commerce tenants, as well as businesses including DHL, UPS, FedEx and the United States Postal Service, that support both retail and wholesale e-commerce deliveries. These tenants lease spaces ranging from 10,000 square feet to 150,000 square feet in size that enable quick delivery to their customers. One of our tenants, Plated, produces prepared meal kits, and they distribute them out of one our buildings close to a major metropolitan area. We are seeing more demand for food and grocery-related businesses that need to be in very close proximity to their customers.

What is your investment strategy, in terms of acquisitions and/or development?

We acquired all the properties that we own today. In most markets, rents have to grow 15 to 20 percent before it makes sense to develop new space. We are just beginning to develop in very limited situations, where we can find good local partners that have a land position and where we can find the right balance between land cost, construction costs, rents and yield on cost.

What is your investment thesis going forward?

We really like this sector. The supply/demand imbalance is very favorable, and it's still a relatively fragmented sector in the real estate space. According to CoStar, as of December 31, 2017, the top 25 owners of bulk warehouses own about 26 percent of properties, while the top 25 owners of light industrial own just 11 percent of the inventory. Many of our tenants have several hundred locations throughout the United States, and one of our goals is to continue to do more business with these companies in multiple markets as we gain greater scale on a national basis.

We're experiencing a very favorable supply/demand imbalance at this time — light industrial properties are becoming more valuable with rising rents, increased demand, and the rising costs and barriers to new development.

Looking ahead, what are your thoughts about the future of the light industrial sector?

We continue to see a positive outlook for light industrial, especially for companies with strong last-mile property portfolios. We're experiencing a very favorable supply/demand imbalance at this time — light industrial properties are becoming more valuable with rising rents, increased demand, and the rising costs and barriers to new development.

I think there will be continued consolidation in the light industrial space, because ownership is so fragmented. Property acquisition and development may be more challenging going forward, which benefits established companies like Colony Industrial, because we already have a large property portfolio, and a highly skilled and experienced team to handle acquisitions, development, asset management and property management.

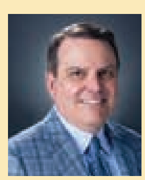
While most attention is focused on retail e-commerce delivery logistics, it's not yet clear whether online grocery delivery, next-hour delivery and other last-mile consumer services can scale, go mainstream, and be sustainable drivers of light industrial growth. We are closely watching the business-to-business sector now — at more than twice the size of consumer e-commerce, it has great potential.

CORPORATE OVERVIEW

Colony Industrial, the industrial platform of Colony Capital, Inc., is headquartered in Dallas, Texas. The firm was formed in 2014 after Colony's acquisition of Cobalt Capital Partners, and it currently owns and manages 47.5 million square feet of warehouse buildings in 20 major markets across the United States, with a gross asset value of more than $3.5 billion as of June 30, 2018.

Colony Industrial has a diversified tenant base of national B2B, B2C, wholesale and consumer businesses. In major markets around the United States, its infill property locations enable the fast delivery critical to last-mile logistics.

CONTRIBUTOR



Lew Friedland, Managing Director at Colony Capital and Head of Colony Industrial

Lew Friedland is responsible for all operations of the industrial platform of Colony Capital, including investments, portfolio management and capital markets. Previously, he founded Cobalt Capital Partners in 2002 to focus on light industrial properties. When the Cobalt portfolio was acquired by Colony Capital in 2014, he and his team joined Colony Capital to continue to expand the platform.

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