COSTAR INSIGHT

Unprecedented Surge in Speculative Construction No Match for Logistics Demand

Supply-Demand Balance Expected To Remain Intact Despite Record Construction Levels

A logistics facility under construction in Rahway, New Jersey. (CoStar)

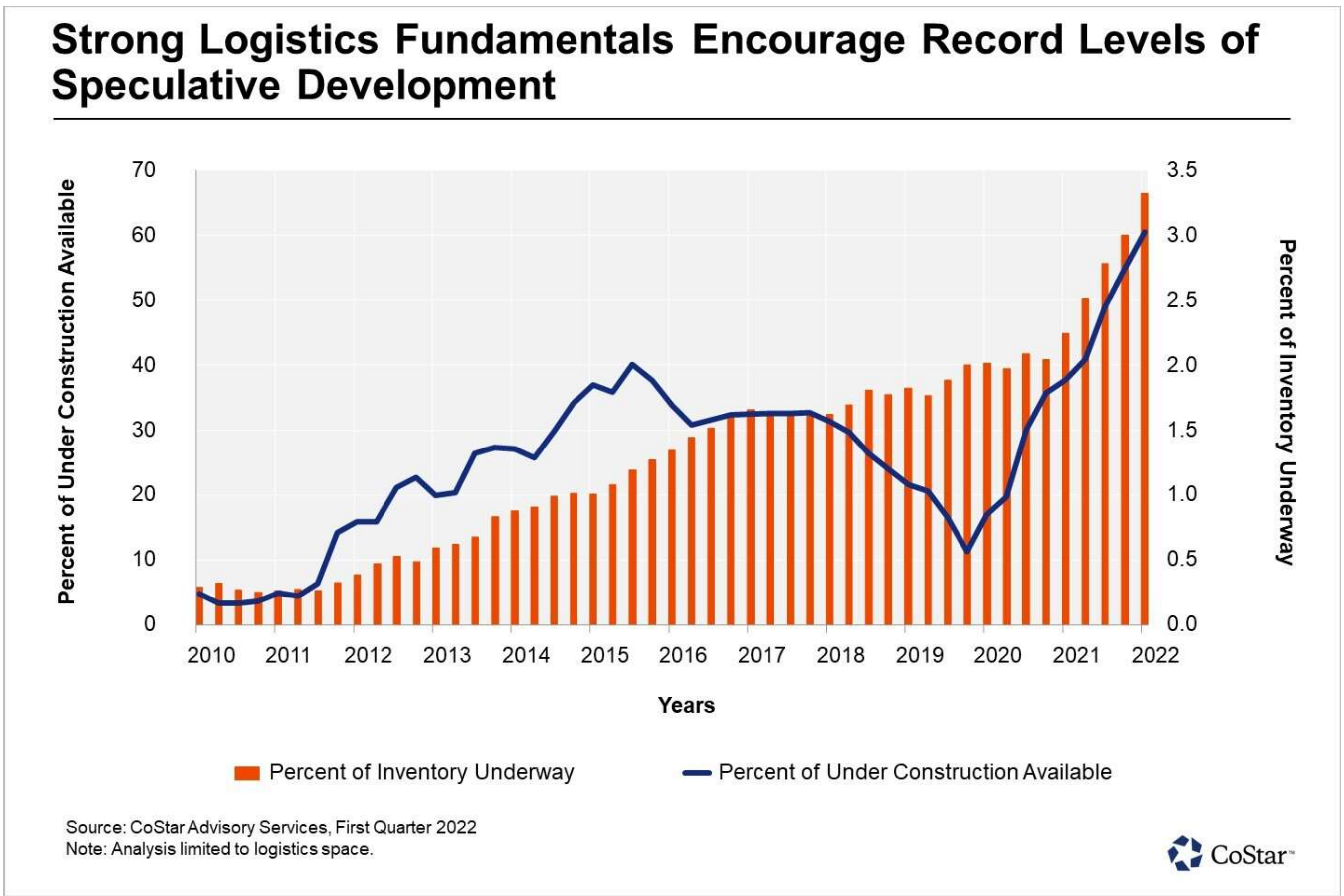
By Andrew Zola
CoStar Advisory Services

June 14, 2022 | 4:32 P.M.

The logistics property sector is experiencing its largest supply wave seen to date. The staggering amount of new speculative space coming online would be cause for alarm if it was any other property type. However, the rapid pace of construction is only exceeded by leasing activity in the sector, as net absorption of logistics space across the U.S. reached a record level of 470 million square feet in 2021.

Given the exceptionally strong demand, low availability and pricing premium being commanded by existing assets, we fully expect new speculative logistics developments to perform strongly, as competition among tenants and owners for existing space has continued to push both pricing and rent growth, which, respectively, are up 30% and 20%, cumulatively, from the first quarter of 2020 through the first quarter of 2022.

Demand has driven the average vacancy rate for logistics space down to 4% as of the first quarter of 2022. On the investment side, capitalization rates for logistics property sales have compressed 80 basis points since the start of the pandemic, encouraging further development across the country in search of compelling yields. A total of 588 million square feet of logistics space was actively under construction at the end of the first quarter of 2022, accounting for over 3% of existing inventory.

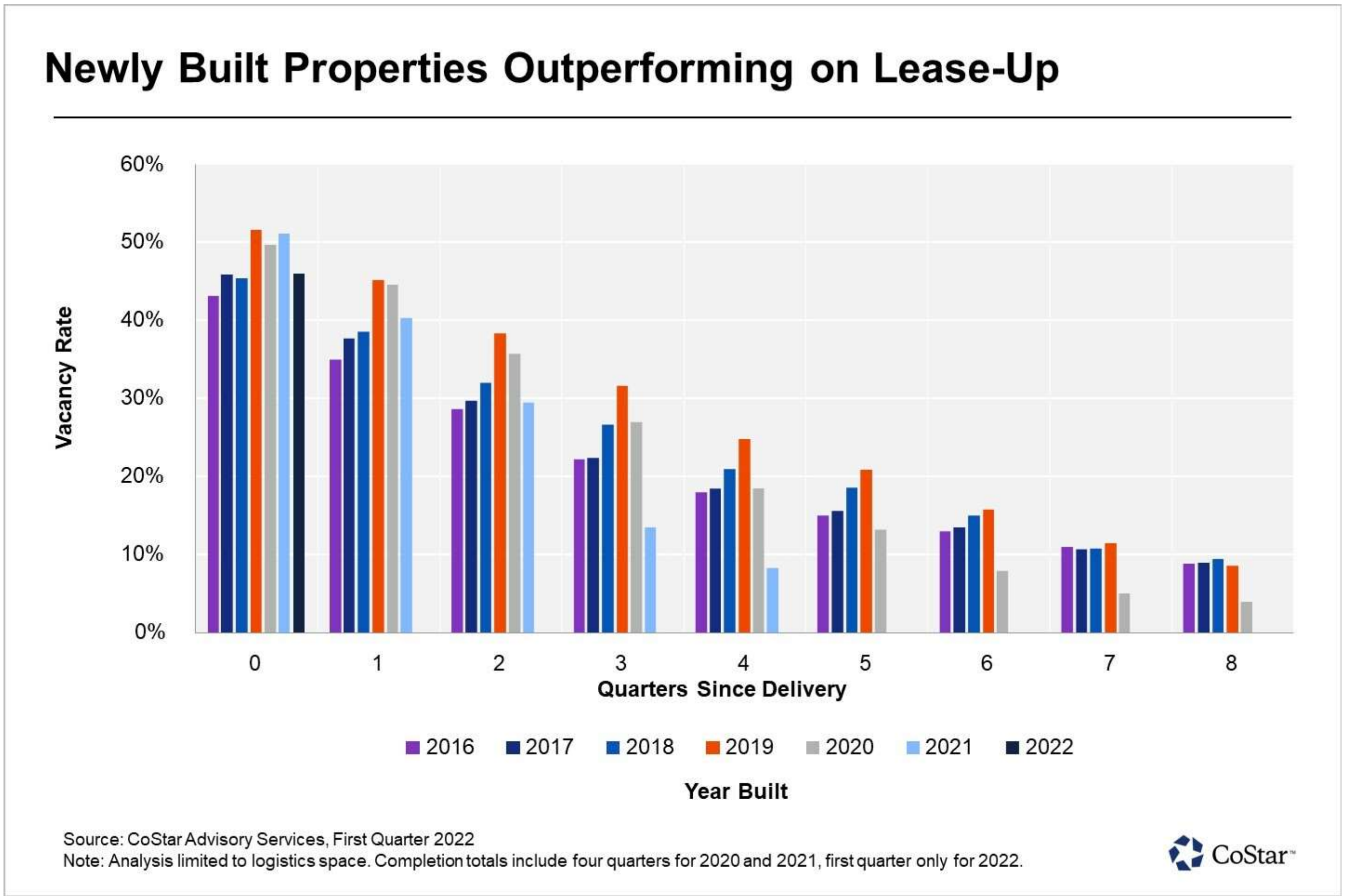


While the amount of new logistics space under construction is significant relative to historical levels, demand for new logistics space has also been exceptionally strong in the current environment. Disrupted supply chains have increased the need for efficiency, making newer, up-to-date facilities more attractive for meeting logistics tenants’ preferences. Furthermore, consumers' expectations for shorter delivery times combined with increasing favorability of just-in-time-manufacturing have also increased demand for modern logistics facilities.

Amazon alone absorbed 240 million square feet in 2020 and 2021 combined. The bulk of that leased space, 154 million square feet, was in properties that were completed in 2020 or 2021, accounting for 64% of the space Amazon absorbed in the time frame. This also accounts for 37% of the total amount of space occupied in logistics facilities completed in 2020 and 2021, according to CoStar’s tenant data.

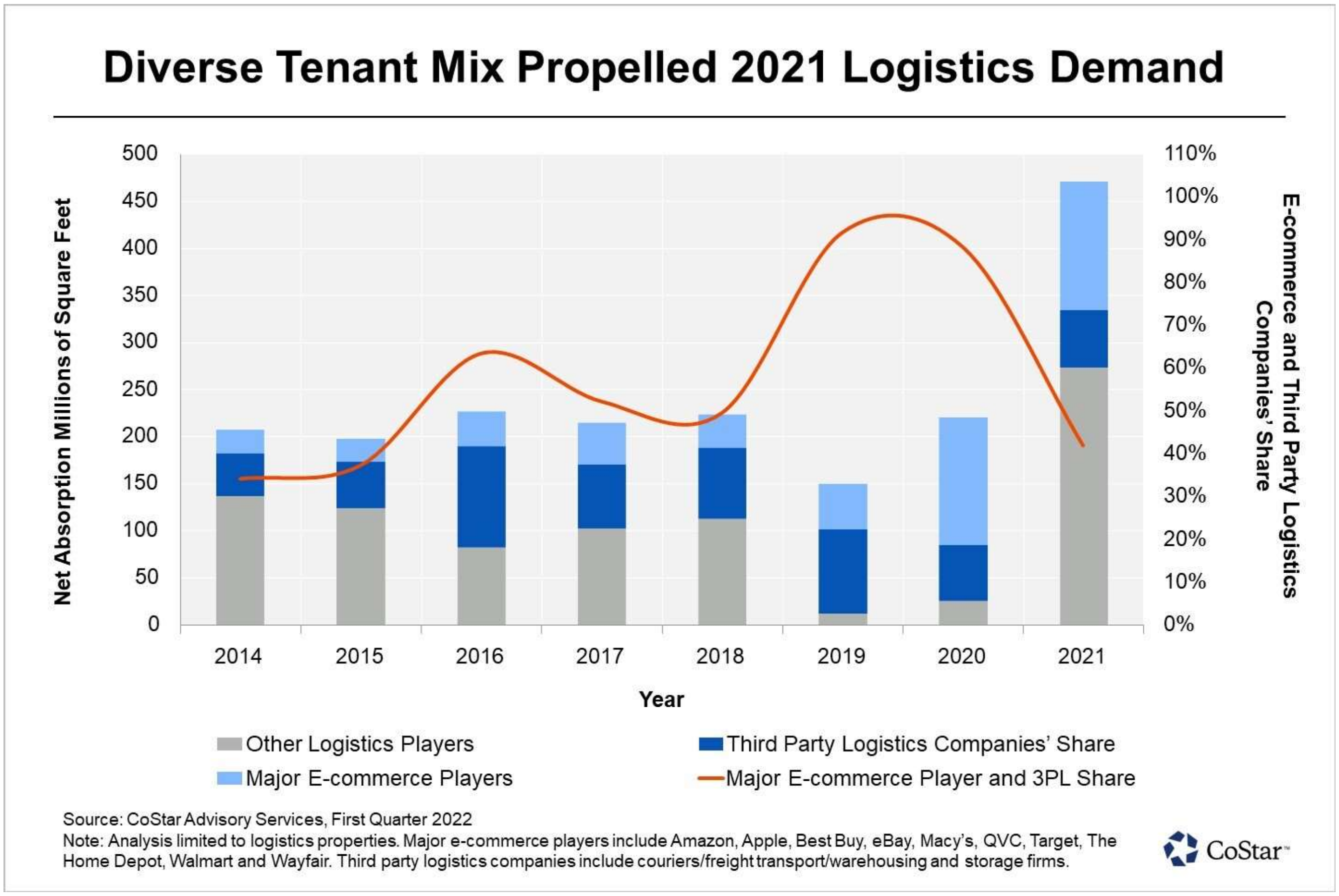
However, Amazon is likely to slow its expansion moving forward after recently disclosing its rapid expansion outpaced the amount of space it needed to meet consumer demand during the pandemic, costing it $10 billion in overhead and resulting in the company putting roughly 30 million square feet up for sublease, according to the Wall Street Journal. As a result, Amazon's pullback is likely to affect demand.

Boosted by tailwinds provided by Amazon and other major tenants, logistics buildings completed during the pandemic in 2020 and 2021 have seen accelerated lease-up compared to new buildings that were built prior to the pandemic.



The lease-up of logistics properties finished in 2020 and 2021 also outperformed prior-year completions. Although vacancies upon completion were near historic averages in 2020 and 2021, the average vacancy rate of 8% after four quarters for buildings completed in 2021 is less than half that of 2020 completions, which were an average of 18% vacant after the same time length. In addition, 2020 properties after eight quarters are an average of 4% vacant, on par with the industrial market and outperforming the pre-pandemic average of 9%. Strong lease-up of newly built facilities should continue as logistics indicators remain elevated and with the continued expansion of omnichannel strategies by non-Amazon retailers adapting to the new consumer expectations.

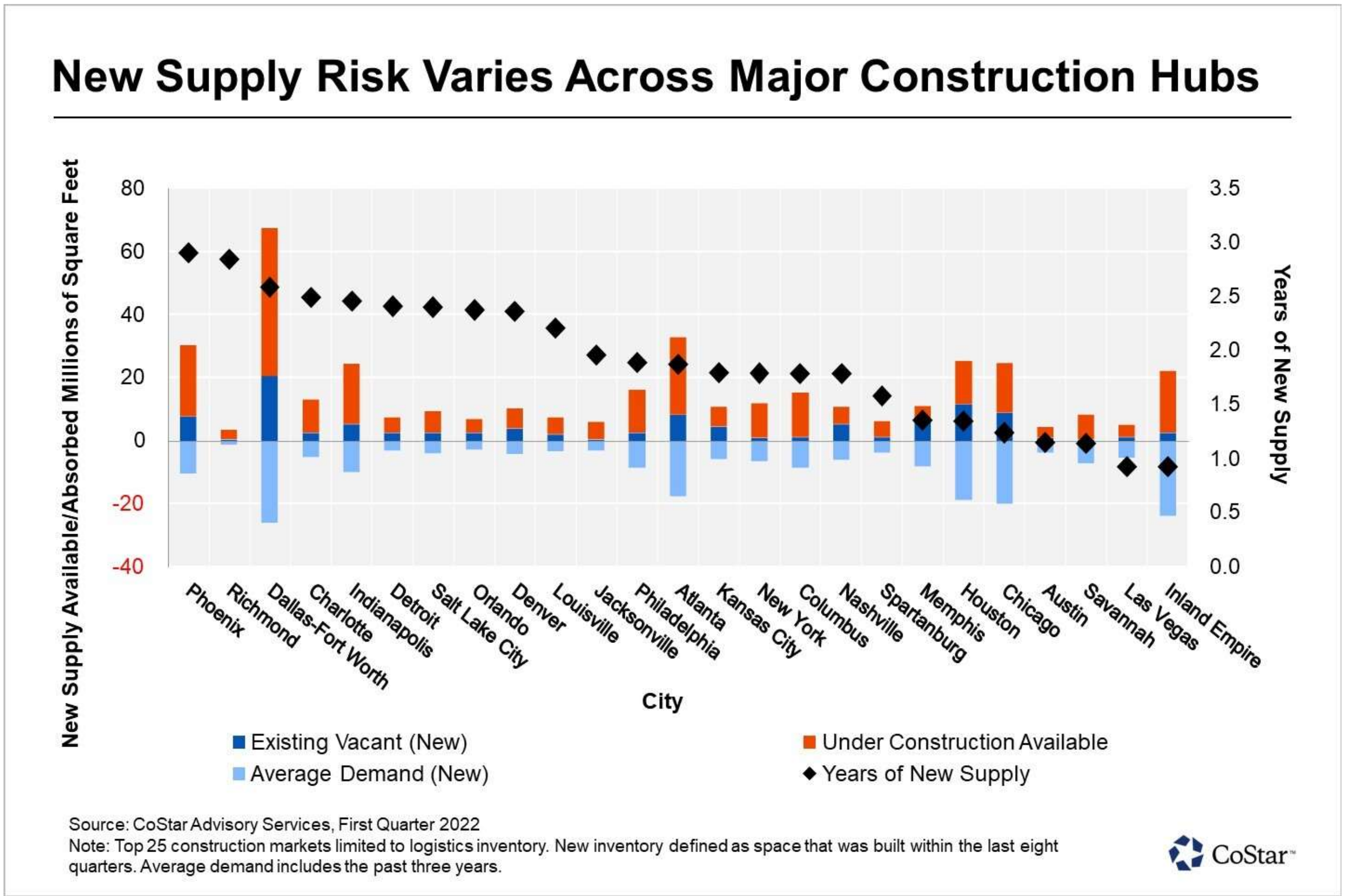
Major retailer expansion of omnichannel strategies, along with other logistics demand drivers, also helped to further diversify the tenant mix in 2021, accounting for 62% of net absorption, adding a different source of demand as Amazon leasing is expected to decelerate. This is a result of tenants pushing to expand their logistics infrastructure and omnichannel strategies to meet the demands of consumers.



Among the notable retailers expanding their logistics footprints is The Home Depot, which absorbed a combined 23 million square feet in 2020 and 2021, 15 million square feet of which was space built in those same years. Fellow home improvement retailer Lowe's also absorbed 10 million square feet, 6 million of which was new space. In addition, other major retailers such as pet supply retailer Chewy, Goodyear, Nike and Target each occupy 3 million square feet of logistics space built in 2020 or 2021.

Diversification of the logistics tenant mix bodes well for the property type, especially as the economic environment weakens in the face of rising interest rates and inflation eating into consumer wages and savings. Moving forward, as business expansion becomes less attractive, demand should normalize but still outperform historical levels.

Certain markets should continue to experience strong demand for new space, despite a deceleration in economic activity, driven by elevated retail and e-commerce sales. Looking at the years of supply for new space in the top 25 markets for under-construction logistics space limited to space completed in the past eight quarters, certain markets have higher relative concentrations of speculative development than others. Years of supply — calculated by adding the under-construction inventory available and existing vacant square footage, divided by the average demand — is a measure to gauge how long available space will take to lease up.



Markets such as Dallas-Fort Worth and Phoenix, which have seen strong demand prior to and during the pandemic, have also had a sharp increase in speculative development resulting in an estimated 2.6 and 2.9 years of new supply, respectively. These markets will likely have a harder time maintaining the supply-demand balance as construction outpaces historical demand levels. Other markets, such as Chicago, Houston and California's Inland Empire, have lower shares of speculative development, coupled with strong demand, limiting the estimated years of supply to 1.2, 1.3 and 0.9 years, respectively. Construction in these markets is likely to have minimal impact on vacancy rates.

Despite a record level of supply and a possible pull-back in leasing from major players in the market, upcoming logistics deliveries are expected to continue seeing strong lease-up, thanks to a diverse tenant mix propelling demand to record levels in 2021, as well as the appeal of newer properties for better meeting logistics tenant preferences. Supply risk varies across markets, however, and the large amounts of new supply delivering in some areas could outpace demand, particularly if U.S. economic activity continues to decelerate.

Andrew Zola is a consultant with CoStar Advisory Services in Boston.

RELATED RESULTS

Could Sacramento Become a New Biotech Hub?

Rents Continue To Climb in San Diego's Apartment Sector

Apartment Rent Growth in Pittsburgh Hits Record High

Northern Suburb Is Puget Sound's New Ground Zero for Apartment Development

Bend's Nonfarm Payroll Eclipses 90,000 for First Time in City's History

Seattle Region's Office Leasing Activity Ramps Back Up to Pre-Pandemic Norms

Rates Drive US Hotel Recovery but Lag Inflation in Most Cases

More Hotel Guests Than Ever Before Opt To Stay Memorial Day Monday Night

Redevelopment a Cure for the Chicago Office Market's COVID, Supply-Demand Woes

Detroit Retail Sector Outperforms Most Midwest Peers