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Client: Matthews CRE

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### Scope of Work

Matthews CRE has contracted with Galvin and Associates to write articles for its commercial properties divisions. This article is for the Industrial division and features Top Ten Trends. Word Count: 2885

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ARTICLE

## The Top 10 Trends in Industrial Real Estate

Commercial real estate news in 2017 is dominated by doom-and-gloom in the retail sector:

-Retail employment is trending down by [13,000 jobs per month](https://www.bls.gov/web/empsit/ceshighlights.pdf)

<https://www.bls.gov/web/empsit/ceshighlights.pdf>

-Store closings are accelerating at triple the pace of 2016, with [5,300 closing announced](http://money.cnn.com/2017/06/23/news/companies/store-closings/index.html) through June 2017, a pace that will easily surpass the Great Recession peak of 6,163 for the full year of 2008 [ <http://money.cnn.com/2017/06/23/news/companies/store-closings/index.html>

-[345 retailers that have filed for bankruptcy](http://money.cnn.com/2017/06/23/news/companies/store-closings/index.html) in the first six months of 2017, according to BankruptcyData.com, up 32 percent from the same time last year.

<http://money.cnn.com/2017/06/23/news/companies/store-closings/index.html>

-[Nearly a third of malls in the U.S. will close](http://time.com/money/4327632/shopping-malls-closing/) in the next five years, according to analyst Jan Kniffen of J. Rogers Kniffen Worldwide Enterprises. [ <http://time.com/money/4327632/shopping-malls-closing/>

-Shopping center closings will [mainly affect lower-tier centers](http://www.latimes.com/business/la-fi-malls-closing-20170531-story.html) – reflecting a long period of over-building and the failure of these centers to attract Millennials

<http://www.latimes.com/business/la-fi-malls-closing-20170531-story.html>

But as any savvy investor knows, bad news for one sector can mean opportunity for another. This is particularly true for the industrial sector, where e-commerce's need for fast shipping has created demand for warehouse facilities and transportation hubs, with employment growing at a rate of [4,000 jobs per month](https://www.bls.gov/web/empsit/ceshighlights.pdf). [ <https://www.bls.gov/web/empsit/ceshighlights.pdf> ]

Matthews CRE offers below a snapshot of ten trends that are animating industrial real estate this year.

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### Foreign Investment

While the U.S. economy is growing at only a modest rate in 2017 – [1.4 percent](http://www.reuters.com/article/usa-economy-gdp-idUSKBN19K1NV) in the first quarter, [ [www.reuters.com/article/usa-economy-gdp-idUSKBN19K1NV](http://www.reuters.com/article/usa-economy-gdp-idUSKBN19K1NV) ] and [2.6 percent in Q2](http://www.npr.org/2017/07/28/539835139/u-s-economy-grows-at-2-6-percent)

[ [www.npr.org/2017/07/28/539835139/u-s-economy-grows-at-2-6-percent](http://www.npr.org/2017/07/28/539835139/u-s-economy-grows-at-2-6-percent) ] – the country's stability, transparency, higher yields, and price appreciation potential relative to Europe and other global markets

makes it a magnet for international investors, particularly for real estate assets. Another attractive feature is a change in the U.S. tax code's Foreign Investment in Real Property Tax Act (FIRPTA) that provides that [foreign investors will be treated the same as their U.S. counterparts](https://urbanland.uli.org/economy-markets-trends/five-trends-commercial-real-estate-watch-2017-2/).

<https://urbanland.uli.org/economy-markets-trends/five-trends-commercial-real-estate-watch-2017-2/>

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Foreign investments are flowing primarily to industrial real estate, with warehousing and distribution centers the big winners. Some dollars are also going to new and retrofitted malls, who are embracing mixed-use live/work/play environments that include shopping, restaurants, entertainment, and retail showrooms.

Foreign money is an important source for developers, since U.S. local and regional banks who left the commercial real estate sector after the Great Recession are not anxious to return to the [market's volatility and tight lending regulatory environment](#).

<https://urbanland.uli.org/economy-markets-trends/five-trends-commercial-real-estate-watch-2017-2/>

A deterrent to foreign investment is the strong U.S. dollar and surging property prices. While the Q1 2017 tally for foreign investments in U.S. commercial real estate was higher than historic trends at \$66.7 billion, the amount was actually [down 33 percent](#) from the peak levels of investment seen in 2015.

<https://www.bisnow.com/national/news/state-of-market/foreign-investment-in-cre-down-33-year-ending-march-31-74970>

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## Repurposing dead mail footage

[36 to 37 million square feet](#) of retail space will be on the market in 2018 – with nearly half of the gross leasable area (GLA) former department store footage, originally rented at an average of [less than \\$10 per square foot](#).

<http://retailblog.jill.com/2017/04/25/anchors-away-department-store-closures-mean-shopping-centers/>

Shrewd commercial real estate firms are snapping up these properties and “repurposing” them at much higher leasing rates. Among the uses:

- Restaurants: While many malls continue to rely on quick-bite food courts, the Millennial consumer is more interested in a more extended experience – a restaurant, especially one with atmosphere that turns a meal into a social event suitable for sharing on social media
- Entertainment: Theater chains like AMC are finding welcome homes in former department store spaces, as are kid-zone interactive centers like the Crayola Experience and laser tag, karaoke, arcade games, pottery making, and concept centers like Dave and Busters
- Supermarkets: 50 percent of all mall shoppers want a supermarket in their mall, reports retail analytics firm GGP Inc.
- Lifestyle: home furnishings stores, fast-fashion, cosmetics, exercise and yoga, and sporting goods are growing segments that can take advantage of a reconfigured department store space.

“The best use for an empty anchor will vary by the demographics and lifestyles of the surrounding community, but the many options available might come as a pleasant surprise,” noted [Holly Rome](#), director of National Retail Leasing.

<http://retailblog.jill.com/2017/04/25/anchors-away-department-store-closures-mean-shopping-centers/>

## Micro-Distribution Centers

It is common knowledge that traditional retail stores are having a tough time competing with Amazon.com and online retailers, who can deliver goods quickly from massive distribution centers scattered across the U.S.

Perhaps the best response is imitation: expand the services of a retail store to provide online shopping, complete with quick delivery, easy return policies and other benefits. This way, the consumer has the choice of visiting the store to sample or try on merchandise, then take it home or have it delivered, or do the entire transaction online.

Seen in this light, a store like [Macy's has 870 Macy's, Bloomingdales and Bluemercury locations](#) that can serve as micro-distribution centers, augmented by 23 mega-distribution centers.

Any retailer wanting to make the transition has several infrastructure hurdles: a fully-digitized inventory and point-of-sale (POS) management system, upgraded store registers capable of handling both in-store and online transactions, and in-store packing stations compact enough to handle volume without gobbling up valuable retail floor space.

Macy's, for one, is having initial success with the transformation, posting [double-digit online sales growth in 2016](#) even as overall sales declined four percent. With nearly 900 points of distribution, a chain like Macy's can enjoy local shipping rates at costs much lower than Amazon. [<https://rctom.hbs.org/submission/can-retail-stores-also-act-as-mini-distribution-centers/>]

Walmart, the largest U.S. retailer, is taking a different tack to meet a similar e-commerce micro-distribution goal. [Walmart has recently teamed up with Google](#) to post merchandise on the Google Express online shopping mall. Walmart will use its more than 4,690 store locations as distribution points for quick delivery. [[https://www.nytimes.com/2017/08/23/technology/google-walmart-e-commerce-partnership.html?\\_r=0](https://www.nytimes.com/2017/08/23/technology/google-walmart-e-commerce-partnership.html?_r=0)]

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## Shallow Bay Buildings

Demand for shallow bay industrial is through the roof, resulting in plunging vacancy rates and increased prices across the U.S. but particularly clustered within and on the perimeter of large metropolitan areas. With demand driven by a combination of online merchants and a shift by traditional retailers to "last mile" same-day delivery, these 15- to 50,000 square foot warehouses are designed for multiple tenants with light to moderate industrial needs.

[According to the NAIOP](#), the ideal shallow bay development characteristics include:

- Sites configured for offices and parking in the front and truck docks in the rear
- Multiple entrances for easy division into tenant spaces
- Ceiling heights of 24 to 30 feet – although developers can go higher to accommodate future growth in tenant inventories.

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“In tier-one markets such as Chicago, e-commerce companies like Amazon will have a big-box facility within an hour of the city and then every several miles into the city there will be another, smaller facility,” said [Susan Bergdoll](#), vice president of leasing and development at Duke Realty, a real estate investment trust. “Those buildings tend to be shallow bay and get smaller and smaller into the city.” [<http://blog.naiop.org/2016/09/opportunities-in-shallow-bay-industrial-development/>]

“We can accommodate smaller importers with shallow-bay buildings, so that’s [a trend we’ve seen](#), definitely in the Southeast,” said Lawrence R. Armstrong, CEO of architecture firm Ware Malcomb. Armstrong noted that these buildings, which are designed for proximity to consumers for two-day delivery, require larger parking lots to accommodate a growing number of employees. [<https://www.bisnow.com/toronto/news/industrial/the-top-10-industrial-real-estate-trends-to-look-for-in-2017-69624>]

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## 1 E-commerce, E-commerce, E-commerce

With e-commerce growing at more than 20 percent a year, demand for industrial/warehouse space for online fulfillment has [doubled over the last three years](#) and will continue to grow at a healthy clip. [<https://www.prologis.com/logistics-industry-research/e-commerce-and-new-demand-model-logistics-real-estate>]

For retailers with existing warehousing facilities, the challenge is to adapt operations and facilities away from their focus on to-store distribution, so that they can serve as to-consumer fulfillment centers. However, the range of products available online creates a wide variation in the needs of a potential e-commerce tenant. While [30 e-commerce merchants account for half of all online sales](#), the remaining half is a profusion of smaller companies with needs that shift as they grow. And while some may be startups with more dreams than capital, 600 of these “smaller” companies in the U.S. have online sales of \$50 million to \$2.5 billion, meaning they are companies doing about [\\$1 million a day](#).

For these smaller e-commerce companies, their warehousing needs represent a spectrum:

- A small e-commerce fulfillment center that can fit into a multi-tenant facility – but may need significant space to accommodate a broad range of products
- A shared facility as multiple e-commerce companies team up to defray costs
- A larger facility with more racking and logistics equipment that can accommodate higher service levels
- A fast-growing company that can quickly requires additional footage and may require additional locations to service a larger geographic area.

Regardless of the size of the e-commerce operation, their fulfillment services mean that the tenant needs more footprint than traditional pallet-based businesses, including footage for packing, labeling and other direct-to-consumer operations. While distribution centers for brick-and-mortar retailers support \$2,500-\$3,500 of annual sales per square foot, that figure drops to [\\$1,000 of annual sales per square foot for e-commerce retailers](#), meaning three times as much space. [<https://www.prologis.com/logistics-industry-research/e-commerce-and-new-demand-model-logistics-real-estate>]

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## Eco-Friendly Buildings

Property owners can add value to their commercial properties by going green.

While many owners have added solar panels as a way to reduce utility costs and to market themselves to socially-conscious tenants, government is increasingly stepping in with their own demands. Municipalities around the country are adding regulations to commercial development plans that require provisions to reduce stormwater runoff.

<https://www.forbes.com/sites/bisnow/2017/06/27/when-buildings-go-green-property-owners-find-increased-value/#1b7a2e7153b9>

Reducing stormwater runoff can take a number of forms: cisterns, rain gardens, green roofs, and rainwater recycling. The goal is to reduce oil, grease, fertilizer and other pollutants in stormwater runoff, which the [U.S. National Research Institute says](#)

[\[https://www.forbes.com/sites/bisnow/2017/06/27/when-buildings-go-green-property-owners-find-increased-value/#1b7a2e7153b9\]](https://www.forbes.com/sites/bisnow/2017/06/27/when-buildings-go-green-property-owners-find-increased-value/#1b7a2e7153b9) is

the most common source of pollutants in local waterways. The Urban Land Institute [recommends municipal planning that coordinates green spaces and runoff systems into a network](#) capable of making a significant dent in pollution levels. [https://americas.uli.org/wp-content/uploads/sites/125/ULI-Documents/HarvestingtheValueofWater.pdf

While owners are likely to bridle at another layer of regulation, they may benefit financially,” [ULI](#) Senior Director of Urban Resilience Katharine Burgess said. “We found that green infrastructure was capable of creating value -it created an enhanced user experience, improved place-making opportunity and improved development yield of land.”

As an example, a recent ULI report noted that a 200-unit apartment complex in Boston reaped an additional \$300 to \$500 per month for units that overlook a green roof. The first-year additional [rental revenue of \\$120,000 more than offset the \\$113,000 cost](#) to build the green roof. [https://americas.uli.org/wp-content/uploads/sites/125/ULI-Documents/HarvestingtheValueofWater.pdf ]

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## Vertical Construction/High Rise buildings

E-commerce promises fast delivery for a plethora of merchandise categories, and that promise leads to increased inventory and more sophisticated handling and logistics at the warehouse distribution level. While e-commerce growth leads to increased demand for warehousing space, the amount of land available for development has not grown, particularly in preferred locations in and on the perimeters of large metropolitan areas.

One answer: go tall. Architects are increasingly designing taller vertical warehouse buildings to provide additional square footage without increasing the building’s physical footprint.

“Land is getting to be more expensive, so like any other product type in commercial real estate, [you end up going vertical](#),” according to Lawrence R. Armstrong, CEO of architecture firm Ware Malcomb.

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## Aging Manufacturing sites become Data Centers

The rise of Internet use has translated into a world awash in data, and the amount of data is growing exponentially, with global IP traffic forecast to increase threefold over the next five years. [<https://www.cisco.com/c/en/us/solutions/collateral/service-provider/visual-networking-index-vni/vni-hyperconnectivity-wp.html>]

All this data must be stored, some as a temporary stop on the way to a new IP address, and much of its stored for long periods of time. This is the role of data centers, which are a prime source of demand for commercial space.

Data centers are expensive propositions, requiring extensive investments in cooling systems, fiber optics cabling, and large and complex server computer configurations. The cabling inside the data center must connect with the outside world – meaning they are buried lines that intersect with major power system nodes, which often involves right-of-way from road and railway networks.

A large building capable of handling concentrated weight loads, connected to major power lines, with some office space, plenty of parking – that sounds like a classic analog-age manufacturing plant, and a trend in commercial RE is to transform these aging and sometimes abandoned relics of yesteryear into digital age data centers.

“Adaptive reuse” is the term for this transformation of industrial building stock, and examples of their use for data centers abound:

-The 320,000 square-foot [former Chicago Sun-Times](#) printing facility

[<http://www.datacenterdynamics.com/content-tracks/design-build/qts-opens-data-center-at-former-chicago-sun-times-printing-site/96547.fullarticle> ]

-The former homes of Western Union and the Port Authority in New York City

-The former printing plant for Sears catalogs and bibles in Chicago is now the [Lakeside](#)

[Technology Center](#) [<http://www.datacenterknowledge.com/archives/2009/01/06/chicagos-data-fortress-for-the-digital-economy-2/>]

-A large Illinois building [once home to Motorola](#) and a television factory

<http://www.datacenterknowledge.com/archives/2016/08/10/digital-realty-buys-campus-in-tight-chicago-data-center-market/>

-Amazon is converting a [former biscuit factory in Ireland](#)

<http://www.independent.ie/business/commercial-property/amazon-to-take-ireland-spend-past-1bn-with-new-data-centre-34143142.html>

-[Sears has a data center real estate division](#) devoted to transforming stores and warehouses

[<https://www.forbes.com/sites/retailwire/2013/05/31/sears-replaces-retail-stores-with-data-centers/#74b7b990766a> ]

Adaptive reuse provides [an opportunity for real estate developers](#). While areas surrounding these aging manufacturing buildings are often run down, the buildings themselves have great potential value and nearby power plants may have idle capacity. Municipalities are often eager to inject new blood into declining areas, making the planning and approval process easier.

[<https://theconversation.com/the-factories-of-the-past-are-turning-into-the-data-centers-of-the-future-70033> ]

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## Technology’s impact on Manufacturing Facilities

Technology affects everyone, including sectors that may lack the glamour of high-tech, e-commerce, and finance. Examples include facilities for manufacturing, industrial machinery,

energy and infrastructure, which are increasingly moving to automation and software-based processing and control solutions.

For commercial real estate, one factor in this move to digital solutions can be a [reduction in the size of equipment](https://blogs.sap.com/2017/05/25/technology-changes-everything-digital-trends-shaping-the-industrial-sector/) and processing areas, and thus a reduction in the square footage necessary for the physical plant. Another factor affects site selection: as companies increasingly move to direct-to-customer solutions, the location of the end-user becomes a priority.

Beyond the immediate plant requirements for a move to digital, transportation systems become a critical priority: intermodal supply chain processes that to date have focused on delivering goods to a manufacturing facility must now accommodate distribution to an increasing number of customers, including end-users. [Manufacturers must move to more sophisticated processing and communications](http://waremalcomb.com/wordpress/2017/04/top-10-industrial-real-estate-trends-to-look-for-in-2017/) software to coordinate these many nodes of a goods transportation process, according to Curtis D. Spencer, president of IMS Worldwide.

These industrial sectors are making the move to digital, but they have a lot of catching up to do. In a recent survey by leadership consulting firm Spencer Stuart, [83 percent of industrial manufacturers](https://www.spencerstuart.com/research-and-insight/digital-transformation-in-the-industrial-sector) reported that a digital transformation was a high priority, but 84 percent said they were in the early stages of transformation, and face significant work culture challenges in effecting change.

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## Mega e-Fulfillment Centers

e-Commerce companies are having a big impact on industrial real estate – renting out large blocks of space, propelling more new construction, and [attracting more institutional and global investor money](http://www.ccim.com/cire-magazine/articles/2016/09/industrial-roars-ahead/).

The newest generation of e-commerce demand has led to ‘mega’ size facilities capable of both handling large and often highly varied merchandise and space to process and pack goods for delivery to consumers. Examples of recent mega e-fulfillment centers include:

- Louisville KY is home hub for UPS and facilities for dozens of retail and e-commerce companies, including Best Buy, Guess, L’Oreal and Camping World
- Milwaukee WI is the site for a new 1.5 million square-foot Amazon fulfillment center plus a 50,000 square-foot in-fill location, one of 70 the e-commerce giant plans to launch in the next few years
- Nashville TN is the site for a 1 million square-foot facility for Under Armour
- Vancouver has [a new 570,000 square foot Amazon warehouse](http://www.ccim.com/cire-magazine/articles/2016/09/industrial-roars-ahead/) and 189,500 in office space, and is experiencing high demand for third-party logistics (3PL) space

Mega e-fulfillment centers may be industrial spaces, but site selection and plant characteristics are much more like those traditionally associated with retail. To be successful, e-commerce companies must address the ‘last mile’ to the consumer’s door as their greatest priority. Thus,

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access to and quality of transportation corridors become as important as low rent in a successful real estate transaction.

Demand for industrial space is boosting rents in many metropolitan areas. According to CBRE, rents for prime logistics space rose 2.8 percent in 2016. Six of the top 10 global logistics markets with the fastest growing rents were in the U.S.:

- Oakland CA posted the highest prime logistics space rent gains at 29.8 percent
- New Jersey locations were second highest, at 15 percent
- California's Inland Empire, which includes San Bernardino, came in third at 13.5 percent.

Nationally, average effective rents for the broader office/warehouse market reached [\\$4.48 per square foot](#) in Q1 2107, which represents an annual growth rate of 2.1 percent, according to commercial real estate analytics company Reis Inc.

<http://www.ccim.com/cire-magazine/articles/2016/09/industrial-roars-ahead/>

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