INDUSTRIAL — STORAGE

Attracting institutional outdoor storage investors

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The commercial real estate asset class known as industrial outdoor storage has seen a dramatic change in investor demand recently. These assets traditionally were owner-user properties, but this subset within industrial properties has experienced an influx of institutional and private equity capital flowing into the space over the past 24 months. These mission-critical facilities typically are zoned for heavy industrial, and they are used for trailer, equipment or material storage; they generally can be characterized as smaller industrial buildings on larger land parcels with a floor-to-area ratio of less than 20%.

As institutional capital allocations have increased in the IOS space, that has led to the question of why now? IOS is a necessity for a variety of industries that make up the backbone of the U.S. economy in the transportation, materials, and construction sectors. Unprecedented demand from these sectors has created a stressed supply chain, resulting in enhanced needs for outdoor storage. As yields compressed in traditional industrial assets, and the fundamentals for IOS continued to stay strong through the supply chain issues of the last two years, it was clear that institutional capital allocations had a place in this mission-critical asset type.

Most IOS assets do not have tenants with credit profiles typically demanded by institutional investors. Other than the varying amounts of tenant security deposits, generally there are three main attributes of IOS that have helped offset a lack of credit tenancy. Institutional investors are able to offset concerns by substituting credit for irreplaceable attributes of the real property; these are heavy-industrial zoning, infill land and widespread tenant demand. Heavy-industrial zoning allows for equipment yards, material laydown and trailer storage, yet this zoning category is in diminishing supply as these publicly "unattractive" characteristics generally won't garner support from municipalities to expand this designation. Infill properties with excess land, regardless of zoning, have become increasingly difficult to find as much of this land was targeted for redevelopment into distribution warehouses or lighter-use industrial parks. Finally, since outdoor storage is a core necessity in supply chains for many industries, tenant demand for improved outdoor storage land is extremely vibrant, providing owners of these assets a long list of potential tenants.

As IOS has become one of the next frontiers of opportunity for institutional capital, locations like Denver have become a focus for acquisitions teams. The market fundamentals of Denver continue to attract investment groups that are aggregating national IOS-focused portfolios. Denver's IOS sector has more supply than coastal locations but still boasts increased rental rates, low capital expenditure requirements and heavy tenant demand. Industrial Outdoor Ventures, an institutionally backed operator that has acquired eight IOS facilities in the Denver area since 2018, had the following to say about the Colorado market: "Amongst all of our target markets, IOV would definitely put Denver near the top of that list given the strong fundamentals and consistent growth that we've experienced firsthand since we entered the market in 2018 with

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4343 Holly St. is 36,781 square feet on 3.65 acres and is leased to Beacon Roofing.

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the time frame of 2019 to the present and are 50,000 sf or greater.

The average new industrial/distribution facility is a building of around 88,000 sf occupying a 6- to 8-acre site. It has four drive-in doors and 15 dock-high doors with 24- to 32-foot clear height. Most buildings are between 24- and 28-foot clear. The sites will accommodate 128 parking spaces for cars and tractor-trailers. Most developments have larger sites with multiple buildings that share common elements and buildings that vary in size. A good example is Trade at 2534 in Johnstown, which is being developed by United Properties. The plan details a development of three buildings of 73,000, 145,000 and 62,500 sf, respectively, on a 16-acre site.

Northern Colorado currently has 3.1 million sf of distribution warehouse in inventory, with 1.4 million sf under construction. Construction is down 2.9% from the prior period due to increasing construction costs and the time that it takes to develop product in Northern Colorado. Rising interest rates and a looming recession may slow development further in the coming months.

The 12-month net absorption in this sample set was 622,000 sf, up slightly from the previous period, when 620,000 sf were absorbed. The vacancy rate for the existing properties in the sample set is 5.1%, according to CoStar's published data. Generally, whatever is built is quickly absorbed.

There is little preleasing prior to the building nearing completion, which makes developers nervous. Several factors contribute to this situation. Construction timelines are sometimes unpredictable because many municipalities are understaffed and can take several months to review and approve building permits; issues related to availability of construction materials and labor; and the nature of the world we live in with a pandemic, regional unrest and a looming recession.

Base market lease rates (excluding triple net expenses) for new construction have increased by 7.8% compared to the previous period and are now estimated to average $12.23 per sf. The average base lease rate in the previous three years was $10.79 per sf. Likewise, the average tenant improvement allowance was $12.67 per sf. Sales prices are up 7.1% compared to the previous period, averaging $199 per sf based on delivery of the building in core-and-shell condition. Sales prices are significantly higher for an investment-grade asset that is fully leased to a quality tenant on a long-lease term.

Warehouse/distribution space is in high demand in Northern Colorado, and all signs point to activity continuing for several more quarters. We anticipate some changes that may help costs both to developers and to tenants. As the increase in construction costs begin to flatten, lease rates will follow suit. With this flattening of lease rates, rental growth rates will be closer to historical norms of 2% to 3% escalations annually instead of the almost 8% in the previous periods. Absorption will remain strong, and vacancy rates will remain low.▲

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the acquisition of 4780 Vasquez Blvd. in Denver. We've continued to see incredible demand for the product type even with rapidly rising land values across the board."

In the Denver metro statistical area, outdoor storage land is being rented for between $4,500 and $6,000 per acre per month. In even more supply-constrained markets such as South Florida and the Inland Empire of California, these rates can exceed $30,000 to $50,000 per acre per month. Owners of IOS properties can realize these rental rates with minimal capital improvement to their property and typically have to offer low amounts of tenant incentives (tenant improvement dollars, free rent, etc.) in comparison to traditional industrial product.

The tenants in the IOS space are extremely sticky, and although they are only signing five- to seven-year leases, it's not uncommon for tenants to remain at these facilities for over 15 years. Even during the great financial crisis, vacancy rates were nearly half what they were the rest of the industrial sector. The expectation of longer-term tenancies allows owners to take advantage of yield structures that are like traditional industrial without the large tenant improvement costs.

Industrial outdoor storage will continue to support industries at the backbone of the U.S. economy, making it a fundamentally important asset. As this property type continues to be in diminishing supply, the flood of institutional capital will only help to preserve these assets and standardized regulations in municipalities. The attributes that support investment into the space continue to be fundamentally true as rates continue to increase in Denver. Denver's continued population growth and urban sprawl will keep IOS as a front-runner of necessity. The institutionalization of industrial outdoor storage will only benefit the asset class and help support industry in Denver's economy for years to come.▲

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