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U.S. logistics: Markets and occupier requirements are changing fast

The enduring U.S. modern logistics growth story is emblematic of the secular trends that have shaped real estate markets during the past decade. The logistics sector has been at the forefront of powerful demand drivers, which have spurred exceptional investment performance, and at the heart of sustainability and technological advancements, which have influenced contemporary occupier requirements. In this article, we examine the differentiated U.S. modern logistics market and the long-term demand drivers to better understand occupiers' evolving requirements. Knowing the market enables investors to implement the most appropriate investment strategy to benefit from continued growth in the U.S. logistics investment market.

Differentiated logistics facilities

Modern logistics facilities are strategically important assets, which are now integral to occupiers' business models. Manufacturers use facilities to store stock, and third-party logistics operators (3PLs) and retailers use them to distribute goods. Typically, modern logistics space falls into four categories:

- **Bulk distribution** (e.g., ecommerce fulfillment centers used for storage and distribution of goods) accounts for 15 percent of U.S. industrial space.
- **Regional distribution** (e.g., similar in function to bulk distribution centers, but smaller, covering less geographic area) accounts for 50 percent of U.S. industrial space.
- **Flexible research and development (R&D) parks** (e.g., hybrid mixed-use structures that often resemble business parks) account for 10 percent of U.S. industrial space.
- **Specialty** (e.g., manufacturing, cold storage, data centers) accounts for 20 percent of U.S. industrial space.

Long-term demand drivers still in play

The continued expansion of ecommerce, supply-chain reconfigurations, highly favorable demand-supply dynamics, and ESG requirements have collectively fueled the need for more warehouse space.

Ecommerce

High ecommerce growth and demand for logistics space go hand-in-hand. As more consumers shop online, the need to fulfill rising order volumes in a timely and cost-efficient manner drives demand for cutting-edge facilities. However, ecommerce growth in the United States still lags behind other countries, such as South Korea, China and the United Kingdom, which suggests room for significant growth in the years ahead. CBRE forecasts U.S. online sales will grow by $330 billion between 2020 and 2025, based on Euromonitor data for 2020. This would see ecommerce penetration reach 26 percent of all U.S. retail sales, up from approximately 20 percent today. The United States will need an additional 330 million square feet of distribution facilities to handle the increase in online ordering, based on CBRE's estimate that every additional $1 billion of ecommerce sales requires 1 million square feet of space.

The acceleration of ecommerce growth has also had a knock-on effect on the supply chain, with retailers and wholesalers needing to hold more inventory to satisfy increasing demand, in a further demand driver for cutting-edge domestic facilities. At the same time, ecommerce growth will continue to put distribution and supply-chain networks under pressure to meet demand when industrial vacancies are at record-low levels.

Supply-chain reconfiguration

Supply-chain reconfiguration promises to be a larger source of demand. COVID-19 exposed the vulnerability of just-in-time models with minimal on-site inventory. The pandemic encouraged businesses to hold more inventory to protect against future disruptions and manufacturers to reshore production back to the United States to increase supply-chain resilience. As a result, more space will be needed. CBRE estimates that redomestication of supply chains could increase demand for new logistics facilities by a further 1 billion square feet.

It is a pragmatic trade-off. Higher rental costs due to more space will be offset by higher inventory levels, helping to retain customers and hedge against rising input and transportation costs, as well as lost demand due to supply shortages. Furthermore, upward pressure on rents is much lower than rising transportation costs, due to energy and fuel inflation. Companies are, therefore, likely to continue to lease more space to cut down on transportation costs, serving as another driver of demand for modern logistics facilities.

Supply-demand dynamics

Demand outpacing supply is attracting capital to the sector. Investment transactions in the U.S. industrial and logistics sector were $36 billion in the first quarter, up 50 percent year-over-year, according to separate CBRE data. Assets with below-market rental rates and leases that are rolling over in the near term are seeing the strongest investor demand, as strong fundamentals are providing an opportunity to achieve outsized returns in the near term from the mark-to-market perspective.

In 2021, 3PLs accounted for 30 percent of U.S. logistics leasing activity, far outstripping ecommerce's 13 percent market share. As companies continue to look to reduce direct logistics costs, remove the need to secure space in competitive markets and avoid having to attract scarce labor, further expansion of 3PLs' market share is forecast for 2022. CBRE expects this to increase to 35 percent by year end, as vacancy rates decline, rents increase and labor markets tighten further.

After a record year for the U.S. industrial market in 2021, strong demand for space continued in first quarter 2022. New supply will struggle to satisfy forecast demand growth. CBRE estimates 1.33 billion square feet of new space will be needed in the United States to meet growing demand from ecommerce and supply-chain reconfiguration by 2025. With an overall vacancy rate of just 3.1 percent, tight market conditions lowered absorption from a year ago, according to CBRE data. Net absorption totaled 93.8 million square feet in first quarter 2022 — down 10.4 percent year-over-year but still above the 10-year average. Demand from occupiers that need "safety stock" to counter supply-chain disruptions should result in further rental rate appreciation and a record-low vacancy rate despite a large amount of new development this year.

As a result, significant new development is required in the coming years just to keep pace with demand growth. Development ensures participation in the sector, enables higher returns to be generated and provides increased certainty that new space will match the high-spec demands of occupiers, meet high sustainability standards and minimize the risk of obsolescence. Approximately 513.9 million square feet of space was under construction as of fourth quarter 2021, while 80 percent of all new development completions in 2021 were pre-leased, according to CBRE data. While this represents a record, it does reflect a degree of catch-up, as it includes projects that broke ground in 2020 and 2021 but were unable to be completed due to COVID-19 disruptions.

Even with new supply at elevated levels, it remains outstripped by demand, and it is taking longer to come to market. Labor and materials shortages are extending development timelines, while in markets where occupier demand is particularly strong, land scarcity is generating another headwind. Also, not all new supply is new space. Roughly 75 percent of existing U.S. logistics facilities were built prior to 2000. Specifications, such as size, height, water and power, let alone the demands and needs of occupiers, were very different 25 years ago compared with today. Together with an increasing focus on ESG and wellness, much of the existing stock in the United States could soon be viewed as not-fit-for-purpose, thereby running the risk of becoming stranded and unrentable. Again, it underscores the importance of knowing what occupiers want. Expectations are changing fast. The longer-term challenge is to produce modern facilities to meet the rapidly expanding and increasing sophisticated market. If developers fail to keep pace, further upside risk to rental rates beyond current record highs remains possible.

ESG requirements

These combined tailwinds have driven exceptional performance, further supported by restricted supply and robust consumer demand through COVID-19. At the same time, more stringent environmental legislation has aligned with higher occupier and investor expectations for environmental, social and governance (ESG) requirements, accelerate the journey to net-zero carbon emissions. Consequently, the risk that outdated or non-ESG compliant logistics assets become stranded is a prevailing headwind in the years ahead.

Whether buying on the open market or taking the development route, understanding what end-users are looking for is critical to participating in the U.S. modern logistics growth story.

What are occupiers looking for?

Occupiers are demanding much more than just big boxes and strategically located warehouses. Modern logistics facilities are sustainable, high-spec, high-functioning spaces for innovation, production, storage and delivery. They are value-add assets that enable operations to run efficiently, timely and cost-effectively. Buildings must be energy efficient, have minimal impact on the environment and local communities, and contribute to the well-being of employees.

Top requirements are as follows:

- **Location:** Distance to seaports, airports, major highways, rail hubs, manufacturing plants and proximity to labor pools and end markets.
- **Space:** Bay depth and width, the distance between posts or vertical support beams, determines how space can be used, what types of goods can be stored, how easily and efficiently they can be accessed and moved, the size and positioning of racks, the design of conveyors, walkways, picking lanes, receiving and staging areas.
- **Yard depth:** Yards can include truck courts with maneuvering areas, as many dock doors that can be accommodated to increase the flow of goods, trailer parking for on-site storage, and ample car parking.
- **Height:** The higher the clear height of a structure, the more goods can be stored, while higher ceiling heights also enable mezzanine floors to be installed and facilitate the adoption of automation, which requires clear heights of more than 36 feet.
- **Floors:** Super-flat floors that are durable and seamless prevent accidents and damage to equipment and are prerequisites for automation.
- **Technology:** Conveyor belts, truck carousels, electric vehicles, automation, robotics, internet connectivity — today's logistics facilities are technology hubs that drive operational efficiency.
- **Power supply:** Increasing use of technology requires reliable, secure and cost-effective power supplies — buildings with renewable-energy sources installed, such as solar panels, provide a sustainable solution. In addition, the roll-out of electric trucks, particularly large fleets, will require more power on site and a closed-loop charging solution, incorporating both renewable energy and battery storage.
- **Energy-efficient buildings:** Energy-efficient buildings not only generate cost savings but also help satisfy increasingly stringent ESG requirements.
- **Water supply:** Larger and higher buildings require adequate water pressure to support fire suppression systems; where there is insufficient pressure, water pumps will be required.
- **ESG:** Given the need to reduce carbon emissions, more sustainable materials, such as timber, may be used during construction, instead of concrete and steel.
- **Amenities:** Buildings that contribute to the well-being of workers through the provision of amenities such as gyms, showers and outdoor space help occupiers attract and retain employees.
- **Flexibility:** Technology, occupier requirements and regulations are changing — the internal configurations of facilities need to be adaptable.

Minimizing risk

The U.S. modern logistics sector appears set fair for an extended period of outperformance. However, it is not a homogeneous market with a one-size-fits-all strategy. Individual markets require their own strategies to capitalize on the opportunities and mitigate risks. In supply-constrained markets, development activity, in the form of existing space reconfiguration, may offer the most attractive risk-adjusted returns. Elsewhere, in markets where the spread between on-cost and market yields are wide, participating in new-build activity may be the preferred strategy. In areas where there is a high level of competitive tension, partnering with developers can enhance returns by capturing the higher spreads on offer. It also provides access to off-market opportunities and delivers cutting-edge properties that meet high standards.

Logistics markets are fast-changing, and so are the requirements of occupiers, demands of regulators and advancement of new technologies. Trends need to be identified early and assets managed over their lifecycles to ensure they continue to be in demand. Knowing which markets are in danger of oversupply, avoiding properties at risk of obsolescence, and monitoring changes in local labor pools not only enables risks to be avoided but also opportunities to be generated.

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