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Narrow Window for Warehouse Investors

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PHILADELPHIA-While the worst hit markets in the US were those areas where there had been exponential growth through the early part of the decade, the Greater Philadelphia region was fortunate that it had avoided much of that excess development and did not suffer as badly as areas like Florida, Arizona, Nevada and California. As the larger economic news seems to be improving, the regional markets are also starting to show some signs of life. While office and retail activity are still a bit sluggish, movement in the industrial markets has begun to pick up, and there are a few deals getting done, including Benjamin Foods, which leased 122,432 square feet in Hatboro, PA and Dependable Distribution Services, which signed for 122,000 square feet at 2500 Grant Ave.

There are still major hurdles related to the refinancing of maturing CMBS loans-over $1 trillion in next five years-but the wholesale foreclosures and write-downs that were predicted are not materializing, says Lou Battagliese Jr., a partner at Jackson Cross Partners/ONCOR International. "It will be interesting to see where the hundreds of billions of dollars of dry powder being accumulated by REITs and private equity firms waiting for these opportunities will eventually be invested. Financing for investment properties is available, but the new normal involves 30% to 40% equity, recourse financing for projects under $5 million and higher interest rates (6.5% to 7.25%) than at the height of the CMBS market."

For the industrial companies who lease or purchase their buildings, the window of opportunity may be short. In a region that has close to 350 million square feet of total industrial inventory, overall vacancy rates have hovered around 14%, according to CB Richard Ellis figures. But this number can be misleading in that "a large segment of available space is in mega warehouses along the I-81 corridor from Harrisburg to Scranton or in the Exit 7A-8A market in Central New Jersey," Battagliese tells GlobeSt.com. "In the core eight county markets surrounding and including Philadelphia, industrial vacancy rates range from 6% to 9%, and below 60,000 square feet to 40,000 square feet, vacancy rates are under 5%."

Over the past 18 months the transactions have been predominately with user/buyers, Battagliese says. "Companies that were being priced out of the market by investors for most of the decade have found lessening competition for vacant buildings," he observes. "Prices for existing buildings that were approaching 85% to 90% of replacement cost have settled back to 60% to 70%." By way of example, Battagliese points to a modern 60,000-square-foot warehouse, which had a replacement cost of $65 a square foot and was trading at $55 a square foot to $60 a square foot in 2006 to 2007. "Today that building would most likely sell for $36 per square foot to $42 per square foot, or approximately $1 million less than in 2007."

In addition, for owner occupants looking to purchase a building under $10 million there is available financing from regional banks. "SBA or Economic Development loans are providing necessary bridge financing to reduce the amount of equity needed to finance the property," Battagliese tells GlobeSt.com. Where a conventional loan might require 30% equity, utilizing SBA or EDA loans can reduce the equity from the purchaser to 10%.

For companies that still prefer to lease, occupancy is still more valuable to landlords than the rental rate. Owners that have current vacancy are under significant pressure from lenders to fill the space and continue to service mortgages, even if they have experienced a maturity default. With backing from the government, lenders are extending loans that are due, in hopes of riding through the cycle rather than taking a significant write down on the loan. As a result, Battagliese notes that landlords are working aggressively to renew existing tenants and offering reduced rates or free rent to attract new tenants to vacant space. "Similar to sale prices, rental rates in certain types of space have dropped 20% to 30% over the past two years," he relates. "Space that was leasing for $4 a square foot to $4.50 a square foot is now being leased for $3.25 to $3.50 per square foot. For a 60,000-square-foot space this can save a company hundreds of thousands of dollars over a five-year lease term."

In the New Castle County, DE submarket, for instance, landlords have reduced asking rents almost $1 since the first quarter of 2009. In Central Pennsylvania, blend and extend strategies are still a common solution for tenants and landlords alike, as tenants are able to immediately decrease their occupancy costs and landlords can guarantee their space will be leased for years to come, says Michael L. Compton, CBRE's research manager. "In Lehigh Valley, a flurry of smaller tenants, generally in the 50,000-square-foot to 150,000-square-foot range, are the most active in the market and are pursuing aggressive proposals from landlords who have dropped average asking lease rates for six consecutive quarters."

So why does Battagliese think that the window of opportunity for industrial tenants and buyers will be a short one? The quick answer is inventory. "One of the primary impacts of the recent economic and financial calamities has been the complete shutdown of new speculative development," he comments. "For the Greater Philadelphia industrial market, new construction has averaged 2.5 to three million square feet of spec development per year since 2000. With no new inventory planned for 2010 or 2011, and already low vacancy rates in certain size ranges, the swing from a demand constrained to a supply constrained market could be as short as 12 to 15 months." What's more, until rental rates increase back to $4.50 a square foot or greater, it will be difficult for developers to finance new construction, says Battagliese. "Given the natural lead times for approvals, site development and construction; it may be 2012 or later before new development, other than build-to-suit construction, returns to the market."

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