Industrial Real Estate Demand Strong Heading Toward Final Months of Tumultuous Year

Leasing Hits Record as Analysts Watch for Signs of Consumer Spending Slowdown

By Randyl Drummer

The nation's industrial real estate market is headed toward the closing months of 2022 with strong demand overcoming uncertainty about the course of the global economy.

Leasing of logistics, manufacturing and warehouse properties has been hitting records during the third quarter as businesses and investors also build and buy industrial properties at near-record levels, analysts and brokers told CoStar News. That comes as they describe heading into a fourth quarter beset by uncertainty as the prospect of a recession looms, interest rates are expected to bump up further and the pandemic grinds on.

A wave of openings of U.S. manufacturing plants including electric vehicle facilities and a planned $12 billion computer chip fabrication plant in Phoenix by Taiwan Semiconductor Manufacturing Co., the world's largest chipmaker by volume, attest to the surge in industrial demand, analysts say.

"While industrial real estate isn’t immune from recessionary headwinds, it does benefit from insulation due to increased e-commerce sales [and] efforts by businesses to diversify their supply chains and hold extra inventory to guard against shortages," Matthew Walaszek, a research director for CBRE specializing in industrial and logistics property based in Chicago, told CoStar News. Population growth in the Sun Belt, in particular, is also feeding demand, he said.

At least 83 million square feet of industrial leases were recorded last month, the highest ever for the month of August and up 14% from the prior-year month, said Adrian Ponsen, U.S. director of industrial analytics for CoStar Group.

“Industrial leasing isn't showing any signs of slowing,” Ponsen said. "Major retailers such as Target and Walmart have announced plans to open multiple large distribution centers across the country."

Potential Risks

Despite the upbeat assessments, analysts are watching several economic indicators — including levels of imported goods, inflation and natural gas prices that could affect heating costs — to gauge consumer spending, a major driver of logistics development.

“We’re watching consumer sentiment and even though it has declined somewhat, we’re still seeing decent retail sales,” Walaszek said. “But if consumer sentiment plummets, we may see a pullback in retail and industrial expansion plans. We’re watching what occupiers are doing, and although some have pressed pause on expanding their logistics networks, many others are still planning to expand their footprints."

One of the biggest risks on the horizon is that the recent spike in natural gas prices could put a serious dent in household budgets as the winter sets in, leaving consumers with less money to spend on goods stored in distribution centers across the country, Ponsen said.

That concern may be limited by Americans racking up an unprecedented $5 trillion in savings during the pandemic that will continue to cushion any drop in consumer spending, he added.

As with every major commercial property type, industrial real estate financing has shown signs of weakening as the Federal Reserve has raised interest rates, which increases borrowing costs, Ponsen said.

Rates on new mortgage loans for industrial properties are up more than 1.5 percentage points since the beginning of 2022, cutting into investors' rates of return and forcing buyers to make higher down payments, he said.

Sales Rise

Still, higher capital costs haven't caused investors to pull back. Sales volume rose substantially in the second quarter of this year, a period when interest rates were rising the fastest, compared with the same time last year.

"The resilience of sales volume in the face of fast-rising interest rates is a testament to just how eager investors are to increase their exposure to the industrial sector," Ponsen said.

On the consumer front, non-store retail sales, a good proxy for e-commerce sales, have grown at almost three times the rate of inflation since the beginning of the second quarter, Ponsen said. Meanwhile, tonnage of containerized imports arriving by sea has set all-time highs nearly every month so far in 2022, he added.

"Consumers are still spending aggressively at levels that are well above levels prior to the pandemic, even as inflation has driven up costs for U.S. households and businesses over the past year," Ponsen said. "Companies are scrambling to find the logistics space to store, pack and ship a record amount of goods flooding across the country, so, I don't expect industrial leasing to soften over the next several months."

Against that backdrop, there is little evidence of overbuilding across the United States, despite nearly 370 million square feet of space completed in the past 12 months, analysts said.

"The majority of the markets still have tight conditions and low vacancy with virtually no space available in markets like Southern California's Inland Empire, which has the lowest vacancy rate in the United States at under 2%," Walaszek said. "We can’t really point to any market that’s getting overheated or oversupplied, but we’re tracking that closely."

Rent growth may slow down and level off, but it won't decline anytime soon, said Scott Perkins, senior vice president with commercial real estate brokerage NAI James E. Hanson, based in Teterboro, New Jersey.

"Landlords and investors are not jamming on the brakes, but they are applying the brakes," said Perkins. "I don’t see rents pulling back yet. There’s just not enough supply for that."