

Episode 4: Greater Boston Industrial Market: Emerging at the Seams

John Lashar

Hello. My name is John Lashar, Vice Chairman at CBRE and co-lead of our CBRE Boston Consulting practice. For today's episode of our CBRE 2021 Boston Brief, I'm joined by my colleagues, Rachel Marks, Senior Vice President and leader of our Industrial practice, and Chris Skeffington, Executive Vice President and leader of our Capital Markets group, to discuss the Greater Boston Industrial market, recently highlighted in CBRE's Emerging Industrial Markets series this past month. As many of you know, we've been in record-setting everything. We've faced supply-demand imbalance, unprecedented rent growth, diversity of demand, and e-commerce and onshoring dynamics that have changed our market over the last 14-18 months.

Rachel, the Boston industrial market has transformed itself from a secondary, end-of-the-line industrial market to one of the most dynamic, high-growth markets in the country. How did we get here, Rach?

Rachel Marks

Thanks, Lash. Well, we all know the story on global industrial market growth. The world has changed, human consumption and convenience habits have changed, and e-commerce is on an absolute tear. But Boston has emerged as one of the highest growth industrial markets in the entire country. Not just because of national industrial market growth, but because of a unique set of circumstances here.

The Boston metropolitan area is the fourth most densely populated region in the U.S., and we're young and growing. The region's population is expected to grow by at least 3% over the next five years. And the density growth across all of New England, as cities like Providence and Portland and Burlington have suddenly become really cool, means that Greater Boston has become the "last mile logistics hub" to distribute to all of New England. Couple that with how smart we are, and I know I'm bragging, but we've got booming industry outside of e-commerce too. Tech growth across the robotics and manufacturing and R&D sectors, this has been eating into industrial supply across all submarkets. And then of course, our life science sector is the real differentiator here.

So, with all of this demand, we should have been at least a little bit ahead of the eight ball on the supply side, but it's come so fast and furious that we are way behind. We're sitting in this crazy dynamic of supply-demand imbalance, where we've got 35 million square feet of active tenants in the market and only around six million square feet of functional vacancy. But what's scary is how little spec development is coming down the pike. Boston's tough on all areas. The barriers to entry in terms of lack of land, topo and wetlands challenges, competition, and the resi and life science development worlds, and a generally difficult and obstinate entitlement process, all mean that it's hard to develop here. So even with a supply-demand imbalance of close to 30 million square feet, we have less than half a million square feet of spec development currently underway.

John Lashar

Skeff, given Rachel's comments on the evolving leasing market and macro demand drivers, how have the capital markets reacted to "The New Boston"?

Chris Skeffington

Yeah, Lash, it's really been nothing short of amazing and explosive as it relates to the capital markets. For context and historical perspective, I think back to the 2014/2015 timeframe when we started to see institutional capital come into the market and Boston finally posted its first 6% cap pricing and hundred dollar per square foot plus transaction, and you fast forward five, seven years later and we're now talking about depth of capital liquidity that has driven cap rate compression

down to the sub 4% cap level. And that correlates back to pricing that in some cases for new high-bay warehouse is going to eclipse \$250/SF. And it's really phenomenal what the capital markets is doing.

We were always a market that was able to attract capital as a yield premium and a spread to some of the core markets like Jersey and that's spread that it feels like yesterday we would have talked about 100, 150, and even 200 basis points spread to Jersey. Today we're probably 25 to 50 basis points. And so it's really been remarkable to see how the capital markets have reacted to Boston. Because we had that end-of-the-line sort of negative connotation for years. There's an education process and an educating process to get capital comfortable with what our market is and how it's set up and why metal-sided buildings are of no concern to us and quite frankly the norm in the market. But once you get through that educating process, the capital is proven and continues to prove that Boston is now a primary target market. And in the words of some of our clients, their own view, Boston has some of the best and highest growth trajectory around the country.

So warehouse is obviously top of mind for a lot of folks, but even light industrial, and Rachel hit on it, robotics and high-tech manufacturing. And now as we're seeing the growth in life science converge into the industrial space and what will biomanufacturing and GMP demand do to an already shrinking inventory on the supply side, it remains to be seen. But we definitely have what you could call the perfect storm, and the capital markets follow the leasing fundamentals. And Rachel laid it out, the leasing fundamentals are about as perfect as you could ask for and the capital markets are responding accordingly.

John Lashar

So, we've touched upon both the life science market as well as the capital markets in our previously recorded CBRE 2021 Boston Briefs. Now, Rachel, Skeff mentioned the biomanufacturing/GMP sector and the intersection of the life science and industrial markets to some degree. Why don't you start the conversation for us at a high level for our listeners to drill down as to what biomanufacturing/GMP really means, where it fits within our Greater Boston industrial market, and how you expect it to impact the Boston market specifically in the years to come.

Rachel Marks

GMP or biomanufacturing, these are words that really mean something different to everyone you talk to. But long story short, as drug production across the globe has transitioned from chemistry-based manufacturing to a much more complex biologic-based manufacturing process, the drug production needs to be done close to the R&D, close to the high-skilled labor, and close to the brain trust of hospitals and research institutions.

With Boston home to the clear number one life science cluster across the globe, we've become a huge target for these biomanufacturing uses. And since they need to be built from scratch, to suit, what better place to start than a clean, open warehouse box? So we've seen tremendous demand from GMP companies themselves to lease or purchase large warehouses. But now that we're becoming a biomanufacturing cluster, we're also seeing tremendous demand from the ancillary uses that support and allow biomanufacturing to take place; the chemical distributors, the clean room manufacturers, the vacuum engineering producers, even the HVAC guys. All of these uses have seen a major uptick in demand for industrial space. And then you need the finished goods warehouses.

So this whole GMP/biomanufacturing thing, it's become its own little demand driver and it's been pretty incredible to watch. That said, we're still in the early days here on how to deliver biomanufacturing space as generically yet quickly as possible. So we're very much in the discovery phase of what deal structure is going to look like across a broader subset of costs.

John Lashar

Rachel, is it safe to say that the price and sensitivity of this user set that we're seeing in the suburban market, that this price insensitivity will have a definitive impact on traditional industrial users ability to pay the rents that we're seeing achieved under the biomanufacturing transaction structures?

Rachel Marks

You know, it's been really interesting to see. Across biomanufacturing and e-commerce, speed-to-market is the single number one factor, and that dwarfs any of your real estate costs. And so they're definitely driving rents up across the board and that's having a trickle-down effect, of course. And so we've been a part of dozens of lease transactions, many renewals over the past few months where we are met with complete surprise, shock, awe from tenants who say they can't stomach the rental increases of 30%, 40%, 50%, sometimes 60%+ compared to what they were paying just last year.

Every single one of these groups has eventually paid up and realized that your base rent is just such a small piece of the pie in terms of triple net expenses, CAM and taxes, labor, move cost, functionality, efficiency. And so I do think that we'll end up seeing many of these groups renew and pay up to compete with the biomanufacturing and e-commerce uses that are new to the market.

John Lashar

Skeff, piggybacking off of Rachel's comments around the unknowns on deal structure, tenant credit, and residual value, how is the capital underwriting these unknowns and pricing amidst uncertainty?

Chris Skeffington

If you asked me that question 12 months ago, I'd have a very different answer than I do today. And what I would say is it feels like it's been almost two years where we've been all watching the biomanufacturing/GMP wave or the start of the wave unfold, but we've all been in a bit of a discovery phase. And so whether I think of the company level, the broker/advisor/consultant level, the banking community level, et cetera, this is obviously a new piece of demand. And with that, the structure in which these deals are getting done, that being TIs and how those are folding into rents and tenants that want to avoid out-of-pocket costs versus those that are rent insensitive and willing to pay the full freight for landlords that will give big TIs, it's really been a bit of an unknown.

But as we've moved through the last 12, 18 months and the market continues to get more educated and the general sentiment has now shifted to biomanufacturing being a widely accepted and direct extension of traditional life science that comes out of Cambridge, I would say the aggressive nature of capital and the overall mindset is now ready to purchase and ready to get out in front of this wave. And we're hearing more and more clients that really don't want to miss the opportunity today, because I think we all know as soon as the data is readily available and the lease comps are out there and the market has a much more comfortable sense of where this subset of demand is heading, all bets are off on pricing at that stage.

So there is a lot of capital right now that is feeling comfortable enough, not perfectly comfortable, but comfortable enough to make the bet to throw price per pound out the window when you're buying single-story industrial with \$20 to \$30 to \$40 NNN rents and truly not looking at a \$500 to \$600, \$800/SF purchase as sticker shock type response. It's really been the opposite. They're looking at these as opportunities, high-growth sector and the ability to get in today while the rents are low and the investment is being made on the tenant side, the residual value is going to be there. And as Rachel hit on, without a relief valve in terms of new supply, we're going to be quickly running out of single-story space and that's going to continue to put pressure on rents.

So, again, it feels like there's a bit of a bubble in the most positive sense that we talk to clients quite a bit about finding land and developing new industrial product. And everyone, I think it's in your human nature to feel like as you get to a certain peak, the trough is right around the corner and we're getting close to the edge of the cliff, but we spend almost every day trying to find holes in the story and understand where the relief valve and the new supply is going to come from. And in a market that's 270 million square feet plus, I wouldn't be worried about three million square feet coming next year. But as Rachel said, we're talking about 300,000 square feet coming in the next 12 months.

So the GMP is still not perfectly clear on how the underwriting will unfold, how the capital markets will react to the deal-by-deal structures, which in a lot of cases I think are going to be different. But what is definitely clear is the capital markets and the equity is ready to jump in head first. And as more of these deals land and those leases and stabilized assets become sales, we're going to have better and better visibility on the capital markets, the pricing, the cap rates, and generally what capital and equity out there is willing to make that bet and really push to new record levels.

John Lashar

Those are all great points, Skeff. Do you believe tenants' investment in space where a tenant's willing to put \$200, \$400, \$600/SF of their own capital into buildings, do you believe that that will help buoy investors' confidence and underwriting deals and pricing through record-setting basis?

Chris Skeffington

Yeah, absolutely. In the sense of the residual value, all of that money is not going to be lost or spent for nothing if a new tenant were to come in and try to realize and benefit from the investment that's been made. And then secondly, obviously from the stickiness of the tenant side, while you may not always be dealing with an investment-grade tenant or something of the like, the comfort that is brought to the deal when a tenant is investing the magnitude of dollars you just laid out, it really brings that risk profile down. And then when you couple that with the residual value of the space and the ability to reuse it and then further compound that with the overall tightness in the market and the growing list of tenants that we're tracking out there, it's undoubtedly bringing enough comfort and confidence to the table from the investor equity side to go ahead and make those bets, even when you are dealing with, in some cases, VC-backed startup companies that in a lot of cases may not even be profitable at this stage.

But as I mentioned, being more educated and being smarter around the science and the company level, that's what's been interesting in the market is seeing how smart the capital is getting and not really just looking at it at the real estate level, but truly getting into the sciences and the futures and the capital backing at the VC or private equity or NIH level. That's where the capital markets have really made, I would say, leaps and bounds progress in the last 12 months of getting comfortable with this sector knowing it will continue to evolve and change, but certainly being prepared and proactive to jump on opportunities as they become available in the market.

John Lashar

Rach, let's transition back to traditional industrial and talk a bit about the warehouse market. You know, everything seems to be hitting on all cylinders. Aside from you and the team being as busy as you are and working six days a week, what's been the biggest surprise to you as the market continues its upward trajectory?

Rachel Marks

The biggest surprise is how slow development has been and continues to be. Demand is obviously firing on all cylinders to the degree that we could see every single industrial development site actually come out of the ground over the next 24 to 36 months and it still feels like it won't be enough. We are so undersupplied. We will continue to be undersupplied because people can't build fast enough. And what's even worse than that is the nationwide steel shortage is throwing a real wrench

into the spec development process, which means we're going to continue to see more of the same. Even though the demand is there in spades, developers are hesitant to come out of the ground on a spec basis when steel prices and lead times are both up 50-plus percent and any sort of change order has become incredibly punitive and almost cost prohibitive.

We're seeing this change plans almost across the board where developers would rather have the ink dry on a new lease and build a build-to-suit building to someone's exact spec rather than risk it and go speculatively ground up. That's a real problem considering that a build-to-suit is going to take 18 months, especially with a difficult entitlement process. And so for the next 18 to 24 months, we are going to be in a supply-constrained city almost to the point of a total supply crisis.

John Lashar

Skeff, that leads to an obvious question. We've been stuck in a bracketed range of land value for a time period that seems forever. What has the dynamic that Rachel just described, what's that done to land values and the market's overall appetite for industrial land and also repurposing alternative uses to industrial?

Chris Skeffington

Absolutely. It felt like forever, Lash. You and I have been doing this together for 10-plus years, and Rach we've been together for three-plus now, and it feels like forever the Boston industrial land value barbells, if you will, were 10 to 15 in FAR. And it was like that in 2010. It was still like that in 2015. And finally, the last, I would say, 24 months, maybe plus 24 to 36 months as the market fundamentals have tightened, the rental growth has continued its trajectory upward, vacancy has come down, absorption year-over-year continues to increase, and overall the fundamentals are about as good as they could be. We're finally seeing that correlate back to land prices.

Our team has been extremely active in the market. And what would have been that 15 to maybe 20 FAR best case a few years ago, in some cases depending on what submarket you're in, we're seeing prices jump to as high as 60, 70, 80 FAR and still pencil out because even the old Boston, when we'd have 10 to 15 land, it didn't even pencil out. Rents were \$5.50 to \$6.00, cap rates were 7.0%+.

And even if you delivered a building at 60% to 70% on cost, it wasn't always a great risk reward proposition because Boston was that end-of-the-line secondary market. And now as we're looking at new construction, rents pushing \$9.00, \$10.00+, and certainly north of the city well into the double digits, and cap rates plummeting below 4%, the math works. The sticker shock is there for groups that have locally been around and developers in the market that are still hoping and wishing the 10 to 15 FAR existed. But the reality is we're in a much different market today. It's a completely different world. The capital markets and liquidity is pouring in left and right, and it's all tied back to land.

But what I would say is while everyone in the market, both local developers and outside capital is trying to find land opportunities, Rachel hit on it perfectly, whether it's typography issues, wetlands issues, municipal zoning issues, we've been working on a site south of the city for probably a year now trying to figure out how to get 300,000 to 400,000 square feet out of the ground, and when we thought we finally had hit a point of success in moving the ball forward and going under contract, the wetlands turned out to be larger than we thought. And then we ricocheted to an abutting owner where we've tried to parcel off a piece of their land so that we can configure the building appropriately. And after a year and many scars and bruising and wondering if we should walk away from this one, we still are not at a point where we know if this site's ever going to become an industrial development.

So while everyone is trying ferociously and the boundaries are expanding beyond I-495, and capital's looking north to New Hampshire and south to Rhode Island, to Rachel's point, it's been astonishing that we're still looking at less than a million square feet per year all the while we're likely going to be at sub 2% vacancy by the time we get to the end of 2021, maybe less, and nobody can figure out a way to solve for new supply.

So as far as I'm concerned, I don't see things letting up until we figure out the supply issue. And that has not been figured out to date. And I do not have a clear vision of where it's going to be solved in 2022. So my personal feeling is the market still has quite a bit of runway. Vacancy will continue downward. That will continue to result in landlord-favorable conditions to push rents. And as long as those two things continue, the capital markets will continue to pour capital into the market and put more pressure on pricing. So 60 to 70 in FAR feels like a huge number, but I wouldn't be surprised if in another 12 to 18 months we could be talking about 80 to 90 plus in certain locations.

Rachel Marks

Skeff, you made a good point there. And we should mention the fact that New Hampshire and Rhode Island are just as tight as Massachusetts. And so as we look at relief valves, they don't exist there and they have the same barriers to entry in terms of development. So we don't really have that outward geography pressure where we could conceivably see those as relief valves in the near future.

Chris Skeffington

Yeah that's right, Rachel. The last comment I heard from our colleagues in New Hampshire, we typically talk about 30 to 35 million square feet of demand in the market and seven to eight million square feet of availability. So you could say maybe a 4x to 5x demand versus available space. The last anecdote I got from our guys up north was six million square feet, they're tracking one million available, so 6x demand to supply. It truly is no different in Rhode Island is 1% vacancy and probably lower today or certainly heading into sub 1% territory with very little new supply coming as well. So it's not just a Boston thing. It's truly a New England phenomenon. And as of right now, our team can't figure out where this is going to stop or where things would plateau or what's going to come that's going to shift the dynamic.

John Lashar

Rachel, Skeff, really great dialogue. As we know, real estate values are buoyed by tenants. Rachel, given our activity level on the tenant representation side, how are tenants reacting to moving beyond I-495 when you get them in the car for a first tour looking for large blocks of space or developable land?

Rachel Marks

Geography is an interesting hot button right now. We are still in the COVID era, and so obviously as you look out there, traffic doesn't exist. And so what we're dealing with is a dynamic where you can do last mile distribution to the city of Boston just as easily from Southborough as you can from South Boston. And so I think that changes as soon as everyone's back in offices and traffic is back, but for right now geography isn't much of a thing. The market is so tight anywhere, from the urban core to Rte. 128 to I-495 and beyond, that you sort of take what you can get. And if a building checks all the boxes from a specs perspective, geography has become a lot less relevant over the past 12 months.

John Lashar

I would like to thank everyone for listening today, as well as Rachel and Chris for joining me. For more information, be sure to check out the recent Boston installment of CBRE's Emerging Industrial Markets Series.