Do Big Retail Companies Still Need Warehouse Space?

Steve Lewis is President of Wordman, Inc., a marketing communications firm based in Atlanta, Georgia. He has been representing real estate clients and covering the commercial real estate industry for more than 30 years, and he continues to write freelance articles about the real estate industry.

By Steve Lewis

While much of the economy, and certainly many real estate sectors, remain in the doldrums, retail warehouse space is a stunning exception, say SIORs. Much of the demand, they note, is due to increasing growth in internet sales and the attendant need for more fulfillment space.

"There is absolutely a need for retail warehouse space. In fact, retailers are taking on, incrementally speaking, a greater amount of warehouse space," says **Anthony J. Lydon, SIOR, CSCMP**, managing director, Industrial | Supply Chain & Logistics Solutions, Jones Lang LaSalle Americas, Inc., Phoenix. "The reason for that is a significant increase in internet retail sales."

"Internet sales were up 8.7 percent in 2009—even though it was a horrendous year for the economy—while every other sales measure was down," notes Lydon.

Lydon cites Richard Cain, Macy's vice president of operations as saying that internet sales are increasing at 12 percent to 15 percent a year—a five-year trend. "This is a very exciting growth-oriented reality that many parts of the country are going to experience," he predicts. "The implication is greater demand for fulfillment space versus warehouse space.

"This is not your father's warehouse," Lydon asserts. "The occupier is a value-add pic-pack-ship activity that also provides reverse logistics, showroom, training, and perhaps customer support solutions."

Gabriel Silverstein, SIOR, president of Angelic Real Estate, LLC, in New York City, also sees strong demand. "The simple answer to the question of whether big retail companies still need warehouse space is 'yes,'" he asserts. "In fact, a lot of them have been very active in logistics and distribution space in the past six to 12 months."

In the past 30 days, Silverstein says, Amazon has authorized the start of the construction process for two warehouses in the Southeast totaling close to one million sq. ft. each, and is looking at as many as 10 or 11 around the country. "That's a major supply chain revamping," he observes.

Things are strong on the investment side as well, says **Nicholas J. Malagisi, SIOR**, managing director and national director of self storage for Sperry Van Ness Commercial Realty in Buffalo, New York. "There is certainly demand for purchasing investment warehouse space," he says. "In fact, coming out of the recession it has the lowest default rate of any segment of the district."

In investments, he continues, credit is king. "I can tell you that retail clientele with triple-lease properties remain a strong investment, provided they have credit; and big boxes remain popular, provided they have the credit behind them," says Malagisi. "What has happened with all investment real estate is that the amount of equity needed is greater; investors are not able to leverage as highly as they used to."

"Outside of the fundamentals is the fact that people continue to buy things, so there is a continuing need for storing goods," adds **John Barker, Jr., SIOR**, senior vice president of development for Red Rock Developments in Charlotte, North Carolina.

The service delivery model has changed, Barker notes. "Customers' expectations are different today than they were two or three years ago, but they still want to get their delivery as quickly and as cheaply as they can," he says.

Strengths in the Sector

Silverstein cites two major factors for the strength in this sector. "One is the lack of product, plus a supply of money to

Contributing SIORS

Greg Gunn, SIOR

Tom Hill, III, SIOR, CCIM

Stan Kurzweil, SIOR

Jim Maenner, SIOR, CCIM

Tim Mills, SIOR, CCIM

Greg Schenk, SIOR

Bruce Wettenstein, SIOR

go after the available deals," he says. "It's indicative of the fact the market has bottomed out, and you can do a 10-year deal and feel comfortable the market will be going up from here."

Even a year ago, he says, people were still scared as investors in terms of what the future would look like in 10 years. "Financing has driven a lot of that," he says. "Six months ago it was really, really difficult to get a construction loan on a build-to-suit with an investment grade tenant with a 15-year lease, even with a take-out buyer in place. But lenders have gotten more comfortable."

The second factor, Silverstein continues, is cost savings. "Boxes that are starting to come out of the ground now have been in the works as long as 18 months," he notes. "First there was a revamping of the supply chain. Companies slowed down so they would no longer 'blink and think'; they could analyze the supply chain."

Also, Silverstein says, "You were in a down economy, so you can see why Dollar General was so successful in the past two years. Consumers forced retailers to squeeze dollars out of their products. But now, you can't take any more dollars out of the product; you make it as cheaply as you can, so where do you go to squeeze costs when suppliers have nothing left to give you?"

The answer, says Silverstein, is to save internal costs, that is, logistics, supply chain, distribution. "How do you create margins in an economy that takes them away?" he asks. "By re-examining distribution networks, and in several cases, either relocating facilities or consolidating multiplying facilities into one," he explains.

Barker notes that the type of facility being sought is also being re-thought. "We've gone through several cycles," he says. "For example, 10 years ago we started moving from a medium-sized fulfillment center to a very large one. That's constantly changing due to a lot of components, such as operating costs, gas, the carbon fuel impact, etc.," Barker says. "Now we're going back to where we were 10 years ago, with 300,000, 400,000, or 500,000 sq. ft. distribution centers.

"Also, the impact the railroad has on the supply chain and the overall distribution of goods is growing like never before," he continues. "It's very evident where the future will be when railroads spend millions of dollars across the country to upgrade trackage and change alignments; they're preparing for more use of rail than ever before."

A lot of that, Barker explains, has to do with the regulation of carbon footprints. "If the federal government says, 'Get trucks off the highway,' then railroad is the way, either piggyback or containerized," he notes.

Big Deals Being Done

SIORs are reporting a number of significant deals in recent months. For example, Lydon says six national retailers have expanded or taken on more space in his region. "They're not only taking on more space, but when these companies go into these facilities, they're spending several million dollars," he says. "For example, we just consummated a 10-year lease with Amazon (1.5 million sq. ft.), and the landlords spent $24 million on fixturizing."

Silverstein reports that Sun Products (the household products company that makes the Kirkland brand) is building a 1.4 million sq. ft. warehouse in Kentucky and is talking about doing 750,000 sq. ft. in the Salt Lake City area in the future. The project is being built by Johnson Development.

"We're doing smaller, and different, distribution centers," says Barker. "We're doing 150,000 sq. ft. for Michelin North America in Louisville, and it's not necessarily finished goods to be retailed."

There's been a "very big shift" in build-to-suit pricing in the past six to nine months, Silverstein adds. "The cap rate compression has indeed happened," he says. "A W.P. Carey deal in spring 2010 was at 9.25 for a 20-year deal with 1.5 percent annual increases. Within three months, there was talk about a Salt Lake City deal already quoting 8.75. And today I think we could do it at 8.25." The bottom line, he says, is, "We're doing seven- to ten-year deals and at cap rates lower than 15-year deals were six months ago."

A Role for SIORs

Though retail warehousing has the word "retail" in front of it, it is still technically industrial space and presents opportunities that a number of SIORs are taking advantage of.

"In our recent Amazon deal there was a Cushman & Wakefield SIOR on the other side of the deal," notes Lydon.

"SIORs do get involved in a number of these deals through tenant rep advisory services," adds Silverstein. "For the tenant rep side, SIOR has built up a cadre of very good outside supply chain consultants that have been tapped into."

As a tenant rep for such space, one of the things an SIOR should do, he says, is take time to better understand how to help structure the deal, "or at least enable the structuring of the capital stack behind a build-to-suit deal, as opposed to just asking developers for a rental rate," says Silverstein. "You should understand the mechanics; do not just find out where you can squeeze a few more pennies out of the rent, but understand what the developer faces on the other side of the table and be able to communicate to your client in this fast-moving environment. A lot more deals should have gotten done in this environment, but too many tenant advisory guys were not able to set the right expectation of what the market really faced," he says

And that "fast-moving" environment will eventually change again, Barker predicts. "I think we will go back to big boxes," he says. "There is always evolution; I'm not smart enough to tell you when, but the model is constantly changing."