Service Industrial:

An attractive niche within industrial real estate

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Over the last decade, industrial real estate has rebranded itself to become one of the darlings of the commercial real estate industry as e-commerce growth and heightened supply chain risks highlighted its strategic importance in the seamless and efficient delivery of consumer goods. Capital rushed into the property type, swelling the development pipeline to over 700 million square feet in 2022. Today's uncertain environment, causing businesses to pause leasing decisions at the same time this supply is being delivered, is resulting in industrial vacancies rising. Market vacancy is expected to reach nearly 7% next year, dampening market rent growth expectations.

However, painting an entire sector with this broad brush is an easy way to overlook the opportunities in the nuanced industrial subsectors. We believe the service industrial subsector, which we define as small-bay multi-tenant industrial product in densely populated infill areas, presents a compelling opportunity that has the ability to generate outsized yields relative to other industrial subsectors due to 1) a significant lack of supply producing strong fundamentals and 2) a fragmented market ripe for institutionalization.

What is Service Industrial?

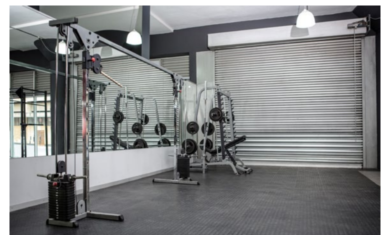
The industrial property type consists of a diverse set of more niche property sub-types, all with their own unique profiles. We consider service industrial to be small-bay assets with average suite sizes below 10,000 square feet and less than 30% office finishes. These buildings are typically less than 120 feet deep with 12- to 24-foot clear heights and predominantly grade-level loading. These spaces are tailored toward service-oriented businesses that are proximate to residences and businesses. As such, the ideal service industrial assets are located in infill, densely populated, or rapidly growing areas.

The small suite sizes in a typical service industrial asset encourage robust tenant diversification (Figure 1) without anchor tenant risk. Often, the tenancy is primarily small businesses, which account for 99.9% of businesses in the U.S.[1], for whom these spaces are mission critical. Therefore, service industrial properties typically boast high occupancy levels through cycles despite the lack of credit tenants, attracting diverse lenders to this subsector.

Figure 1: Typical tenant profile


Electrician

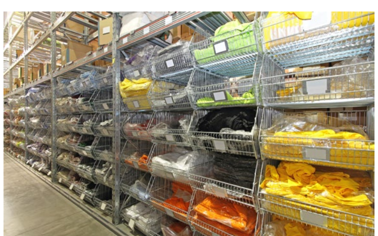

HVAC Contractor

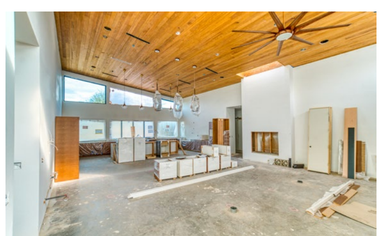

Health/Fitness


Industrial Services


Carpentry


Plumbing


Retail


Home Remodel


Moving Services


Residential & Commercial Construction


Supply Warehousing/ Distribution


Cleaning & Landscaping Services

[1]U.S. Small Business Administration, as of March 2023.

A significant lack of supply is producing strong fundamentals

Throughout the last real estate cycle, the industrial sector has emerged as a favored property type, attracting significant capital, particularly for new developments. During that time, the development pipeline has meaningfully skewed toward larger individual assets, rather than smaller infill assets for several reasons. First, development has shifted away from infill locations due to land scarcity and zoning restrictions, and second, investors' desire to deploy large amounts of capital has resulted in larger individual assets, making the capital deployment process more efficient.

As a result, less capital has been deployed into developing industrial assets smaller than 25,000 square feet. Despite these assets representing 29% of the existing industrial inventory in the U.S., they represent less than 2% of the industrial space under construction this year[2]. Further, due to the infill nature of existing service industrial product, existing product is frequently repurposed into other higher and better uses, generally residential, resulting in net demolitions and decreasing supply. The stock of industrial assets smaller than 25,000 square feet has grown by 1.5% cumulatively over the past five years while the inventory of industrial product greater than 500,000 square feet has grown by nearly 26% (Figure 2).

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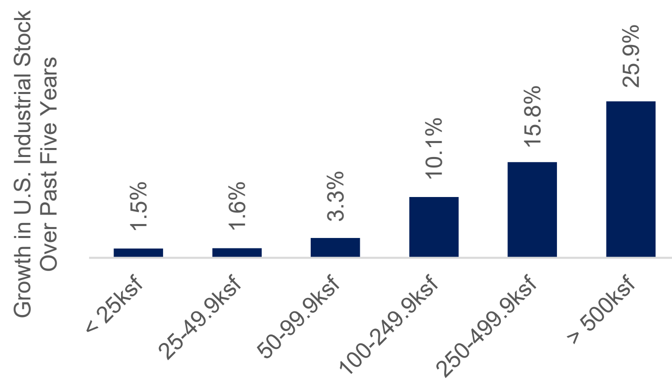
Figure 2: Recent growth in U.S. industrial stock has been concentrated in larger properties



Concurrently, demand for service industrial product continues to grow. In fact, industrial assets smaller than 25,000 square feet represented the only segment within the industrial sector with positive leasing volumes in the first half of this year when compared to the first half of 2021 and 2022, both years of record industrial leasing activity (Figure 3). Meanwhile, leasing across larger assets has not kept pace. Taken together, these favorable supply and demand dynamics have resulted in service industrial product boasting the lowest vacancy among industrial assets (Figure 4).

Figure 3: YTD 2024 leasing volumes vs. comparable periods in 2021 and 2022 by size range

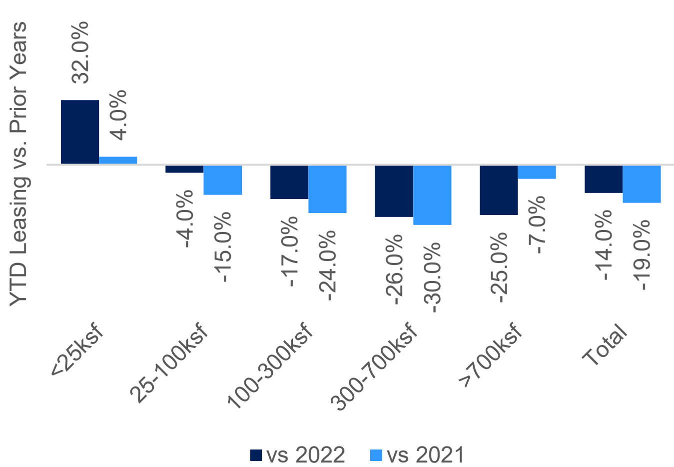
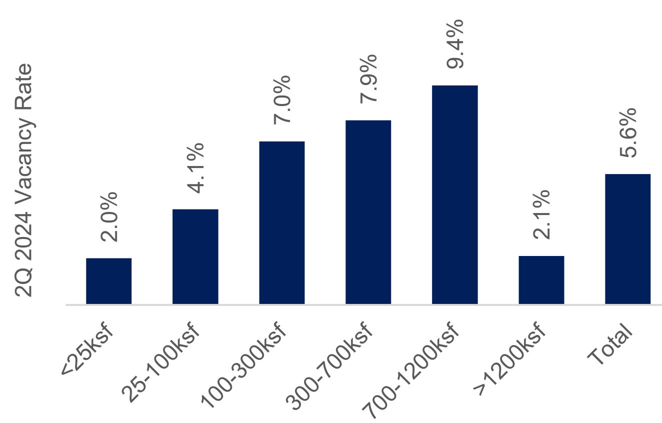


Figure 4: Industrial vacancy by size range



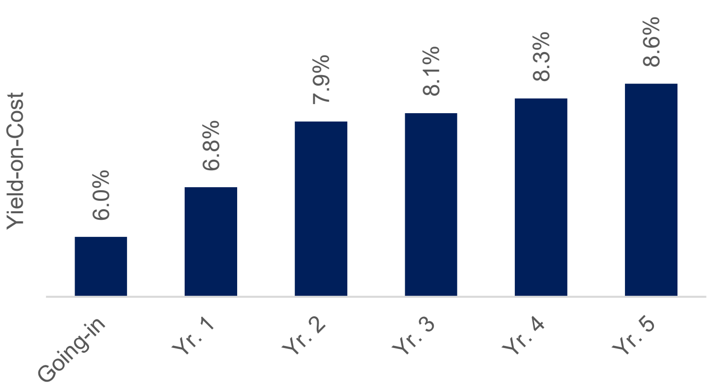
[2]CoStar, as of February 7, 2024; Figure 2: CoStar, CSIM, as of June 30, 2024; Figures 3 & 4: CBRE, as of July 2024.

Fragmented market ripe for institutionalization

Due to the older and smaller nature of this product type, service industrial assets have historically been owned by local, private owners. Today, ownership is significantly fragmented, with few institutional investors in the space, creating a meaningful consolidation opportunity. Further, service industrial presents an attractive opportunity for investors looking to deploy capital into the industrial sector, with an attractive yield-on-cost well wide of prevailing cap rates. While service industrial assets tend to be stabilized properties at acquisition, they typically have shorter weighted average leases that are well below existing market rates and tend to have deferred maintenance. The execution risk is limited, offering value-add or opportunistic returns by simply institutionalizing the management and operations of the asset. This can be achieved by converting shorter duration leases (monthly to 2 years) to 3 to 5+ year leases at prevailing market rents with 4% or higher annual rent escalations and addressing deferred maintenance for the asset.

Take, for example, the following typical transaction in this subsector. Going-in cap rates range from 5.5%-6.5%, with existing leases 30-60% under prevailing market rents and weighted average lease term under two years. The business plan would consist primarily of capturing the mark-to-market opportunity and converting the shorter-duration leases to longer-term leases with 4% annual escalations. Assuming even modest 3% rent growth, the stabilized yield-on-cost for this transaction would be between 8-9% (Figure 5).

Figure 5: Yield-on-Cost based on average deal characteristics



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Elsewhere, more traditionally institutional and core industrial assets are still being priced at steep valuations driven by two factors. First, there is a scarcity premium appearing in the market – given the limited transaction volumes, any available traditional institutional product is being bid up by investors looking to deploy capital in the sector. Second, traditional developers are now looking to invest in existing institutional product given it remains very difficult to build and finance new development today. As such, institutional product is transacting at a basis we believe to be too high, given the reset in real estate valuations occurring because of structurally higher debt costs, and generating yields-on-cost we believe to be too low in the current market environment.

While the outlook for the industrial sector might not be as bright as it appeared a few years ago, compelling opportunity remains in certain, more specialized subsectors. The convergence of a development pipeline biased toward large industrial assets and conversions of infill properties to higher and better use has resulted in limited to no new supply within the service industrial subsector. Limited supply, along with the opportunity for the institutionalization and consolidation of assets that have historically been privately owned and rented well below market rates, has created an attractive entry point for service industrial within the broader industrial real estate landscape.

Figure 5: CenterSquare, as of September 3, 2024.

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Robert Wasenius is a Senior Vice President in the Private Equity Real Estate Group. Since joining CenterSquare in 2014, he has been responsible for portfolio management, acquisitions in the Eastern United States, asset management, and dispositions. He also serves as the sector lead for service industrial and co-portfolio manager for the value-added fund. Additionally, Robert is responsible for establishing valuation policy and is a member of the Private Equity and Strategic Capital Valuation Committees.

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