Savills x CompStak Partnership Report

COMPSTAK savills

Industrial reset: Analyzing the shift toward tenant-favorable leases

As 2024 unfolds, the industrial sector is experiencing significant changes from peak market conditions observed 18 months ago. Despite easing recession fears, 11 consecutive interest rate hikes since March 2022 have instilled caution in commercial real estate (CRE). The once white-hot industrial sector is now cooling, with rents stabilizing or declining in some areas. Savills and CompStak have thoroughly analyzed this shift across eight key markets, including a detailed focus on the prominent industrial hub of Greater Los Angeles (Los Angeles – Orange County – Inland Empire).

Key findings:

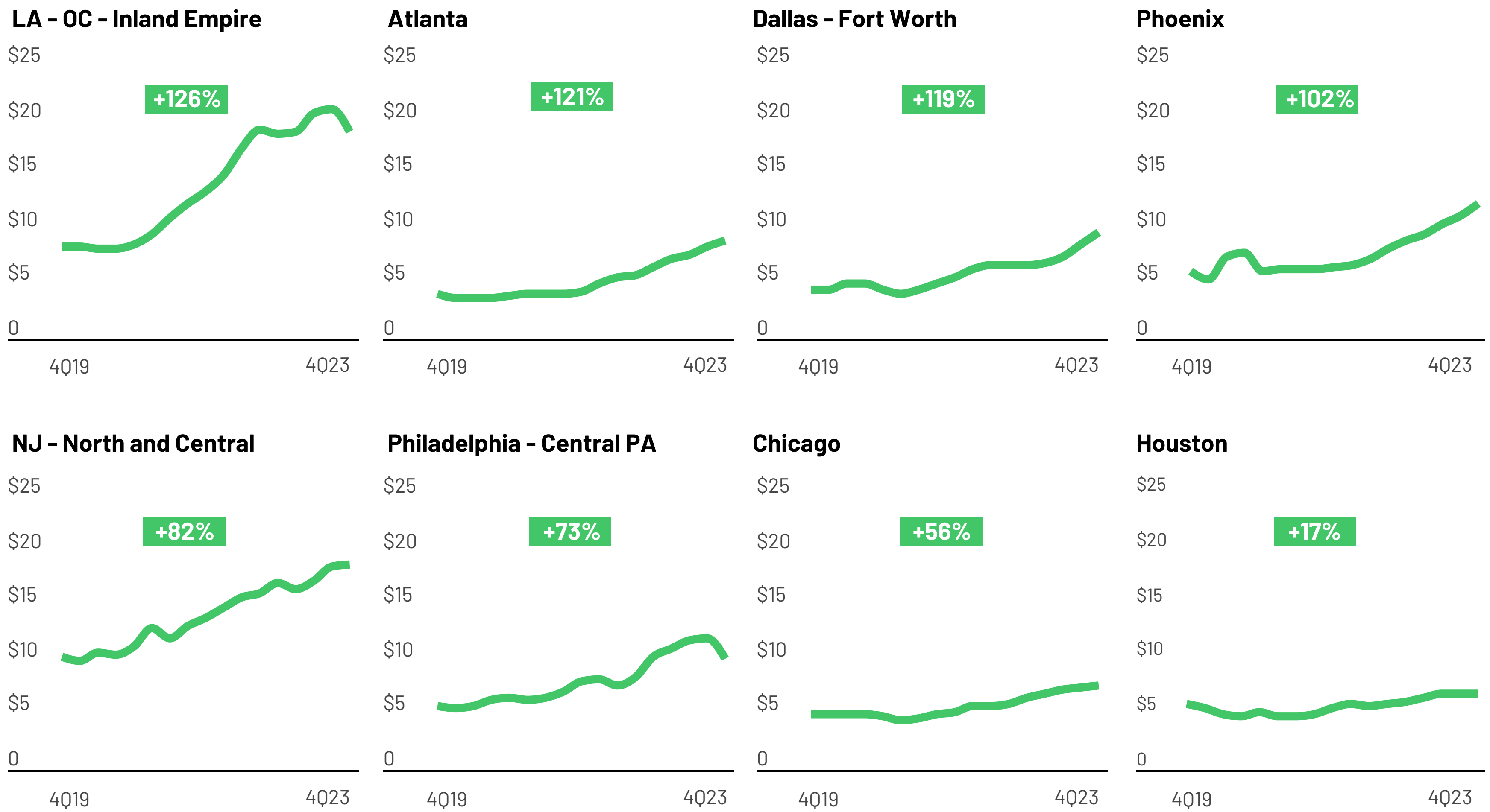
1. Effective rent growth has decelerated in major industrial hubs, with vacancies increasing over the last year due to heightened new supply and moderating demand.
2. Among the eight markets analyzed in this study, two experienced steady declines in effective rents during the past year, while the others continued to record increases.
3. The Greater Los Angeles bulk market has experienced a notable shift, as landlords have become more flexible on starting rent and free months yet remain steadfast on high annual escalations.
4. Inflated pricing due to rapid growth in the past four years, along with recent sharp increases in vacancies is creating potential for additional effective rent declines in select markets.
5. Effective rents are still 17% to 126% above 2019 levels, and with a 69% drop in construction starts nationwide, the current softening is expected to be temporary and controlled.

Demand for industrial space remains healthy, yet both landlords and tenants are navigating through a period of price discovery.

After unprecedented growth leading to a space shortage in 2021 and 2022, the U.S. industrial market faces challenges from elevated new construction and moderated tenant demand. The national vacancy rate is now 6.0%, up by 220 basis points (bps) in the last year. Additionally, record levels of available sublease space are exerting downward pressure on all deals. Effective rents, up by 17% to 126% since 2019, are beginning to drop in some areas. Notably, this trend still coincides with minimal distress in industrial properties: rents remain high, loan delinquency is low, and values are stable relative to other sectors of CRE. Landlords, often ahead of projected rents, have leeway to negotiate, including on starting rents. Following a period of unsustainable appreciation, this adjustment reflects a shift towards longer-term stability.

Four-year average effective rent growth

Top Markets



Note: NNN rents are trailing 6 month averages, including leases 10,000 square feet and up, excluding subleases.

Lease insights across three key time periods

	Pre-COVID	Peak Market	Reset	Change From	
Average of Leases 100,000 SF and Up	2019	Q3 22 - Q2 23	Q3 23 - Q4 23	Pre-COVID to Reset	Peak Market to Reset
Effective Rent	$7.88	$21.10	$19.67	149.6%	-6.8%
Starting Rent	$7.65	$19.56	$18.85	146.4%	-3.6%
Rent Spread: Effective/Starting*	3.0%	7.9%	4.4%	140 bps	-350 bps
Free Months	1.7	1.2	2.2	0.5	1.0
Lease Term Months	72.4	68.7	62.1	-10.3	-6.6
Ratio: Free Months / Lease Term	2.3%	1.7%	3.5%	120	180
Annual Escalation	3.0%	4.0%	3.9%	90 bps	-10 bps

Note: Annual NNN rents exclude subleases
*Higher effective/starting rent spreads indicate more landlord-favorable deal terms.

Spotlight on Greater Los Angeles bulk market.

Totaling more than 1.4 billion square feet, the Greater Los Angeles industrial market has been a first mover in softening conditions due to its port ties and consumer economy sensitivity. In this well-watched market, effective rents for bulk warehouse deals since mid-2023 are 6.8% lower than the peak, which occurred between mid-2022 and mid-2023. As tenants and landlords adjust to new dynamics, some deal terms are flexing while others stay steady. Notably, lease terms have been dropping reflecting economic uncertainty and supply chain recalibrations that have tenants seeking shorter leases. Landlords have been generally accommodating, expecting tighter conditions ahead. Ample second-generation space is now on the market, offering pre-existing infrastructure and reducing the need for long-term leases to amortize costs. Landlords have also been increasingly willing to provide turnkey deals, something that became uncommon in the peak market.

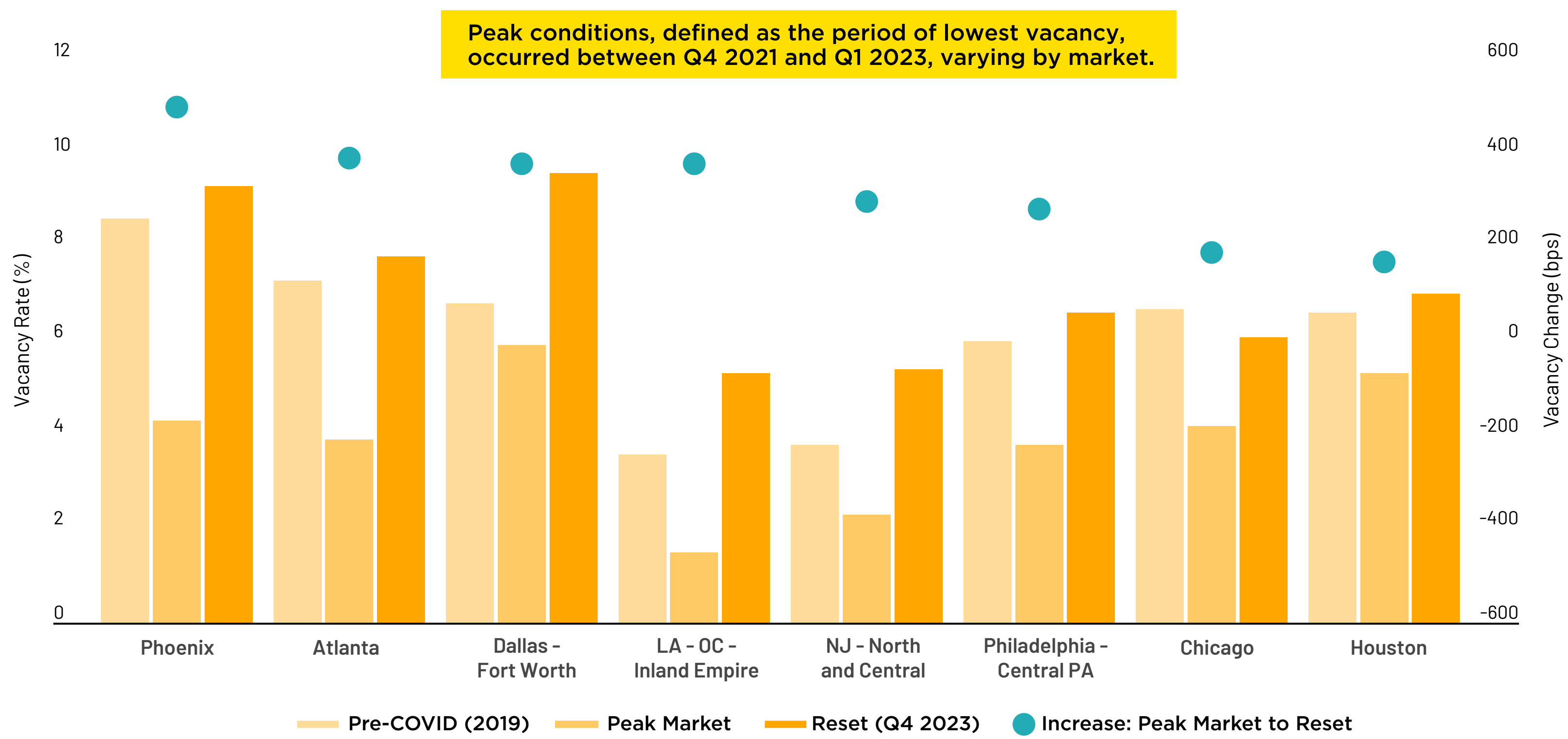
Landlords have been more flexible on starting rents, now 3.6% below the peak. Despite recent drops, rents are still much higher than pre-COVID levels, causing sticker shock for tenants at renewal. Tenants in active, unexpired bulk leases today are paying on average 37.7% less per square foot than starting rents on leases signed in the second half of 2023. Free rent periods have almost doubled since the peak, a notable increase given shorter lease terms, with the ratio of free months to lease term rising from 1.7% to 3.5%. Landlords are maintaining lease escalations, which shifted from 3.0% pre-COVID to 4.0% due to higher inflation expectations. Now, in the Greater Los Angeles “reset” period, escalations average 3.9%, little changed from peak.

However, it is not one size fits all. Tenants with superior credit can often achieve even more favorable concessions packages. Additionally, the profile of landlords can dictate what is offered with large institutional owners less willing to negotiate.

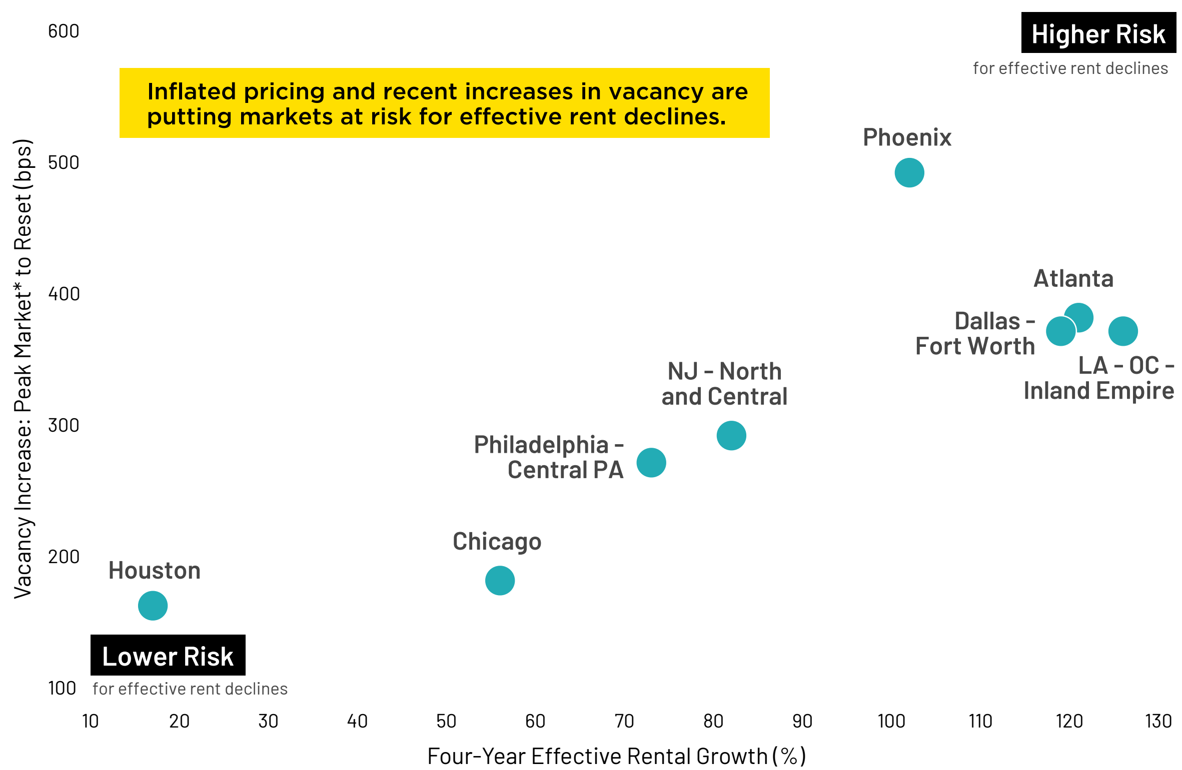
A comparison of vacancy rates across three key periods reveals why effective rents have grown so much in four years and why they are now starting to plateau or decline.

The core driver of both the COVID-era pricing bubble and the recent uptick in rents is vacancy, including how low it became under peak market conditions as well as how dramatic the reset has been. In Greater Los Angeles, vacancy was 3.6% in Q4 2019, got as low as 1.5% and now has bounced up to 5.3%. While that may not sound like a high number, it represents a rapid, significant change in dynamics and explains why rents have been declining here and are more stable in a market like Chicago, where vacancy never fell below 4.0% during the peak and is still, in fact, lower than it was pre-COVID.

Vacancy trend and comparison, major markets



Four-year effective rent growth vs. recent vacancy uptick



*Peak conditions, defined as the period of lowest vacancy, occurred between Q4 2021 and Q1 2023.

Conclusion: Markets with larger recent jumps in vacancy and wider spreads between current and pre-COVID rents face greater likelihood of future effective rent declines.

Different major markets exhibit varying potential for future rent declines, influenced by increases in vacancy rates and how much rents exceed 2019 levels. The Greater Los Angeles market, at a higher risk, has seen rents decline but could face further decreases. It ranks fourth in vacancy rate increases since the peak, and rents have more than doubled since pre-COVID. Dallas-Fort Worth and Atlanta are also likely to see rent stagnation or decline, with recent vacancy rate upticks of 380 and 390 basis points, respectively, and have yet to see rents reset. NJ – North and Central and Philadelphia - Central PA occupy a medium risk position moving forward, with Philadelphia already seeing rent declines combined with a less severe vacancy rate increase (+280 bps). Houston, where four-year effective growth was significant but much lower than in Greater Los Angeles, likely will avoid substantial rental rate or concession changes in the near term.

While this analysis illustrates that recent changes and softening may be unequally felt across markets, it is important to note that this most recent moderation is still likely to leave U.S. industrial rents substantially above pre-pandemic levels, even with additional headwinds in the near term. Still, the current reset is significant, and investors, landlords, and tenants should not take for granted that rents only continually rise over time, as a correction is overdue following a period of exponential growth under atypical market conditions.

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