KEYNOTE INTERVIEW

Consumer proximity offers a sound basis for investing

Assets in densely populated and infill locations should provide the most resilient value and vigorous growth for US logistics investors, say Crow Holdings' Ben Doherty and Ken Valach

Trammell Crow began his career in real estate 70 years ago by building and leasing a warehouse in Dallas, Texas. Crow Holdings carries on this legacy in the logistics space through Crow Holdings Industrial, its industrial development company, and Crow Holdings Capital, its investment management company. Ken Valach, chief executive officer of Crow Holdings Industrial, and Ben Doherty, managing director of the logistics and self-storage groups at Crow Holdings Capital, drill down into the US logistics market with *PERE*'s Stuart Watson.

SPONSOR
CROW HOLDINGS

Q What locations are most attractive to institutional capital to invest in US logistics today and does e-commerce impact market selection?

Ben Doherty: Crow Holdings Capital focuses on the top US markets that serve the highest population density and consumption base, as these markets tend to have barriers for new supply and the strongest operating fundamentals. It is clear that continued growth in e-commerce is the main demand driver for logistics space today. However, it is hard to quantify exactly how much e-commerce is contributing to absorption because of the difficulty in determining what space is dedicated to online sales versus more traditional logistics uses, including the replenishment of traditional retail stores.

Nevertheless, e-commerce users tend to demand three times more space and lean toward newer product, except in infill locations where location and proximity to customers may trump functionality. In deeply populated markets, drive time to consumers becomes the most important factor for e-commerce operators because of the pressing need to get their products to end users quickly. Often, these urban infill locations are in high-barrier markets with little opportunity to build new product, so tenants will lease existing product that may not meet their needs from a functionality standpoint.

Ken Valach: Future proofing your investment in the logistics sector always comes back to location. Crow Holdings Industrial is focused on the top eight US metropolitan areas, which represent approximately

Minding the store

US self-storage still offers possibilities for investment

Self-storage has been a challenging sector for investors in recent years, says Doherty, but it may be about to turn a corner. "We have seen an abundance of new supply come onto the market. Operators have shown themselves willing to give substantial discounts in order to fill up their facilities, and in some cases this has driven rental rates below the levels underwritten by developers and capital providers. However, many believe that new supply peaked in 2019, and while 2020 fundamentals may continue to be challenging in affected trade areas, demand continues to see year-over-year increases. We expect this to continue over the next few years."

Self-storage remains attractive to investors because it provides a diverse but predictable cash flow, and virtually no capital expenditure is required when a tenant vacates a space. "For the most part, all you need is a broom to sweep out the unit," quips Doherty. The sector may also provide a useful hedge against fluctuations in national economic cycles. "Self-storage is a needs-based product. Life events drive the demand, and this can offer resiliency to economic swings."

As in the logistics market, Crow Holdings Capital is mainly focusing on new development in major US metros with strong consumer demand.

"You can still find pockets of opportunity because self-storage is a trade area business – facilities largely serve only a three- to five-mile radius. We are seeing trade areas where it still makes sense to put new supply on the ground, and where we can achieve our lease-up projections and rental rates," says Doherty.

However, it is vital to have detailed knowledge of the local market landscape before building. "You have to understand demographics and the potential 3-5-7 mile area, what is under construction today, which existing stores could be expanded, who has applied for permits to build new product and what land is or could be zoned for storage use."

50 percent of the absorption in the country. However, city selection is not the only important element; developers need to consider additional factors like access to freeways and the number of traffic lights trucks will have to go through when driving to and from the location.

Further, selecting a location with good access to employees is increasingly important, especially for some of the labor-intensive e-commerce uses. The employee base in the logistics sector is generally not highly compensated, so if the drive for employees is too far, hiring can be difficult. To address this challenge, some tenants prefer infill locations, not just for distribution of products, but also because proximity to mass transit makes it easier for employees to get to work.

Q Are investors in the sector better served by acquiring existing space or by backing development?

KV: Crow Holdings Industrial is a developer by specialization. In the rare case when we do an acquisition, it is because we are going to tear something down and re-zone it to construct a new building. With that caveat, we believe the best opportunity today in logistics is ground up development. We see market support for this belief in two recent separate accounts with institutional investors in which our partners find there is greater value to build rather than buy.

> *"We believe we will continue to see the highest rent growth in premier high-barrier sub-markets due to constraints on available space and the growing demand for last-touch properties"*
>
> **BEN DOHERTY**

BD: We place great emphasis on investment basis. In previous years, we focused primarily on acquisitions where we could lease vacant space and roll existing below-market leases to market rents to drive net operating income and increase asset value. We were able to acquire these highly functional and well-located assets at a favorable basis relative to replacement cost. However, during the last five years, we have largely pivoted toward speed-to-market speculative development because we see greater value in our investment basis for modern Class A buildings and an opportunity for outsized returns. This is supported by the improving trends in logistics fundamentals; demand is outpacing supply, and we have seen consecutive quarters of increasing rents and declining vacancy.

Q Which industrial asset types provide the most resilient value?

BD: We spend a lot of time talking to tenants and brokers to understand current tenant needs and how they may evolve in the future. Today, we see the greatest potential value in buildings that are 400,000 square feet or smaller. In fact, most of the recent warehouses we are building are 150,000 to 300,000 square feet. We prefer smaller buildings for a few reasons: there is generally a lack of available space in modern buildings this size; they tend to provide greater optionality for demising into multi-tenant use; and they historically serve the deepest tenant market. Last-touch infill locations are particularly scarce due to the high barriers for new supply. In some markets, we are seeing double-digit rent growth for those types of assets.

Investors are aware that while they might be paying a seemingly low cap rate today, these investments have historically provided the most predictable cash flow and the opportunity to realize the highest increased rents over a longer duration of the hold period.

KV: Over the past 10 years, e-commerce has changed the definition of what constitutes a Class A logistics building. We try to examine the supply within each market and build something that stands out above the competition. For instance, the amount of land available for employee and trailer parking can affect the value of the building and is often overlooked as a value source. Future proofing is a popular topic today, but with speculative buildings it is always tough because of the lack of clarity around what the market will look like in twenty years.

You also have to avoid individualizing a space in such a way that your building becomes less attractive to some tenants. For instance, a popular idea today is to go to the highest clear height that tenants demand to 'future proof' a property, but the truth is that some tenants do not want that kind of height. It may actually be too specialized. It is more art than science to find the right mix of features to best position a property for today and tomorrow.

Case study: Wildlife Commerce Park, Dallas

Wildlife Commerce Park is a 220-acre business park located in the heart of Dallas-Fort Worth. This cornerstone logistics park is the result of a floodplain reclamation project by Crow Holdings Industrial. It is centrally positioned between Dallas and Fort Worth within close proximity to the DFW International Airport. The strategic location offers easy access to regional population centers via multiple transportation modes.

The project currently consists of eleven Class A buildings totaling 3.7 million rentable square feet. Phase II was completed in December 2019 and was 92 percent preleased. A focus on prime location, access to a strong labor force, a diverse mix of building features, the newest security and quality amenities are key factors in the success of the project and have resulted in a robust tenant base with national credit. The logistics park also features a 100-acre lake, interior roadways and infrastructure. Wildlife Commerce Park is expected to be a long-term hold by Crow Holdings Industrial.

"Wildlife Park is a great example of creating a site in a central location in one of the major markets which is a regional distribution hub and has a large and growing population. The site has convenient access to labor, freeways and a major airport. We had enough land to execute on a variety of buildings that appeal to a wide range of tenants," says Ken Valach.

Q Are there any areas of the US logistics market where investors should exercise caution?

BD: I worry about new supply in certain low-barrier markets, but at the same time some of these markets have great aggregate consumption drivers for logistics demand. This tends to mean that some developers and capital providers believe that 'if you build it, they will come'. In these markets, site selection, design and labor are critical – if you choose the wrong location and design, and the property remains vacant for a long period of time, it can have a depressive effect even on transactions in the surrounding area, so a lot of research and knowledge are required to avoid these risks."

KV: I agree, however, some of the low-barrier markets are very large, so you must avoid painting them with the same broad brush. For example, South Dallas is arguably overbuilt because of land availability and low barriers to permitting, but there are other parts of Dallas where an entitled site will do very well. North-east Atlanta is soft, but Atlanta is very strong overall. Wherever you are, you must remain aware of pricing. We do a lot of one-off joint ventures with third-party private equity groups, and everything today is priced to perfection. We recently dropped out of a deal in Southern California because of pricing. We could not justify rental rates that were so far above what anyone has achieved to date. That is where a lot of capital gets nervous and so do we.

> *"Future proofing your investment always comes back to location"*
>
> **KEN VALACH**

BD: On the positive side, the permitting process is getting longer and more expensive, which helps limit new supply. These types of constraints in high-barrier submarkets should sustain high rent growth and favorable fundamentals for the foreseeable future. ■