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E-Commerce fueling demand for industrial distribution space

How investors can access this key market sector

Executive Summary

E-commerce has become the darling of the post-recession retail economy, as online sales push past $225 billion, growing 15.8 percent in 2012 alone. This growth is being fueled by the success of companies such as Amazon.com, Inc. that don't offer a bricks and mortar setting, as well as traditional retailers looking to supplement in-store sales with an online presence.

As these retailers grow and expand there is correlating positive momentum being created in the industrial real estate market: the expansion of retailers' online presence produces greater demand for distribution-center space across the country. This is particularly true in and near high-density metropolitan areas, and markets that serve as regional distribution hubs. This demand creates opportunities for owners and investors to position themselves for significant upside potential when buying and selling distribution-oriented assets.

"E-commerce is a strong economic engine that is touching many different industries," said report author **Erik Foster**, an Avison Young Principal and Industrial Capital Markets Practice Leader based in Chicago. "For commercial real estate owners and investors, there is great opportunity to capitalize on this growth in industrial assets, and generate strong returns for many years from this asset class. The demand for industrial space will increase with the importance of e-commerce distribution. Conversely, we believe that retailers' bricks and mortar square footage will continue to show minimal square footage growth, possibly impacting investor's returns within the retail product sector.

Solid Occupancy Growth For Distribution

One of the greatest benchmarks of the demand for warehouse and distribution space is the significant increase in the amount of occupied space. Since 2000, the amount of occupied distribution space has increased by 86.2 percent to 855.1 million square feet (msf) at the end of the first quarter of 2013 from 459.3 msf, according to CoStar. The change — almost 400 msf —represents an average annual growth rate of just over 7 percent. While not all of the increase in occupied space is allocated for e-commerce, the increase is significant.

To help put this situation into perspective, during the same timeframe, the level of occupied retail space also increased, but at a substantially lower pace. Since 2000, the level of occupied retail space increased 10.9 percent to a current level of 6.3 billion square feet from 5.6 billion square feet. On an average annual basis, this represents a growth rate of less than 1 percent (0.9).

While the economy's recent recessionary performance has taken a significant toll on the retail industry, consumer buying preferences — shopping online versus standing in line — has also had a measurable impact on retail expansion.

Defining The Market: New Distribution Centers

The top tier in the distribution sector generally can be characterized by the following building features. They:

- Are newer facilities, typically built within the past seven years;
- Typically feature 32-foot to 36-foot ceiling heights;
- Offer 50 by 50-foot bay sizes; and
- Have additional truck trailer storage and parking for e-commerce employees.

Defining The Market: Older Distribution Centers

The next tier of distribution centers generally can be characterized by the following building features. They:

- Were built eight to 12 years ago and, while acceptable for many e-commerce businesses, do not have all the bells and whistles of the newer facilities;
- Typically feature 24-foot to 28-foot ceiling heights;
- Offer 40 by 40-foot bay sizes;
- Have additional trailer storage; and
- Appeal to owners and tenants who want a lower price point and may not need top-of-the-line space or functionality.

Parking is King

In both new and older distribution centers, extra vehicular parking is a key selling point for many e-commerce retailers. These types of businesses often have a higher ratio of employees than other types of distribution-oriented businesses. Thus, rental rates may increase, as larger land sites are required for these facilities and the users typically must absorb those costs.

New Distribution Centers By State

According to CoStar, the following states have the most distribution space built after 2010. It must be noted that this has been a period when new construction of any kind has been severely limited as the overall economy continues to work through the effects of the recession and a general uncertainty in the market. In total, according to CoStar, more than 151 msf of distribution space has been developed since 2010.

State	Rentable Building Area	Ceiling Height Range
California	29,361,995	28-42-feet
Texas	17,803,197	22-32-feet
Illinois	13,069,931	30-38-feet
Pennsylvania	11,750,778	28 ½-40-feet
Georgia	11,121,156	24-36-feet
Ohio	10,537,103	22-37-feet

Source: Costar Group Inc.

Defining The Market: Regions To Watch

The following markets are expected to see growth in distribution space during the next three to five years, through general business growth and that of the e-commerce sector.

State	Reasons for Growth	Key Retailers with Distr. Centers
California	Proximity to large population center; port access/ boom in Inland Empire	Amazon, Kohl's, Skechers USA, Mattel, Target
Texas	Strong transportation routes, Port of Houston; growing demographic; oil and gas industry	Amazon, Kohl's, Target, Walgreen's
Illinois	Proximity to large population center; Central Midwest location; strong transportation routes	Home Depot, Walgreen's
Pennsylvania	Proximity to East Coast	Amazon, Target
Georgia	Proximity to Southeast markets	Home Depot
Other Submarkets		
Columbus, Ohio	Access to Rickenbacker Int'l Airport's cargo distribution	Kohl's, Walgreen's
Memphis, TN	Access to FedEx World Hub distribution facility; leader in air cargo distribution	Nike

Source: Avison Young, Costar Group Inc.

E-Commerce and The Investment Market

Many U.S.-based pension funds and institutions continue to be under-allocated in commercial real estate, with 5 to 10 percent of their total assets in that sector. As the London-based research firm Preqin reported recently, public and private pension funds are under-allocated by 17 percent and 23 percent, respectively, in real estate. Private pension funds have an average of $434 million in real estate investments — or 5.2 percent of their assets in real estate, according to Preqin.

Industrial real estate has been a staple of the investor for some time because of its stable and inexpensive features. Yet today, the rationale to buy industrial product becomes increasingly not just a choice to buy a warehouse or distribution facility, but a prime opportunity to gain another access point to the public.

In other words, industrial is becoming "consumer" real estate. With the advent of the Internet and its growing ability to provide goods directly to individual households, the Internet is impacting retail space needs.

E-Commerce: Investment Opportunities In The Second Tier

This growth in demand for distribution space also should filter down to buildings developed eight to 15 years ago. These types of properties have the ability to satisfy the needs of some e-commerce retailers with nominal, if any, investment needed to repurpose the property. Owners will need to:

- Be flexible with their tenant demands for improvements as they could be substantial depending on the conveyors, racking and warehouse layout desired.
- Look for ways to maximize vehicle parking to allow for the increased manpower typically associated with e-commerce. A few options are to utilize neighboring land parcels and work with local municipalities to increase parking allotments.
- Take proactive steps to make the facility a "Foreign Trade Zone", which can help lower operating costs for businesses. Having this designation in place or in the works can influence a prospective e-commerce tenant.

In addition, many of these older industrial assets typically are located in more dense, urban areas and may lack the amenities of newer e-commerce assets. These properties still can be viable for some second tier e-commerce companies or those who are distributing goods to households—often referred to as the "last mile" of the supply chain.

These older buildings may not provide space for 53-foot trailers or generous truck courts, for example, but will have access for smaller trucks that can utilize drive-in doors instead of docks. Those buildings with higher parking ratios can be a draw for e-commerce companies because of their high workforce demands.

In some cases, major e-commerce retailers may be willing to spend money to assemble enough land in an urban area for a new building with modern specifications.

E-Commerce Growth

According to the U.S. Census Bureau, e-commerce sales rose 15.8 percent in 2012, reaching $225 billion. That figure has nearly doubled during the past seven years. As consumers increasingly look to the Internet for ease of shopping and discounted pricing, those numbers are expected to continue climbing.

To that assessment, noted consumer research firm Forrester is projecting online retail sales will reach $370 billion by 2017 and continue to outpace the growth of physical retail stores. The 2017 number equates to a 10 percent compound annual growth rate over the next five years. This is good news for owners of distribution centers, who can count on steady demand in the near future.

Population Drivers

Population growth also is a driving factor in the increase in e-commerce and the correlating need for distribution space. Population in the United States is growing by an average of 2.5 million people annually. According to Dr. Glenn Mueller of the University of Denver's Daniels School of Business, each person consumes goods that require approximately 50 square feet of warehouse space. This equates to new demand for 125 msf of space annually. The compounding effect of an uptick in population growth, and the rise in demand for e-commerce could be a significant demand driver for industrial real estate.

Market Leaders

E-commerce giant Amazon is leading the charge for large distribution centers that can help expand sales and meet consumer demand for quick delivery and specialized order fulfillment. In 2012, for example, Amazon opened nine new distribution centers in North America, totaling 8.45 msf, bringing its distribution space to more than 33 msf.

Other, more traditional retailers such as Walmart and Target are also looking into different ways of distributing and taking advantage of their existing retail stores. Walmart distribution space — for its stores and online business — is massive, with 50 msf.

Among the approaches some retailers are testing are free shipping to stores for consumer pick-up and home delivery from those stores. This may all lead to the retail store being located in the heart of dense population areas and, thus, becoming the point of distribution, not purchase.

Like any new innovation, time continues to refine e-commerce, creating new opportunities. Among the current trends in e-commerce growth are:

- The movement toward same-day fulfillment. Amazon, Walmart and Home Depot are in various stages of testing same-day delivery and are making decisions about their distribution facilities based on those forward-thinking concepts.
- A shift toward locating distribution facilities in urban areas, where the population growth is, and near order-fulfillment companies, such as UPS, FedEx and DHL. In some densely populated areas, bicycle messengers also are used for some deliveries.

The Future Of E-Commerce Space

As e-commerce continues to grow, its presence will become increasingly important to owners of distribution space. Investors who want to take advantage of the industrial demand for e-commerce space should look to two avenues — buying in major industrial markets that cater to this segment, such as Los Angeles, Indianapolis, Dallas, Columbus and others. Or, they can find opportunities to buy in urban, infill areas, such as Chicago and New Jersey (with its access to New York City), where e-commerce companies are eyeing expansion into same-day delivery.

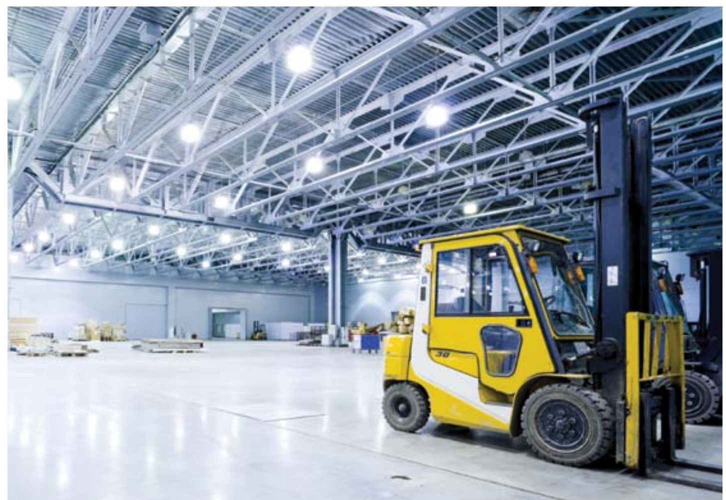
Industrial markets that cater to e-commerce are ones that have favorable tax treatment of goods sold online, the ability to create a foreign trade zone, and strong regional transportation infrastructure to link air, truck and rail. Low land costs for new build-to-suits that require less land coverage will be a driver in attracting tenants too.

E-commerce is expected to grow at a compounded annual average rate of 10 percent over the next five years, creating tremendous opportunities for owners and developers of distribution space. This economic shift will further strengthen the supply and demand drivers for the development, redevelopment and sale of distribution center space, a sector that saw more than 151 msf of new development since 2010, at the height of the post-recession economy.

Owners and investors who have a clear understanding of the nuances and idiosyncrasies of this retail sector will have a significant competitive advantage. This includes having the ability to identify those buildings that are ideally-suited for e-commerce — and those that can become competitive alternatives with a certain amount of investment/redevelopment. ■

About The Author

*As a national industrial capital markets specialist, **Erik Foster** and his team focus on providing asset advisory, disposition and sale-leaseback services to industrial property owners in Chicago and across the U.S. He has nearly 20 years of experience in real estate investment sales. Erik has a strong track record of investment sales success and relationships with the leading institutional and regional commercial real estate owners across the country, such as AEW, CBREI, Clarion, Cobalt Capital Partners, DCT, First Industrial, Heitman, IIT, IndCor, Inland, JP Morgan, Liberty Property Trust, Manulife, Prologis, RREEF, and TA. He can be reached at **erik.foster@avisonyoung.com***



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For more information, please contact:

Erik Foster, Principal
erik.foster@avisonyoung.com

Avison Young
9700 W. Higgins Road Suite 500
Rosemont, IL 60018 United States
847.849.1900