The ElmTree Edge

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Evolving Construction Trends in the Industrial Sector

Capital constraints are slowing construction activity and will potentially boost sector fundamentals

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In recent years, few commercial real estate sectors have delivered sustained demand growth and consistently positive leasing fundamentals in line with the industrial sector. As an evolving market begins to change some of the underlying dynamics driving growth in the sector, and as the pace of new construction slows, what can owners, developers, and investors expect to see moving forward?

Today, the narrative is much the same across the industry: there is scarcity of capital for new construction, renovations, and expansion projects. Furthermore, sourcing construction loans is challenging right now, and the lack of liquidity in the banking sector is making it more challenging for private equity owners, REITs, and other commercial real estate investors to secure financing for new projects. As a result, we are seeing signs of a slowdown in construction activity in the industrial sector. While there is likely to be somewhat of a lag effect that occurs as elevated levels of deliveries will likely persist through much of the rest of 2023, the impact of the construction slowdown in the industrial sector should become more apparent in 2024 and into 2025.

That might sound like a negative, but owners of industrial real estate assets are likely to be better positioned to grow rents and maintain high occupancy levels over a mid-term horizon if these trends play out as forecasted. Secular and foundational demand trends (e.g., e-commerce growth, businesses reshoring their manufacturing operations, and a shift toward higher inventory levels) remain in place, and lower construction activity should limit new supply growth in the sector. Thus, with less new inventory coming online and demand trends still in place, we expect to see positive net absorption, consistent rental growth, and high occupancy metrics over the next several years.

Another potentially impactful trend to watch moving forward is a corresponding slowdown in speculative development and a shift to higher percentages of build-to-suit construction activity. That pattern is already emerging and seems likely to continue and perhaps even become more pronounced. Without a lease in place, accessing capital markets to secure construction loans is often more challenging in a constrained financing environment. On the contrary, a long-term lease commitment from a creditworthy tenant on a build-to-suit project can often significantly enhance the ability to secure construction financing due to its risk mitigating characteristics. Consequently, even during a period of slowing construction activity, owners and developers that focus primarily on build-to-suit products will likely continue to be well-positioned to source and finance investment opportunities.

Additionally, we believe experience becomes a more pivotal consideration in a constrained financing environment. Lenders with limited capital will likely focus on providing funding to owners and developers with a track record of successfully completing projects to mitigate execution risk. We believe this trend will likely decrease competition in the build-to-suit sector by limiting new entrants, which positions experienced managers well in terms of sourcing investment opportunities in the current market.
