RESEARCH

Uncovering Various Aspects of Real Estate

SMALL BAY INDUSTRIAL OVERVIEW

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Main Characteristics

Small bay industrial (SBI) real estate refers to a specific subtype of industrial property. We will use the terms small bay, shallow-bay, multi-tenant, and light industrial somewhat interchangeably, as there is significant overlap between these definitions. The others essentially function as proxies for small bay in this analysis.

Small bay is characterized by smaller units or bays designed to accommodate SMEs (small and medium enterprises), startups, or local operations. These industrial spaces typically have limited footprints. CBRE categorizes shallow bay industrial properties as those between 50,000 SF and 120,000 SF, while JLL uses the range between 20,000 SF and 100,000 SF to define multi-tenant industrial properties.(4,2) They typically have clear heights between 16 ft and 20 ft, and in some cases, office space can be up to 20% of property size.

These complexes are often found in multi-tenant business/industrial parks or commercial complexes and may be used for light manufacturing, distribution, warehouse, flex/industrial showroom, and/or R&D (research and development).(3) Typical tenants include small manufacturers, service providers, e-commerce businesses, contractors, and other locally based companies. They can be infill properties within urban cores or in more remote locations.

In many cases, small bay industrial complexes offer shared amenities and services, such as common loading docks, parking areas, security measures, and maintenance services. These shared resources can reduce costs for tenants.

Demand Drivers

The key drivers of demand for small bay industrial real estate can differ from those of larger industrial and logistics properties. These factors are explored below.

1. E-commerce and last-mile delivery

The rapid growth of e-commerce and online shopping, particularly since the pandemic, has increased demand for smaller warehouse and distribution spaces closer to urban centers. As sales channels shift away from a brick-and-mortar-centric approach and into an e-commerce or hybrid approach (the so-called bricks-to-clicks phenomenon), supply chains have had to adapt.

E-commerce needs individualized, last-mile deliveries ranging from 28% to as high as 51% of total shipping costs.(1) Small bay industrial properties are ideally suited to bridge this gap, affording large and smaller retailers the space and flexibility required to cost-effectively support last-mile delivery, thus ensuring customers can be reached quickly and efficiently.

2. Supply chain reconfiguration

Growing emphasis on supply chain efficiency and cost-effectiveness has contributed to increased demand for small bay industrial properties, many of which were constructed on the periphery of urban populations decades ago. As urbanization accelerated, these properties are now engulfed by population centers, making them ideal for infill supply-chain networks.(3)

Businesses seek strategic locations for their warehouses and distribution centers to minimize transportation costs and

Source: JLL Research, CoStar, Real Capital Analytics, NCREIF

reduce delivery times, particularly in the more individualized, 'hub and spoke' distribution model driven by e-commerce. Small bay industrial properties, situated close to urban centers and optimized for high-throughput and quick turns, are ideally suited to benefit.(1) To that end, they are used as infill distribution centers, micro-fulfillment centers, and showrooms. For last-mile situations, it often makes more sense to have several 50,000 SF spaces distributed throughout a city instead of one centralized 300,000 SF space.

Further, the prospect of onshoring and nearshoring of American businesses will support long-term demand for light industrial facilities since vendors supporting the reshoring phenomenon often operate out of them.(5)

3. Startups and SMEs

SME and startup growth in various industries also contributes to demand.(6) While big-box distribution facilities typically cater to national distribution networks or major manufacturers, SBI properties are more likely to cater to local and regional businesses. These companies often have limited space requirements and cannot afford larger industrial facilities, making small bay industrial properties an attractive option due to their affordability and scalability. Local distribution, construction, light industrial, service industries, and other uses predominate in this space.

4. Technology

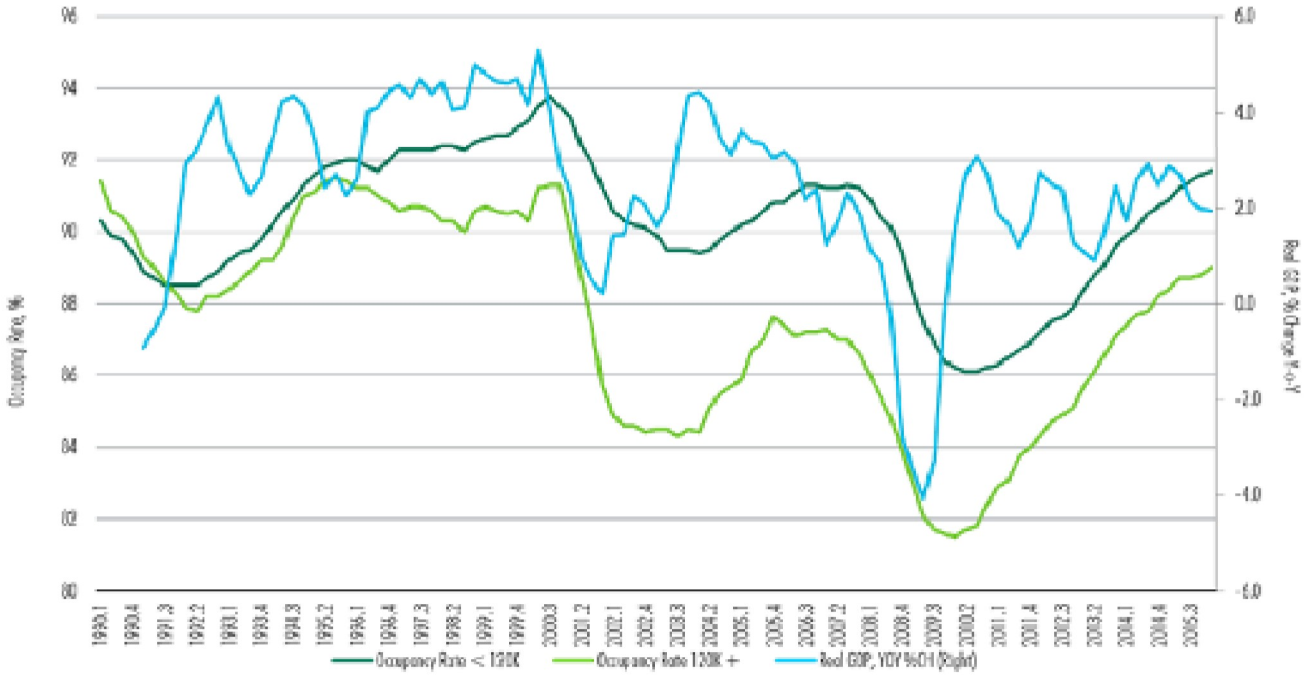
New technology has transformed how businesses operate, particularly in supply chain management, manufacturing processes, and inventory tracking. Advances in distribution and supply-chain automation have made smaller spaces increasingly suitable as high-throughput distribution facilities. At the same time, 3D printing technology has reduced the building size required to house a manufacturing business.(5)

Possible Leading Indicators

Below are some concrete indicators that could help predict SBI demand for a given market, in addition to the broad secular drivers outlined above.

1. Population growth
2. General economic activity
3. Job growth
4. Logistics activity
5. E-commerce last mile (inventory-to-sales ratio)
6. Local e-commerce sales
7. Reverse logistics (return ratio)
8. Manufacturing PMI
9. Parcel and freight data
10. New business registrations

Exhibit 3: Occupancy Consistently Higher in Smaller Buildings



Source: CBRE, CoStar Group, Moody's Economy.com

Investment
SBI properties offer many attractive qualities for investment.

Development of multi-tenant properties has been very constrained in dense infill locations because it competes with other uses, such as multifamily and commercial, for these high-value locations.(1) Annual construction has hovered around only 1% of total inventory for some time, far below the industrial overall average. The assets already in place tend to be located in more densely-populated infill areas and thus benefit from higher barriers to entry and replacement costs, making the overall inventory stagnant and increasing the amount of competition for the finite amount of existing space.(4,3) Further, their attractive infill locations make them easy to repurpose to a different highest-and-best use down the road.(6)

Light industrial facilities feature significant revenue upside, as multi-tenant leases tend to have shorter lease terms than the typical 5 to 10 years for big box warehouses. This allows them to adjust to rising market rents more rapidly, leading to more immediate value capture and an increased ability to offset inflation.(2,5) Not surprisingly, they experienced rent growth of 33% between 2015 and 2020, while warehouses larger than 250,000 SF had rent growth of only 16% over the same period.(1) JLL projects NNN rent CAGR of 6.2% into 20262 for this asset class.

One potential downside of the features outlined above is heightened credit risk, given that tenants are more likely to be smaller and non-credit and can be more susceptible to macroeconomic shifts, compounded by the short-term nature of most leases.(1) Despite this, cap rate compression for this asset class, down 240 bps during this cycle to 5.15%, has far outpaced that of the broader industrial market, down 180 bps to 5.35%.(2)

Ownership of this property type tends to be highly fragmented, which creates value-creation opportunities through aggregation.(4) Its inherent tenant diversification is also an important consideration for investors, especially those lacking the scale to build large diversified portfolios.

Finally, these properties tend to have lower operating and capital expenses. CBRE concisely summarized this asset class as having "demonstrated lower vacancy, high and less volatile growth rates, and superior cash flow yields in both strong and weak markets."(4)

What's not to like?