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US Industrial Tenant Demand Downshifts in Early 2023

Soft First Quarter Likely Foreshadows Further Vacancy Increases This Year

Bed Bath & Beyond closed its 800,000-square-foot distribution center in Lewisville, Texas, in early 2023. (Adnan Jebbeh/CoStar)

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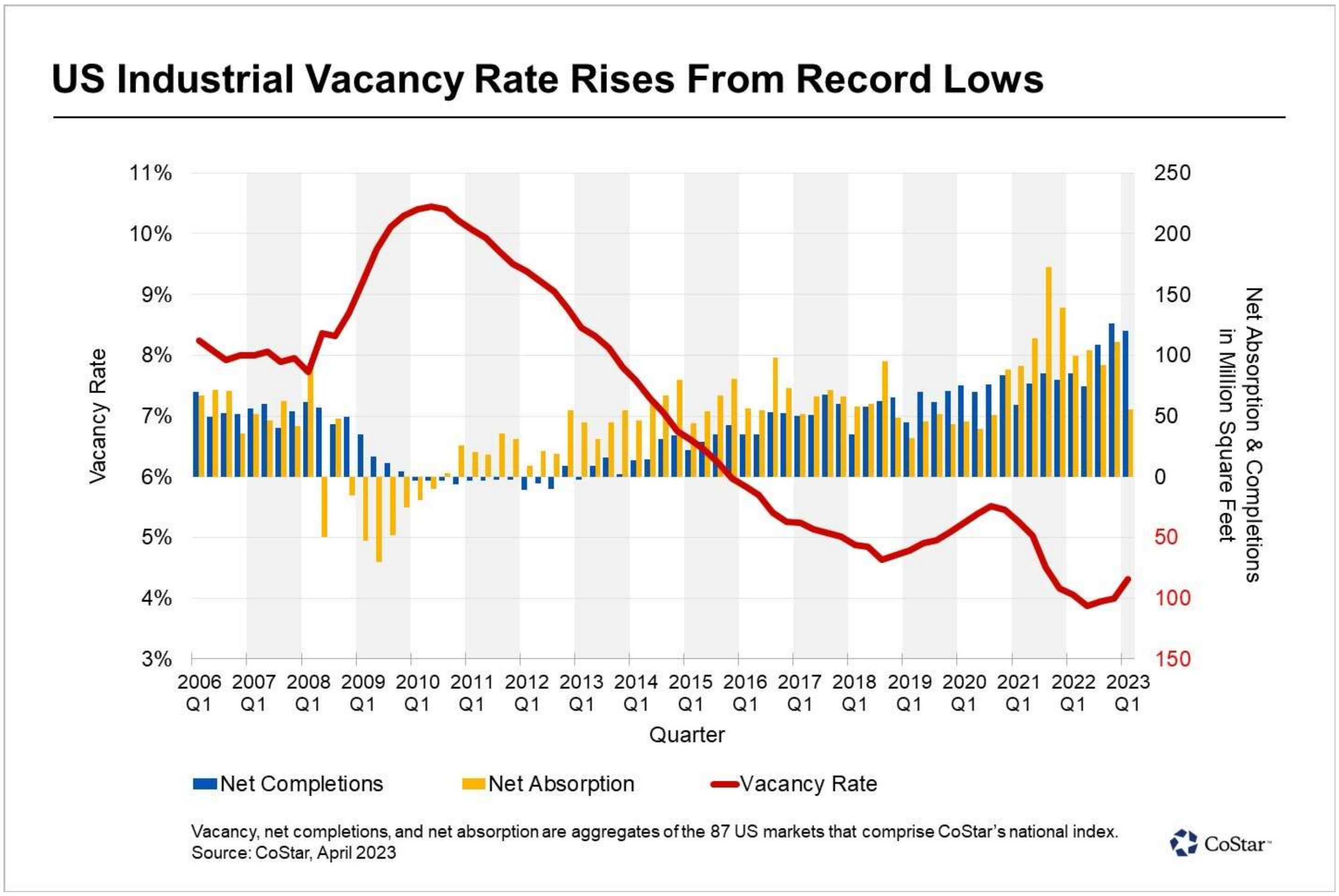
An early read of the economic and commercial real estate market data this year signals that industrial property owners are facing a more challenging market environment in 2023 than they did during 2022.

Industrial net absorption, which represents the change in industrial space occupied by tenants and owner-users across the country, decelerated notably in the U.S. during the first quarter, to 55 million square feet, a level only half as strong as first-quarter absorption last year.

This moderation in absorption, coupled with near-record completions of new industrial developments, caused the U.S. industrial market vacancy rate to end the quarter higher, at 4.3%.

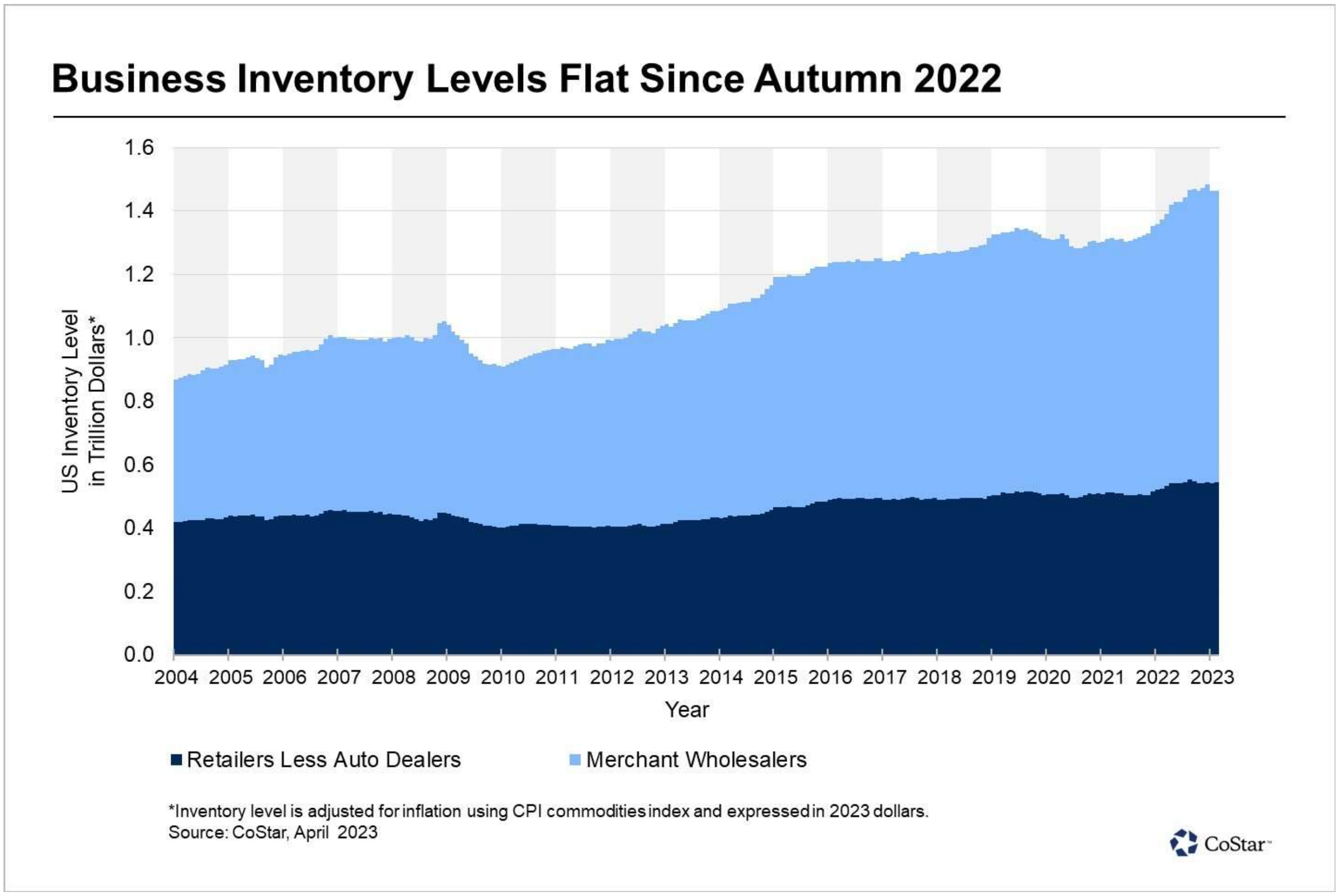


The slowdown in absorption is no cause for panic, as the first-quarter tally this year is still about 15% higher than the five-year pre-pandemic average for first-quarter absorption. The opening quarter is also generally the weakest of the year for absorption as tenants often delay closing distribution centers until after the spike in holiday sales.

This means that seasonality will be working in favor of stabilization and a potential pickup in tenant demand during the months ahead.

Businesses Appear Hesitant To Build Inventories

However, over the next few quarters, a rapid re-acceleration in industrial leasing is also far from guaranteed. After continually growing inventories from mid-2021 through mid-2022 and leasing record amounts of distribution space to accommodate that expansion, retailers and wholesalers have been pausing further inventory accumulation since the fall of 2022.



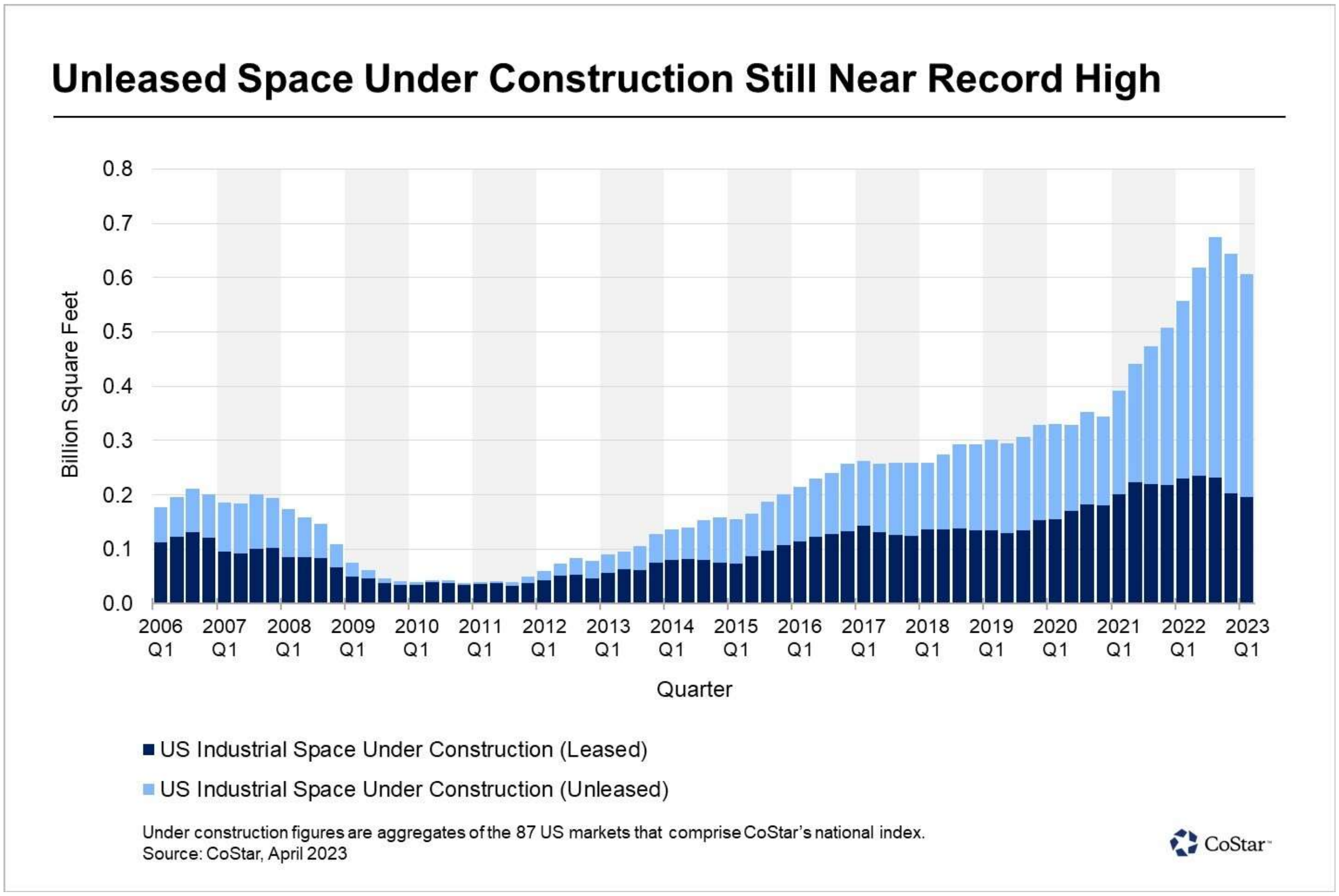
This hesitancy to further build inventories stems more from caution over the economic outlook than from any glut of products that industrial tenants might already have on hand.

According to the U.S. Census Bureau, businesses are holding inventory equivalent to about 1.3 months of sales, in line with the average inventory-to-sales ratio since 2000. But most retailers are providing tempered guidance on the outlook for sales according to

CNBC and will likely need to see revenue growth surpass expectations before inventories can resume their long-term growth trend.

Pressure From New Supply Could Carry Through 2023

Even if retail sales do surprise to the upside, recession fears dissipate quickly and industrial absorption rapidly re-accelerates, the U.S. industrial vacancy is still all but certain to rise, at least modestly, through the remainder of 2023.



Completions of unleased industrial developments have been outpacing tenant demand since the fall of 2022. The near-record tally of 625 million square feet of industrial space still under construction across the 87 markets that comprise CoStar's U.S. national index suggests that quarterly completions will remain at elevated levels through late 2023.

While new construction looks all but certain to drive the industrial vacancy rate up in the months ahead, there are a few factors that will help limit overall downside risks for property owners.

Vacancy Remains Historically Tight

The first is the extraordinarily low vacancy rate that the industrial market has maintained heading into this more turbulent period. The national vacancy rate hit all-time lows in 2022, and even as it has risen slightly over the past few quarters, at 4.3% it remains tighter than at any point from 2000 to 2020.

Even in the unlikely downside scenario that all 418 million square feet of unleased space under construction across CoStar' national index markets delivers over the next four quarters and remains vacant, this alone would only drive the national vacancy rate up to 6.5%. That would be a fraction of the peak vacancy rates of 10.4% and 9% reached in the aftermath of the Great Recession and the early 2000s recession, respectively.

Construction Starts Continuing to Decline

Signs are also emerging that record completions of unleased new construction projects, the key contributor to the recent rise in vacancy, will begin to abate by early 2024. Rising interest rates and construction costs have caused groundbreakings on new industrial projects to fall by more than 40% over the past two quarters.

The pullback in U.S. bank lending since mid-March suggests industrial construction starts will fall even further in the months ahead. Given that the average time for large industrial projects to complete construction is about 13 months, the pullback in starts that has been underway since late 2022 clearly signals that the number of new projects completing construction each quarter will begin to decline rapidly by the spring of 2024.

Oncoming completions of unleased industrial projects will likely cause market conditions to shift more in tenants' favor during 2023. However, with overall vacancy still near historic lows and construction starts falling quickly, a few key ingredients necessary for market conditions to re-tighten significantly in 2024 and 2025 are also beginning to fall into place.
