Logistics Market Trends Q4 2008

North America

GRUBB & ELLIS
From Insight to Results

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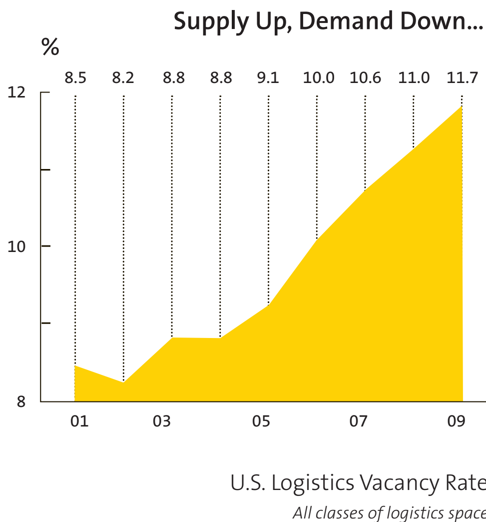
State of the Market

by Robert Bach
Senior Vice President, Chief Economist

Grubb & Ellis is pleased to present its first report focusing on logistics property market conditions in the U.S.

For several decades we have reported on the industrial market with property subtypes defined as warehouse/distribution, general industrial (primarily manufacturing), R&D/flex and incubator, each with its own definitional criteria. In concert with the Grubb & Ellis Global Logistics Practice we have undertaken a project to analyze properties designed or well-suited for logistics operations, defined as the transport of manufactured goods from their source or their arrival point in the U.S. to their final destination for consumption or sale. The outsourcing of U.S. manufacturing jobs to China, Mexico and other countries with low labor costs has given rise to a sophisticated logistics industry focused on bringing products manufactured abroad into and through the U.S. to their intended destinations. Supply chains have become longer and more complex, and logistics buildings are the points in the supply chains where the products being shipped are transferred from one mode of transportation to another. Supply chains and logistics buildings have become the focus for manufacturers who are intent on ringing cost savings from their operations.

We have used a set of criteria on page 8 to identify logistics properties and divide them into three classes, A through C. The criteria focus on the age of a property, clear height, number of loading doors per 1,000 square feet, truck turning radius, sprinklers and other systems, and general functionality and finishes.



U.S. Logistics Vacancy Rate
All classes of logistics space

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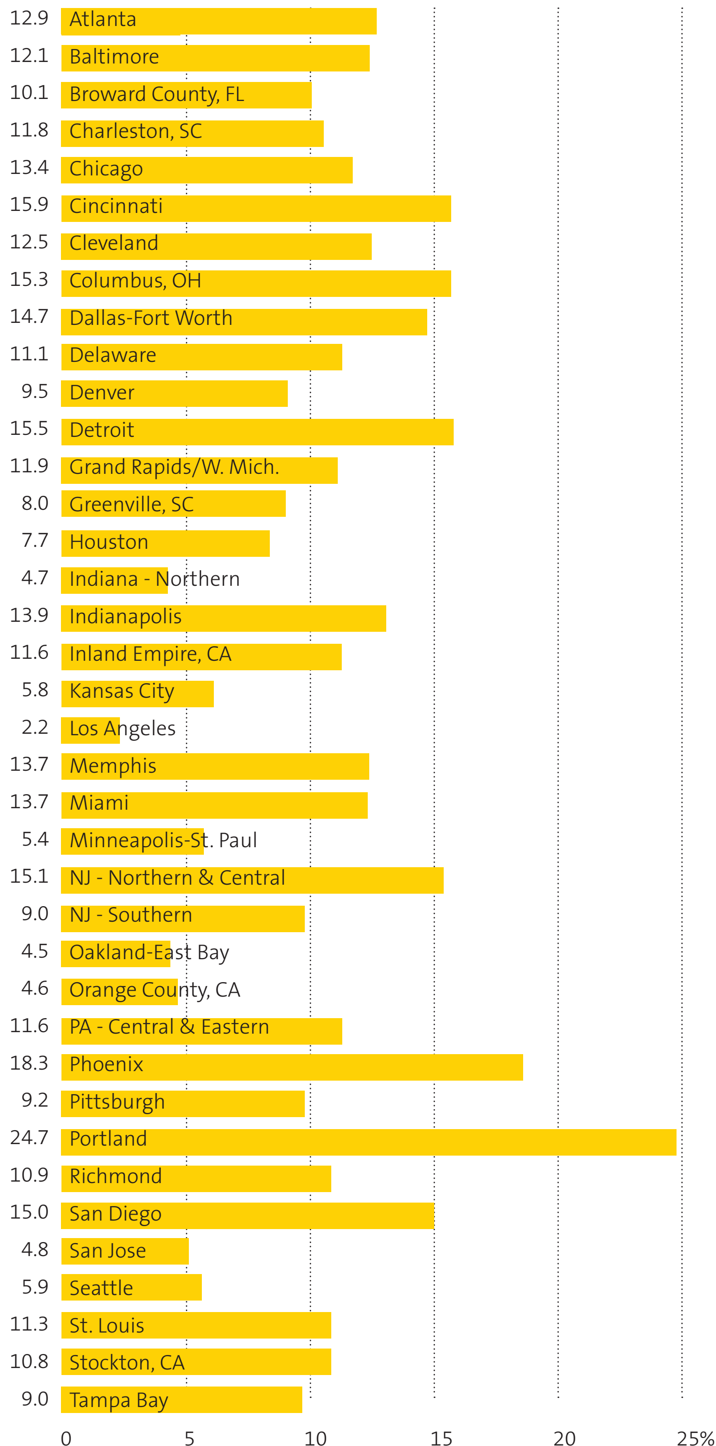
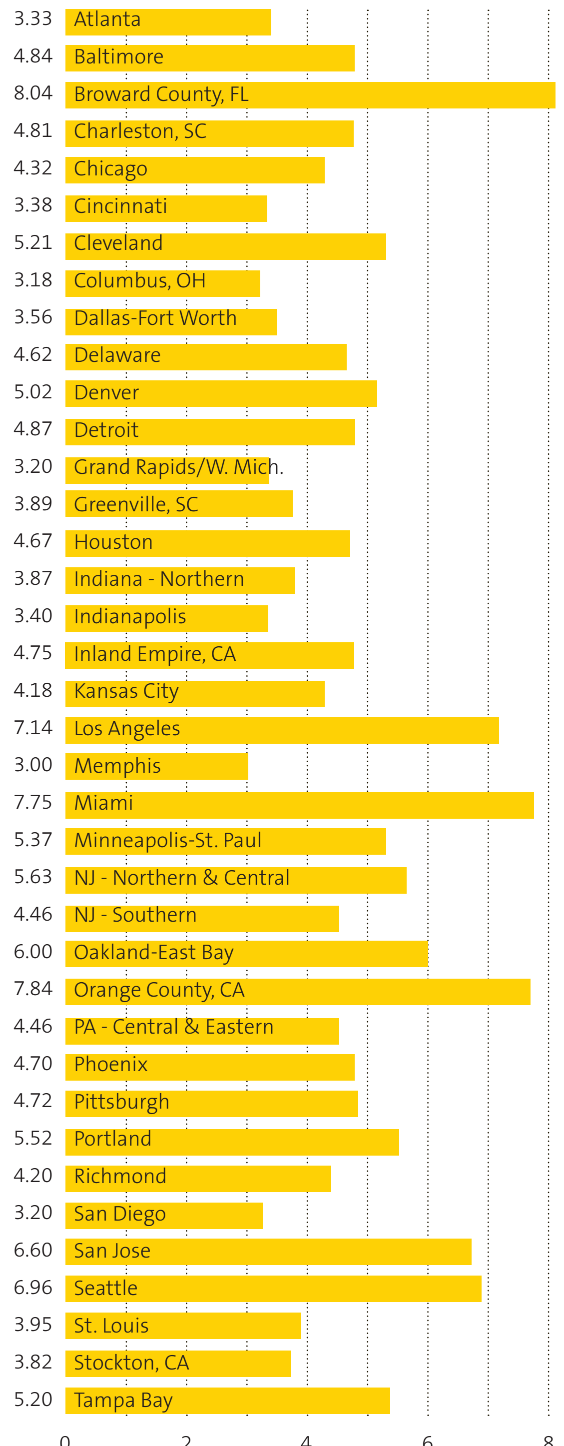
Class A Logistics Market Vacancy and Rental Rates

Note: Vacancy and rent data refer to logistics buildings with minimum size thresholds of 100,000 square feet. Inventory includes multi-tenant, single-tenant and owner-occupied space. Rental rate data refer to space that is available for lease on the market at the end of the quarter. Rates are per square foot, quoted on a triple net basis. Rates for each building are weighted by the amount of available space within the building





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Key Metrics of the U.S. Logistics Market

Vacancy

The construction of new, Class A logistics buildings is the major force driving up the industrial vacancy rate. The overall industrial market ended 2008 with a vacancy rate of 8.8 percent, an increase of 110 basis points from year-end 2007. By comparison, the vacancy rate for logistics properties gained 260 basis points ending the year at 11.7 percent, while vacancy in Class A logistics properties rose by 330 basis points to 15.6 percent. Other (non-logistics) industrial properties recorded a moderate 40-basis-point increase, ending 2008 at 7.6 percent vacant.

Net Absorption

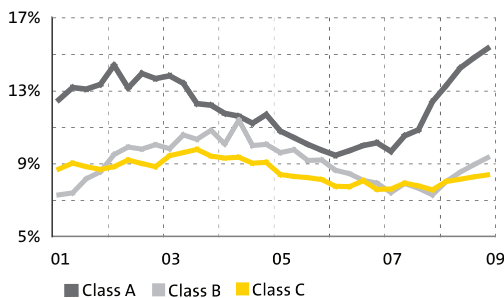
Through the first eight years of this decade, logistics properties absorbed 410 million square feet with 26 million square feet of that coming in 2008. Other industrial properties absorbed 327 million square feet of which 24 million square feet was absorbed in 2008. Class A logistics properties captured 85 percent of the logistics space absorbed this decade, posting positive absorption in every quarter. Class B and C properties, however, posted several quarters of negative absorption during recessionary periods including the second, third and fourth quarters of 2008, suggesting that logistics tenants and owner-users trade up to Class A space when rental rates soften.

Deliveries

In the current decade, 464 million square feet of new logistics space was completed, slightly ahead of the 410 million square feet absorbed. Developers delivered 344 million square feet of other industrial space, near the 327 million square feet absorbed. Recently the market has tilted toward overbuilding. Deliveries of new logistics space in 2008 totaled 98 million square feet, nearly four times the 26 million square feet absorbed. With absorption badly trailing completions, developers cut back, starting only 57 million square feet of logistics space last year, including just 17 million square feet in the second half. As a result, the amount of logistics space under construction ended the year at 34 million square feet, off 39 percent from the cyclical peak of 88 million square feet recorded in the second quarter of 2007.

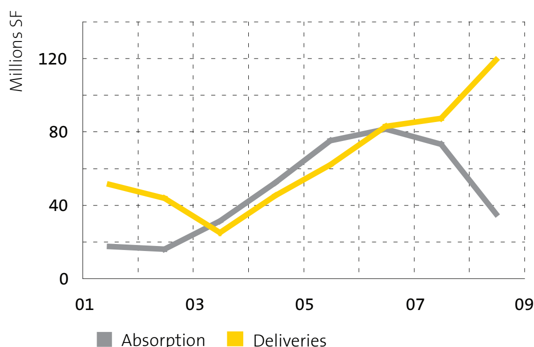
Logistics Vacancy Rate

By Class of Space



Logistics Absorption vs. Completions

By Year



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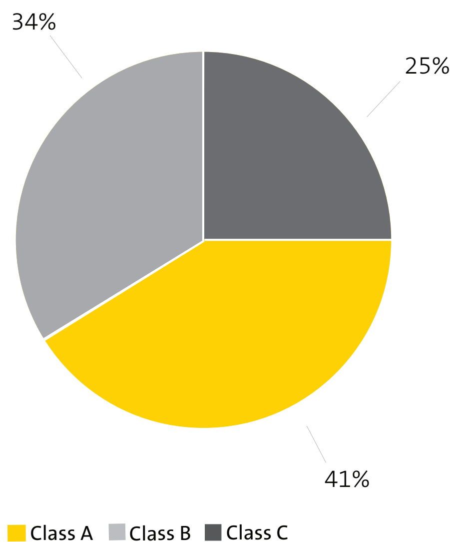
Rental Rates

Despite the recent spike in vacancy for logistics properties, asking rental rates have come down very little. The national average at year-end 2008 was $4.16 per square foot per year triple net, off 3 percent from the cyclical peak of $4.29 in the fourth quarter of 2007. Logistics rental rates have changed very little during this decade. The average asking rate in 2000 was $4.21 compared with $4.19 in 2008. This stability masks a decline early in the decade; a recession in 2001 followed by an anemic recovery pushed rents to a low of $3.82 in 2003 before a more vigorous economic expansion pushed rents back to where they began the decade. Part of the reason why rents have not risen further is the gradual increase in the average size of newly constructed logistics properties, which rose from 221,657 square feet in 2000 to 362,039 square feet in 2005 before falling back slightly over the past three years. Another reason is that new construction is increasingly distant from major urban areas where lower land prices enable developers to attract tenants with lower rents.

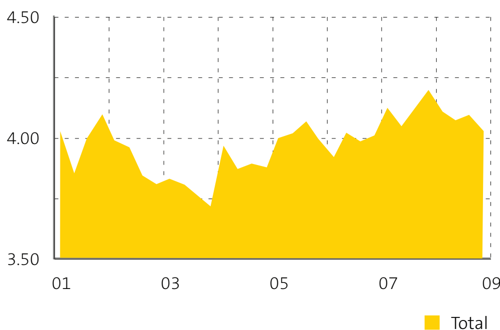
Logistics Inventory by Class

2008 Fourth Quarter



Logistics Rental Rate

Weighted Average Asking Rate NNN



Outlook

The recession that began in December 2007 took a turn for the worse in September 2008 when the credit crisis deepened. Personal consumption expenditures, which account for 70 percent of gross domestic product, increased 0.3 percent in 2008, a 17-year low. This included annualized declines in the third and fourth quarters of -3.8 percent and -3.5 percent, the steepest quarterly declines in 28 years. Seasonally adjusted retail sales fell 2.7 percent in December, the sharpest one-month drop in 22 years, while the Conference Board Consumer Confidence Index plunged to its lowest level in the 40-year history of the survey. Global growth has contracted sharply taking export and import volumes with it, while business capital spending has dried up. The labor market has shed 3.6 million payroll jobs since the start of the recession, a jolting 2.6-percent drop. These and other indicators point to a further decline in demand for logistics space.

The outlook is not entirely gloomy. Demand for logistics space tends to hold up better when the economy slows than demand for other types of industrial space. Manufacturers need to store excess inventories when their sales slow, which boosts demand for warehouse space. Longer-term, businesses look at logistics space as a productivity enhancer, an integral part of their supply chain strategies. The relentless quest for cost-saving efficiencies by businesses should cushion the fall in demand for logistics space even as the economy struggles in 2009. Another positive is that the construction pipeline for logistics space is emptying rapidly. Nevertheless, market conditions will soften over the next few quarters. Even Class A logistics space could see several quarters of negative net absorption, which would be the first time this decade.

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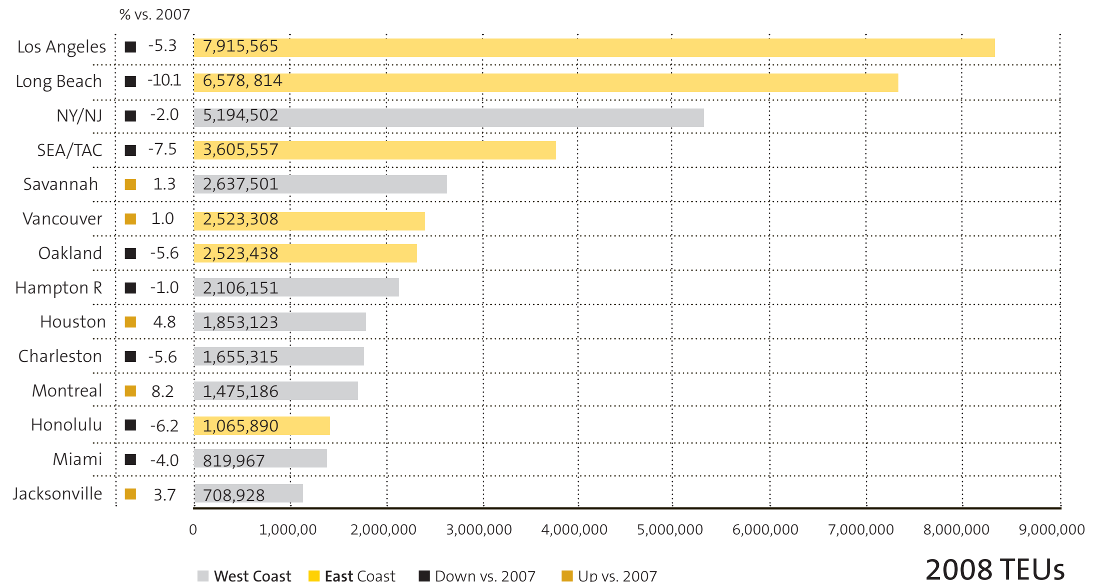
Port Container Activity

by Tim Feemster
Senior Vice President,
Director of Global Logistics

U.S. port container volume as, measured by TEUs (twenty-foot equivalent units) fell by 3.9 percent in 2008 versus 2007, but this disguises differences among ports. West Coast ports reached their peak volumes in 2006 and saw volumes decline in 2007 and 2008. Most of the major East Coast ports except Charleston were up in volume in 2007 versus 2006, and many continued the upward trend in 2008. The volume declines for the West Coast ports and the increases for the East Coast ports are related to what is called "West Coast diversion." Ever since the lockout in 2002 at the West Coast ports, major Beneficial Cargo Owner (BCO) companies have been forced by risk mitigation to divert some of their Asian import traffic to Gulf and East Coast ports. They cannot afford to have all their eggs in one basket by bringing all their Asia freight into the West Coast. This container traffic increase since 2006 has been spread among Houston, Jacksonville, Savannah, Norfolk and New York/New Jersey with Houston (+8.8 percent), Hampton Roads (+2.9%), and Savannah (+28.6 percent) being the biggest gainers. The diversion will be exacerbated by the fees being levied on the California port system that are not being charged in other ports at this time.

The decelerating economy pushed U.S. port TEU traffic down by 4.7 percent in 2008. We project that traffic in 2009 will be down a modest 1 percent versus 2008. Not until 2010 will annual growth return to prior levels of around 4 percent. Below is a sampling of port container TEU volumes for all of 2008. Note that the West Coast diversion continues to gain strength. Total East Coast traffic declined only 0.9 percent in 2008 while West Coast traffic declined 7.2 percent. West Coast ports will continue to have challenges with container traffic volumes in 2009, and the East Coast will also see a slowing until the economy begins to pick up steam. Port related logistics projects also will slow down on this same schedule.



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Market in the Spotlight

Southern California a Critical Link in the Supply Chain

By Terry Reitz
Senior Vice President, Global Logistics

Logistics Overview The Southern California logistics industry plays a crucial role in both the local and national economies. Southern California's five-county area has a population in excess of 21 million, making it one of the country's largest consumer markets. And 14 million of this population can be reached within a two-hour truck trip from the twin ports of Los Angeles and Long Beach. Couple this with the fact that the ports handle over 40 percent of all U.S. container imports and it is easy to understand why Southern California has a thriving logistics business. The combined port complex is the largest in the U.S. and fifth largest in the world. With its natural deep water draft, large container terminals and state-of-the-art material handling equipment, the ports can load and unload 14,000 + TEU mega-ships with ease. The port's infrastructure, excellent on-dock and near-dock intermodal rail system (including the $2.4 billion Alameda Corridor) and efficient highway connections are virtually unmatched by competing markets. These monster ports are projected to double their throughput in the next 10 years with a combination of operating efficiencies and new infrastructure investments.

Real Estate Overview The market real estate market is composed of three primary regions, each playing a crucial role in the local logistics industry. The Los Angeles market area contains 1,300 distribution buildings over 100,000 square feet totaling more than 238 million square feet. LA is directly adjacent to the ports and serves as the western home base for most of the freight and logistics companies. With a vacancy rate of 2.3 percent and dwindling land supply, Class A properties have become increasingly desirable. Class A asking rental rates for spaces in excess of 100,000 square feet range from $6.50 to $8.50 per square foot per year triple net depending on location. The market also offers an abundance of functional Class B product at lower rates. While rental rates have risen substantially over the last three years, rent growth will stall for the next two years. In the last six months asking rents have remained stable but effective rents have receded between 6 and 9 percent from their 2008 highs.

The Inland Empire (Riverside and San Bernardino counties), with fewer buildings, actually surpasses Los Angeles in total logistics market size by roughly 10 million square feet. The market is composed of 900 buildings over 100,000 square feet, totaling 266 million square feet. The Inland Empire is home to mega-warehouses ranging in size from 500,000 to over 1 million square feet. As a function of its ample land supply, the Inland Empire has attracted users who need large blocks of highly efficient big-box warehouse space. The" IE" drive-time to and from the ports ranges from 1.5 hours to 3+ hours depending on the time of day and whether the destination is in the western or

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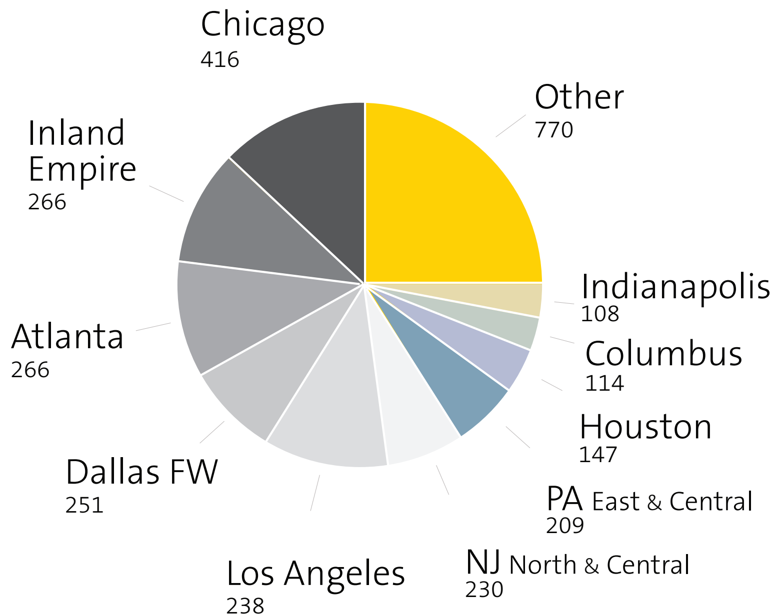
Logistics Inventory Top 10 Markets
Millions of Square Feet



Southern California a Critical Link in the Supply Chain *continued*

eastern part of the region. The erratic cost of fuel has made it difficult for users to justify the long trips from the ports to the eastern inland locations. In other words, transportation costs trump rent savings. In the logistics operating-cost formula, transportation holds a 50 percent share, while rent represents just 5 percent. The rise in drayage costs plus the faltering national economy contributed to a doubling in vacancy in 2008 to nearly 10 percent. Vacancy ranges from 6 percent in the western region to 16 percent in the more distant eastern end. These numbers are projected to climb as the recession deepens and new product comes online. Rental rates have fallen back to 1999 levels. The average asking rate for Class A space is $4.70 per square foot per year triple net, but effective rates range from $3.12 to $3.96. The rent spread between comparable Class A product in the Inland Empire and Los Angeles is approaching $2.40 asking and $3.60 effective.

Orange County plays a small but supporting role in the success of the Southern California logistics market. "The OC" has 145 distribution buildings over 100,000 square feet, totaling about 30 million square feet. The majority of the logistics users are concentrated in North Orange County near the LA border and therefore closer to the ports. Due to high land costs, the area is less conducive to large warehouses. However, the market has some very efficient logistics facilities that serve the Fortune 1000 companies that reside in the area. There is an added cost associated with the area; a user can typically expect to pay $0.60 to $1.00 per square foot more than a similar building located across the Los Angeles border.

Challenges – Macro and Micro Despite the size and power of the Southern California logistics market, it is not immune to the problems facing the nation. The recession, fuel cost inflation and unstable dollar are having sweeping effects on the shipping business. The cost of moving containers across the Pacific has tripled since 2003. Container cargo shipments through the local ports were down by nearly 10 percent in 2008 from their peak in 2006. Imports slowed in 2007 and 2008 as the collapse of the housing market impacted shipments of construction materials and home furnishings. At the same time, shippers began to bypass West Coast ports due to congestion and labor concerns, using Gulf and East Coast ports instead. The decline in imports through the local ports was partially offset by an increase in export volumes of 17.5 percent in 2007 and 9.5 percent in 2008, driven by the declining value of the dollar. But exports also began to slip by the end of 2008 as the global economy sank deeper into recession.

The Southern Californian ports are facing local challenges as well. The opening of the expanded Panama Canal in 2014/2015 will drain some business, as ships will stay on the water longer to reach their Midwest and East Coast destinations. The rail companies (UPRR and BNSF) have announced rate increases for intermodal service that is already adding costs to the land bridge alternative. And then there is the environmental issue. In response to increasing environmental concerns, the ports have launched several initiatives to reduce their carbon footprint. The most aggressive is the Clean Trucks Program approved in October 2008, which is designed to reduce air pollution from harbor

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trucks by more than 80 percent by 2012. It calls for the immediate elimination of all trucks 20 years or older and for those trucks not meeting 2007 air pollution standards they began to pay a $10 fee per 401 loaded conainers to finance the $2 billion truck replacement program. Some are arguing that these new costs will force shippers to reconsider their routing. While it will likely not have much of an impact on large shipments of staple goods, it may affect discretionary cargo that can easily be diverted or rerouted elsewhere to avoid the added costs. The fact that the Southern California ports are tackling these environmental concerns now, before their counterparts around the nation, may eventually work in their favor as the nation moves into a new, environmentally mindful age.

Logistics Building Classifications

Class A Buildings

- State-of-the-art functionality, systems and finishes
- Minimum of 28-foot clear height for buildings over 100,000 square feet
- Excellent truck door/building ratio (minimum of 1/7,500 square feet)
- Excellent truck yards with minimum of 135-foot truck turning radius
- Minimum of .60/3000 or ESFR sprinkler system

Class B Buildings

- Some functional obsolescence
- Fair to good building systems
- Minimum of 22-foot clear height for buildings over 100,000 square feet
- Adequate loading capability
- 33/3000 to .45/3000 sprinkler system
- Minimum of 110-foot truck turning radius

Class C Buildings

- Considerable functional obsolescence
- Less than 110-foot truck turning radius
- Below 22-foot clear height for buildings over 100,000 square feet
- Insufficient number of truck doors
- Non-calculated fire sprinkler system

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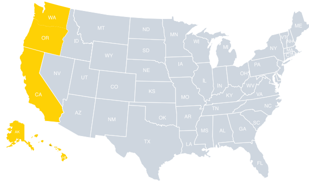
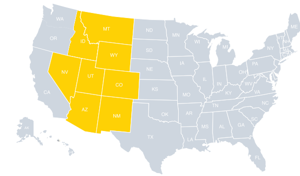
Market Quick Takes Regional Overview



Pacific



Mountain/Southwest

Oakland-East Bay: Logistics space absorbed more than 500,000 square feet in 2008, while asking rental rates held steady. Watch for slower deal velocity and flat rental rates in 2009... **Portland**: The recent announcement by FedEx that it has started construction on a new 415,000-square-foot distribution hub, set to open in 2010, bodes well for the long term viability of this market. The project will kick off the Troutdale Reynolds Industrial Park, a 700-acre superfund site which is the largest industrial property inside the urban growth boundary... **San Jose/Silicon Valley**: Tenants are renewing existing leases rather than relocate, forcing landlords to adjust their asking rents to fill vacancies... **Seattle**: The construction pipeline has thinned considerably, a sign that developers anticipate weaker demand in 2009... **Stockton**: Construction of Class A big-box facilities is being fueled by a stream of distribution users targeting the northern San Joaquin Valley as their West Coast distribution hub. Six new speculative facilities sized 159,000 to 735,000 square feet were completed in 2008, which exemplifies the need for "speed-to-market" availability for logistics users.

Inland Empire: New sales and leasing activity declined in 2008 with many tenants opting for renewals. Tenant consolidations have become a recurring theme, pushing the vacancy rate higher... **Los Angeles**: A drop in container traffic through the local ports contributed to modest negative absorption of logistics space in 2008, but the market remains stable overall. Construction has declined due in part to land scarcity, which has made existing Class A properties more desirable. Budget-conscious users will settle for functional Class B space in return for lower rental rates... **Orange County**: Logistics plays a supporting role in this market mainly because the cost of land is so high. There are distribution centers, but properties are generally 100,000 square feet and below... **San Diego**: Local vacancy rates remain extremely low.

Denver: Cutbacks by retailers have set in motion the shrinkage of many logistics providers. Speculative construction of new product has ceased. Distribution companies are seeking space along the less-congested I-76 corridor with FedEx and other large distributors moving operations to build-to-suit product in this submarket... **Phoenix**: Fear in the capital markets has caused a slowdown in logistics-related leasing and sales activity in the short term, but long-term drivers of demand remain in place: population growth, the market's proximity to California and Mexico, and a lower cost structure compared with California. The state legislature recently passed a $1.7 billion sustainable energy tax credit that will create demand for solar manufacturing and distribution solutions.

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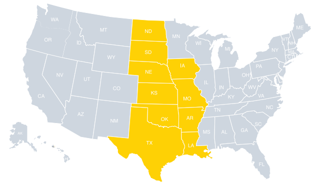

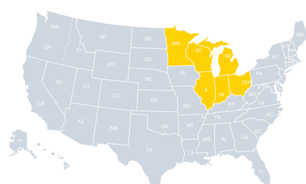

Central/Great Plains

Dallas-Fort Worth: With 37 million square feet of empty logistics space, the market can accommodate relocating distribution companies with an immediate requirement. More than 5 million square feet of logistics space is under construction, which will have a great impact on the vacancy rate when it delivers... **Houston**: A strong economy coupled with expansion at the Port of Houston has carried the local logistics market into an expansion phase. Developers brought 5.9 million square feet of new logistics product online in 2008. The surge of new projects coupled with a slight drop in leasing demand caused vacancy to edge up in 2008, a trend that is likely to continue in 2009... **Kansas City**: The market is seeing a lot of new logistics-related development. Licausi Development is building a 600,000-square-foot speculative bulk warehouse in Gardner, Kan. while Kessinger/Hunter recently completed its 602,000-square foot spec building in Olathe, Kan. Construction has started on the infrastructure for the KCI Intermodal Business Centre at Kansas City International Airport. The 180-acre Phase I is expected to have four buildings totaling 1.8 million square feet of commercial space... **St. Louis**: Several major companies such as Procter & Gamble and World Wide Technology have recently expanded in the area or committed to move here. Excess speculative space is slowly being absorbed. Even well capitalized developers will no longer start new buildings without 50 percent pre-leasing.

Great Lakes

Chicago: Distribution space users are planning for smaller sites in more locations to lower fuel costs. Speculative construction has declined in response to reduced tenant demand that has left some markets with Class A warehouse space over 30 percent empty. Several logistics companies are offering sublease space as many of their national retail customers have reduced inventories in response to sluggish sales. Space that is being absorbed by logistics companies tends to be smaller than the mega big-box distribution centers the market has witnessed in the past few years.... **Cincinnati**: A drastic slowing of leasing velocity along with limited access to financing has prompted developers to put the brakes on new construction starts. All major submarkets posted negative net absorption in the second half of 2008 with the exception of the Northern Outlying submarket where Home Depot took occupancy of a 657,000-square-foot distribution center at Corridor 75 Industrial Park... **Cleveland**: Some planned projects have been put on hold due to financing difficulties. With the limited availability of state-of-the-art product, owners of newly completed buildings will test the market with higher rents but may need to reconsider in order to lure cautious tenants. Property sales will continue to be a challenge in 2009... **Columbus**: More than 4.3 million square feet of logistics space was completed in the market during 2008. With the completion of the Heartland Corridor project in 2009, Norfolk Southern will offer direct double stack container service from the Port of Virginia to Columbus days faster and at a lower cost than before. This should boost demand for logistics space near the railroad's intermodal yard at the former Rickenbacker Air Force Base... **Detroit**: The continued decline of automotive production in the coming quarters will put a damper on the shipment and warehousing of components leading to a drop in demand for logistics space... **Grand Rapids**: The local industrial market is heavily weighted toward owner-occupied manufacturing facilities. The 21-million-square-foot warehouse/distribution inventory has a relatively high vacancy rate due to overbuilding in the 1990s. Grand Rapids' location in the peninsula that is Michigan does not lend itself toward a high concentration of modern logistics facilities or tenants... **Indiana – Northern**: Plans are developing for a major inland port southeast of Chicago that would provide a transfer point for the major railroads while bypassing the congested Chicago yards... **Indianapolis**: Cooper Tire & Rubber Co. will move its Ohio-based distribution operations into an 800,000-square-foot, LEED-certified distribution center in Franklin Tech Park... **Minneapolis – St. Paul**: The Twin Cities logistics market currently has a low vacancy rate compared to the traditional industrial market. But it is not immune to the poor economic conditions and will experience some softening in 2009. Users looking for space will have more opportunities next year, with a likely migration from Class B to Class A buildings as leases begin to roll.

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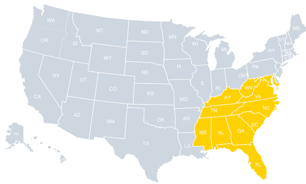
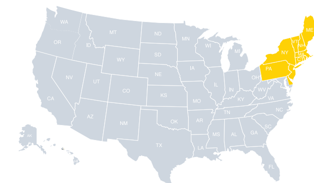


Southeast

Atlanta: Hartsfield Atlanta International Airport has become a gateway to and from developing South American countries, and the recent addition of a fifth runway will accommodate more international routes. The Airport/South Atlanta logistics hub has been somewhat resistant to deteriorating domestic economic conditions… **Charleston**: Many developers who took down large land positions prior to the economic slowdown remain committed to their projects. Their optimism is fueled by a recently approved port expansion set to increase container capacity by 50 percent. This new terminal will come online about the same time as the improvements to the Panama Canal are completed in 2013, positioning the market for strong growth over the long term… **Greenville-Spartanburg**: The completion of the first phase of Adidas's East Coast distribution hub delivered 1 million square feet of Class A logistics space to the market in the third quarter of 2008. The second phase will bring another 800,000 square feet in 2009… **Memphis**: Ballooning sublease space is putting downward pressure on rental rates… **Nashville**: IDI, Opus and Verus Partners have completed the first buildings in their respective inaugural developments in Middle Tennessee… Richmond: The availability of older logistics space is increasing rapidly and at more attractive rents and sale prices than in recent years. New construction has virtually come to a halt… **South Florida**: The market is strategically located to service Latin American and Caribbean trading partners with its international airports and seaports. However, the future may bring a movement of business northward to Jacksonville and Savannah as these ports make more geographic sense for distribution to the majority of the U.S… **Tampa Bay**: Landlords are reducing asking rents to overcome negative absorption brought on by the struggling economy. Deliveries of new product begun before the market worsened last fall continue adding vacant inventory to the market with no tenants in sight.



Northeast

Baltimore: Volatile fuel costs are forcing companies to continually rethink their space requirements. Intermodal hubs with access to ports, rail and highways such as Baltimore continue to be logistics hot spots… **Delaware**: Class A and high-end B product is the most sought-after space. Currently no large projects are under way, and there are no plans for any large-scale developments on the horizon… **New Jersey, Northern & Central**: The market's strategic location along the East Coast attracts retail chains seeking big-box distribution space. But declining consumer spending is pressuring retailers to put expansion plans on hold, resulting in some consolidation of existing distribution centers used to replenish inventories. The construction pipeline continues to empty as developers shelve their plans… New Jersey, Southern: The market has softened, and no new logistics projects are being started. Prime developable land along the major interstates is in short supply… **Pennsylvania, Central & Eastern**: Construction has shifted from a speculative to a built-to-suit basis, while the profile of tenants with requirements has shifted from retailers to third-party-logistics companies… **Pittsburgh**: Though not a traditional logistics hub, Pittsburgh has attracted a number of third party logistics operators to support local manufacturers and distributors, a trend that is expected to continue.

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Office Locations

Logistics Market Trends Q4 2008

North America

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