Exploding online sales and a three-in-10 return rate mean industrial real estate finally feeling the love

Amazon's purchase of Whole Foods is expected to add to the pressure for warehouse and distribution space

An Amazon.com distribution centre: Online sales are up but so are returns and that is causing a spike in the need for industrial space to build returns centres. *Jens Meyer/The Associated Press*

Bananas are the Holy Grail of online delivery, the one thing that's almost impossible to perfectly ship to someone's doorstep after being ordered.

“They are so finicky,” said Ben Conwell, a Seattle-based senior managing director at real estate company Cushman and Wakefield Inc. and leader of its e-commerce fulfillment division. “They can’t be too cold, they can’t be too hot, they bruise like the dickens and they have a limited shelf life.”

That’s why everybody in the fast-growing world of logistics, which has created an unprecedented demand for industrial space across North America, is watching how online giant Amazon.com Inc.’s US$13.7- billion purchase of upscale grocer Whole Foods Market Inc. plays out.

“There is nothing more difficult to fulfill than perishables,” said Conwell, who predicts Whole Foods, which has 13 locations in Canada, will help Amazon with distribution even though online food sales are a paltry one per cent of the grocery business and Amazon Fresh has struggled south of the border.

The online grocery business struggles partly because you can’t return that brown or bruised banana and a key element of the e-commerce revolution has been the ability to send anything back — a process called reverse logistics in the industry. Industrial space is already rapidly expanding to meet that finicky customer demand and could soar if online grocery buying ever takes off.

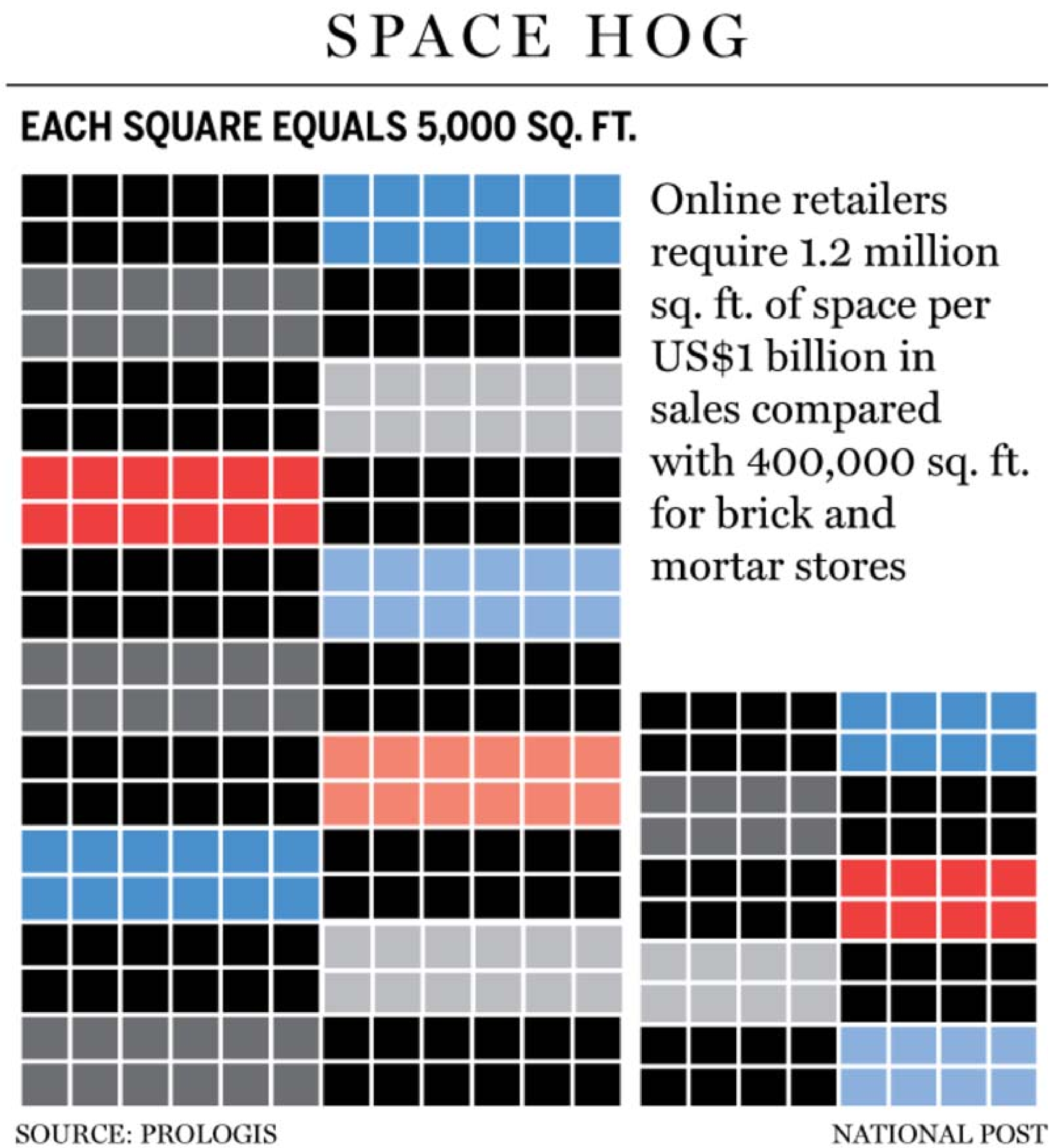
Canada’s inventory of industrial land already encompassed about 1.8 billion square feet of space at the beginning of 2017, according to an RBC Capital Markets report, and space is being absorbed as fast as it can be built in most markets.

“As e-commerce continues to grow, retailers are positioning themselves to take advantage of online sales,” RBC noted in a report in early 2017. “Central to this positioning are the logistics of getting the end product to the consumer.”

About 25 to 30 per cent of industrial leasing can be traced to e-commerce needs, Cushman and Wakefield said. On a global basis, e-commerce concerns take up 20 per cent of new leases, up from less than five per cent five years ago, adds industrial real estate and warehouse logistics management company Prologis Inc.

E-commerce is simply more demanding than traditional retail when it comes to distribution space.

Online retailers on average need approximately 1.2 million square feet of space per US$1-billion worth of online sales, three times the distribution centre space required for traditional brick-and-mortar retailers, according to Prologis.



About three of every 10 goods purchased on online are now returned, about three times the rate of in-store returns, said Conwell, who spent three and a half years in charge of North American real estate for Amazon Fulfillment Services Inc.

Amazon’s Prime Wardrobe, unveiled last month in the U.S., threatens to expand that return rate by allowing consumers to try on clothes before purchasing them and then pop any unwanted items into a box to be returned.

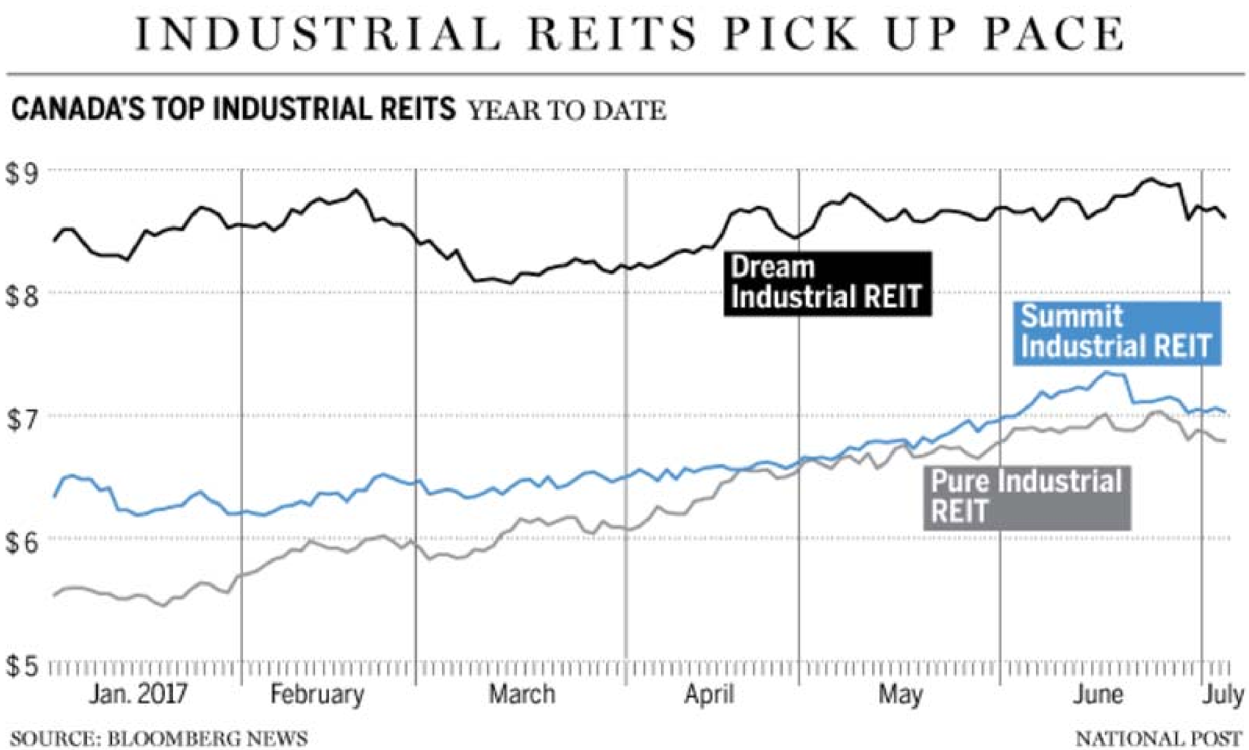
“We see only (online) sales growing 14 to 15 per cent a year in Canada and the U.S.,” said Conwell, adding that overall demand for industrial space will exceed any efficiency improvements. “We haven’t come close to the end of the story.”

The Greater Toronto Area is near the centre of this industrial revolution, with a real estate inventory of 760 million square feet, trailing only Los Angeles at 1.1 billion and Chicago at 1.2 billion.

But land in Canada, because of real estate costs and regulatory difficulties, has never been harder to develop. Industrial space under construction was at a seven-year low of 9.5 million square feet, CBRE Canada said in its 2017 national outlook last spring.

A tight market has boosted investor demand with CBRE expecting $5.9-billion worth of industrial space to change hands in 2017, up from $5.8 billion the year before. Investment in the beleaguered retail industry, meanwhile, is expected to drop to $5.7 billion from $6.8 billion during the same period.

All of this has been good for publicly traded companies holding real estate in the right industrial markets.



Neil Downey, managing director of global research at RBC Capital Markets, said industrial real estate has been one of the investment bank's favourite asset classes for the past two years while retail has been second from the bottom.

"Investment demand and performance of public companies in the industrial/warehouse/distribution segment of the market has been stronger than we anticipated," he said.

Pure Industrial Real Estate Trust, which had its initial offering back in 2007, has grown into a leader with a $1.9-billion market capitalization and is the largest internally managed industrial portfolio in the REIT sector.

Kevan Gorrie, chief executive of PIRET, said 30 per cent of the trust's income is related to e-commerce and FedEx Corp. is its major customer.

“The reverse logistics side is really interesting in that more and more companies are specializing in that and they are taking up more and more space in and around the cities in North America,” he said. “It is becoming a standalone business on its own.”

Gorrie said existing distribution and fulfilment centres are not really set up to do returns. “They’re not made for a product to come back on the shelf, it really screws up the inventory.”

The 30 per cent of PIRET’s net operating income from e-commerce comes from smaller fulfillment centres, while another 50 per cent is probably warehouse or distribution centres — better described as locations where stock will sit for months. The rest of its income is mainly from transportation facilities and light manufacturing.

“What we saw five years ago was that distribution centres just stocked the stores, but now a lot of them are dual: they’ll feed the stores, but also operate an e-commerce facility out of there,” Gorrie said. “In some cases, you can go straight to the store from that facility, but in a lot of cases, they separate the two completely.”

A distribution centre in Brantford, Ont. The centres have dual functions now supply physical stories and doing fulfilment for online retailers. *Brian Thompson/Brantford Expositor/Postmedia Network*

He predicts Amazon’s purchase of Whole Foods could have a profound effect on industrial space.

“If you think grocers are immune to this, you have your head in the sand. Amazon didn’t buy (Whole Foods) for the physical buildings, they want the brand. I can tell you a lot of the demand in our business is coming from grocers,” Gorrie said. “They come in and take a building, maybe 25 to 30 per cent of a building, build walls and it becomes a gigantic fridge.”

The entire industrial retail sector has grown rapidly in the past decade. Before then, Summit REIT had very few publicly traded comparables, but it disappeared in 2006 after an unsolicited $2.1-billion bid from a unit of Netherlands-based ING Groep NV.

Today, in addition to PIRET, there’s Dream Industrial REIT, worth about $520 million and Summit Industrial Income REIT, worth about $370 million and a second coming for management who ran the old similarly named REIT.

A fourth player, WPT Industrial REIT, trades on the TSX and has a market capitalization of $453 million, but its holdings are in the United States.

There are a few other key players as well. For example, Canadian REIT, with a market capitalization of $3.3 billion, doesn’t solely focus on industrial space, but its 10 million square feet mean it is no bit player. Granite REIT, whose main tenant is still Magna International Inc., also hopes to expand into industrial space.

Downey said there are “secular headwinds” for some publicly traded retail entities, but there are also some “strong tailwinds” for some of those same REITs as land becomes scarcer in Canada.

“The intensification forces in Canada’s largest markets, if you are already urban (with great locations), it’s great,” he said. “Sure, they have the secular headwinds of online shopping. But the tailwinds are the number of people in their trade area is rising at a much faster rate than retail square footage in their trade area.”

Retail has been migrating to things the Internet can't replace such as food or restaurants, but the retail REITs are also sitting on land that can be further intensified.

Rick Pennycooke, president of Toronto-based Lakeshore Group, which works on development approvals, said it's hard to keep up with the demand for industrial space.

"E-commerce is definitely part of it, but there is rush to get stuff on shelves and demand for greater efficiency on the retail side," he said.

Pennycooke said what's really changed in his practice is that clients who used to be strictly retail developers are now mixed use: a little bit of retail combined with office with residential. "I just see smaller retail spaces," he said.

Financial Post

gmarr@postmedia.com
twitter.com/dustywallet

Financial Post

GARRY MARR
July 7, 2017
7:39 AM EDT