



**BKM** Capital Partners

SCALING SUCCESS: SMALL-BAY INDUSTRIAL'S  
**STEADFAST FOUNDATIONS**



**BKM INTEL | THOUGHT LEADERSHIP SERIES**

## SMALL-BAY INDUSTRIAL DEFINED

Industrial has long been considered the darling of real estate, emerging through the COVID-19 pandemic as a CRE powerhouse despite the softening economy and tight lending environment.

More notably in the industrial asset class are small-bay warehouses, which have shone brightest in the spotlight as they present a promising investment opportunity as a facilitator for local distribution networks, an excess inventory solution to combat supply chain disruptions, and a diversified industrial alternative with capabilities to accommodate a wide array of tenant needs. Small-bay industrial properties typically fall below 200,000 square feet in size, with units ranging below 50,000 square feet.



## SMALL-BAY PROPERTY FUNDAMENTALS



### Low Availability

Small-bay warehouse availability remains at record low levels in key markets across the country, despite increases in the overall vacancy of the broader industrial market. Leasing efforts continue to remain fast-paced, bolstered by continued demand for this product type as a result of secular changes in the industrial tenancy. With the need for warehouse space at such high levels, availability of these spaces remains coveted.

Warehouse and distribution units under 50,000 square feet sit at a mere 4.4% availability rate, 180 basis points below the U.S. industrial market average, while smaller spaces sit even tighter at a 3.5% availability rate.<sup>1</sup>



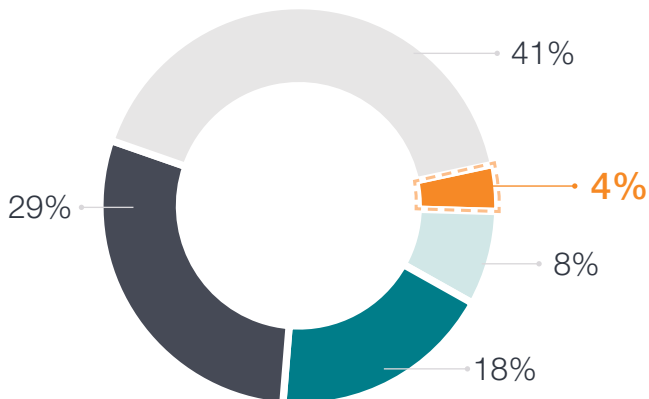


## Low Development

As warehouse availability remains critically low, developers have been racing to meet space demands with a robust construction pipeline and plans for market expansion. **In 2022, industrial net absorption reached 477.3 million square feet, marking the sector's second highest total net absorption on record just behind 2021. As a result of this, U.S. vacancy dropped to 3.3% in Q4 of 2022,** leading developers to kick-start new projects in an attempt to keep pace with demand.<sup>2</sup> Despite this attempt to re-balance the market, recent interruptions in construction activities due to inadequate financing and economic uncertainties have exacerbated the disparity between the growing demand for industrial space and the limited influx of new space entering the market, with small-bay industrial showing an even greater divide as construction projects remain predominantly for larger spaces over 500,000 square feet.

Only 4% of space currently underway falls in the small-bay segment, even as this space makes up over 36% of the total U.S. industrial inventory.<sup>1</sup>

### Under Construction



### Percent of Existing Inventory



■ Under 50K SF   
 ■ 50K - 99K SF   
 ■ 100K - 199K SF   
 ■ 200K - 499K SF   
 ■ 500K + SF

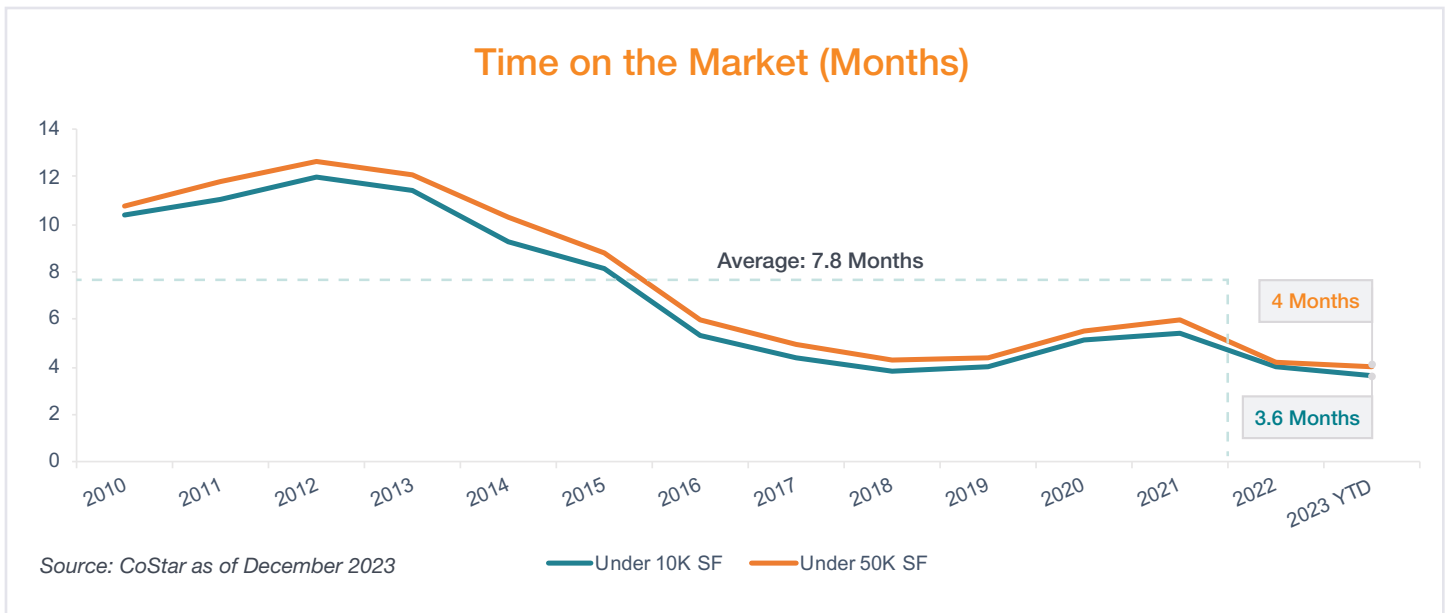
Source: CoStar as of December 2023





## Low List to Lease/Time on Market

As a result of limited supply and record-high demand, time on the market has reduced significantly as tenants rush to snatch up available space. **As of 2023, time on the market for small-bay space sits at a record low of just 4 months, 48% less compared to the average time between 2010 and 2022.** Time on the market for spaces under 10,000 SF is even lower, averaging at just 3.6 months.<sup>1</sup> As we have seen markets cool off slightly in the past few months, there is still a strong case for small-bay industrial to remain competitive as a result of this supply/demand imbalance.



## Low WALTs/Mark to Market Opportunity

Assets with shorter Weighted Average Lease Terms (WALT) have exceptional mark-to-market potential, and skilled operators are well-positioned to create value from the resulting NOI increase. Multi-tenant industrial product's short lease-terms coupled with growing institutional favorability of the asset class make for a strong hedge against the typical decreasing of returns during high inflationary periods, providing more income stability.



## Tenant Diversification

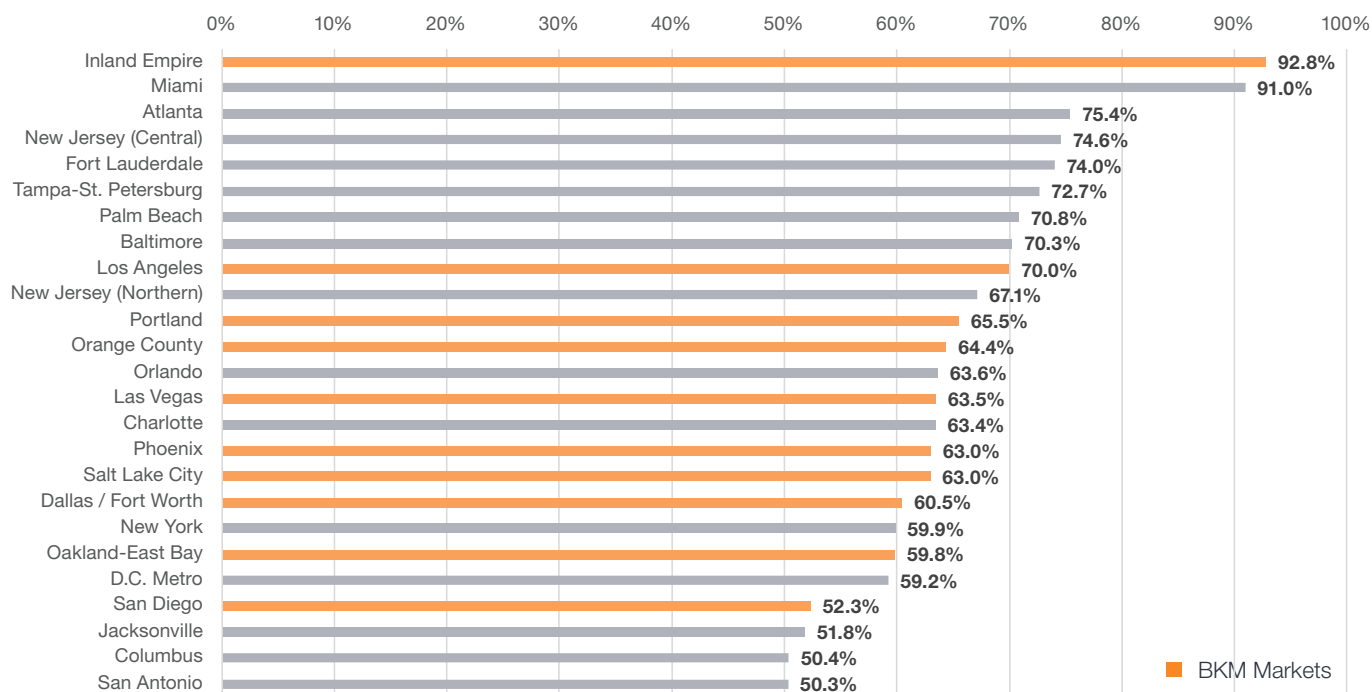
Single tenant warehouses lack diversification, exposing these assets to more risk when one or more industries faces economic turmoil. Multi-tenant light industrial falls on the opposite end of the spectrum, providing a highly diversified tenant base and rent roll. This diversification minimizes the impact of any one tenant on the performance of the property. During times of heightened uncertainty and volatility, diversification is a widely desired attribute given its downside protection benefits.



## Historic Rent Growth

Small-bay industrial assets have experienced exceptional rent growth in past quarters as their place in the integrated global supply chain becomes more commonplace, creating sustained value for the product type while transforming the traditional orientation of supply movements through national and global systems. **With major markets seeing rent growth as high as 50-90% between 2021 and 2023**, the question remains of how long this growth can be sustained as the sector normalizes post-pandemic.

### 2021-2023 Cumulative Industrial Rent Growth - Top 25 MSAs



As of Green Street's Q4 2023 M-RevPAF forecast. The M-RevPAF growth combines changes in effective rents and occupancies into a single measure.



## WIDESPREAD DEMAND FOR SMALL-BAY SPACE

There has been a significant change to tenancy within the light industrial asset class as secular demand tailwinds from e-commerce growth, innovation, and onshoring contribute to record demand, a higher-quality tenant base, and value-creation opportunities.

A common theme emerging through the turbulent post-COVID environment is shift to smaller space requirements, piggybacked by the following trends:

**The modern supply chain requires smaller space in close proximity to end-users**

**The onshoring/reshoring boom creates new demand for smaller vendor networks**

**Technology reduces space requirements in manufacturing**

### Supply Chain Optimization

- » Following the widespread supply chain disruptions experienced during the pandemic, many businesses were forced to re-strategize ways to optimize product movement to prevent hiccups caused by overseas and cross-country transportation. This operational adjustment reframed how many businesses stored local inventory and brought popularity to the Just-in-Case (JIC) inventory method, increasing the need for small-bay warehouse space as an accompaniment to traditional brick and mortar storefronts.
- » E-commerce businesses require more than 3X the logistics space than traditional brick and mortar, attributed to the scale and nature of backstocked inventory's space requirements versus the limited product found on store shelves.<sup>3</sup>
- » As customer demand for rapid delivery has morphed into expectation, both sellers and manufacturers have realigned their logistics strategies, focusing on accumulating inventory closer to end-users. Small-bay warehouses play an increasingly important role in the modern supply chain.



## Onshoring Driving Industrial Demand

The onshoring of large manufacturing plants provides opportunities for smaller operators to supply goods and support services while promoting innovation in the local community. This ripple effect results in increased demand for space, higher rental rates, and potentially increased property values which is amplified by other external factors such as infrastructure improvements and economic development initiatives like the 2022 CHIPs Acts.



TSMC's \$40B commitment allocated towards chip manufacturing plants in Phoenix has had a tremendous ripple effect in the light industrial sector as space for supporting vendors becomes more in demand. Since the firm's announcement, at least 14 other companies have announced expansions in the Metro region, and more than 40 of the TSMC's suppliers have reportedly expressed interest in locating in Phoenix.<sup>4</sup>

Manufacturing leasing volume hit a record 136.9 MSF in 2022, a whopping 42% above the pre-pandemic average.<sup>5</sup>

This new demand, coupled with a constrained supply chain, place small-bay industrial assets in a strong position for growth through 2024.

## Technology Catalyzing Operational Efficiencies

- » Digitization is quickly transforming the industrial and logistics space, with companies adopting new technology to streamline their manufacturing operations.
- » 3D printing and inventory management systems are two examples of technology that reduce the need for larger warehouse space by making previously large-scale tasks more efficient with less space needed for operation.
- » Significant growth of the life science sector has increased the need for available industrial space that can support growing R&D and advanced biomanufacturing needs.

## LOOKING FORWARD

- » Strong demand for smaller warehouse properties will continue as retailers and logistics operators expand their networks to increase their proximity to consumers. As such, rent growth likely will continue outpacing that of large bulk warehouses.
- » Currently, the U.S. leads global GDP growth, surpassing other nations as their numbers consistently trend upwards despite slowdowns elsewhere. This trajectory is poised to draw significant investment from companies and investors. Consequently, the outlook for industrial space demand remains robust, indicating continued strength in the U.S. industrial sector.
- » When compared with global e-commerce adoption rates, the United States still has ample room for expansion. While e-commerce in China, the world's largest e-commerce market, accounts for nearly half of all retail sales in the country, the pace of that growth is expected to be relatively stagnant. Comparatively, the U.S. — with the world's second-largest e-commerce market — is ranked fifth in terms of its share of e-commerce sales at 15.6 percent, behind Indonesia (31.9 percent), the United Kingdom (30.6 percent) and South Korea (30 percent). U.S. e-commerce is expected to grow at a 10 percent annual pace through 2027, when it's forecast to hit 20.6% of overall retail sales.<sup>6</sup>

Strong property fundamentals and surges in e-commerce, technology, and manufacturing have positioned small-bay industrial as a favorable asset class with strong growth potential going into 2024.





## SOURCES

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<sup>1</sup> CoStar, as of December 2023

<sup>2</sup> “U.S. Industrial MarketBeat Q4 2022”, Cushman and Wakefield

<sup>3</sup> “COVID-19 Special Report #6: Accelerated Retail Evolution Could Bolster Demand for Well-Located Logistics Space”, Prologis, June 2020

<sup>4</sup> Greater Phoenix Economic Council

<sup>5</sup> “U.S. Manufacturing Resurgence?”, Cushman and Wakefield

<sup>6</sup> eMarketer



## ABOUT THE AUTHOR

BKM Capital Partners was founded in 2013. Headquartered in Newport Beach, California, BKM Capital Partners is a leading real estate operator and fund manager specializing in the acquisition and improvement of value-add light industrial multi-tenant properties in major markets across the Western U.S. The firm has 13 offices and over 90 employees and continues to produce top quartile performance for its investors.

**Please visit our website below for more information.**

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## LIGHT INDUSTRIAL FUNDAMENTALS



Properties less than 200,000 SF,  
spaces under 50,000 SF



~80% industrial, ~20% office  
buildout



Typically found in infill locations  
with close proximity to city  
centers



20-200 units, typically housing  
manufacturing, distribution, and  
e-commerce tenants



Typical WALT of 1-3 years