THE PORTER REPORT

Q2 2019 | RICHMOND, VA INDUSTRIAL MARKET REVIEW

OCCUPANCY RATES UP AS CONSTRUCTION ACTIVITY CONTINUES.

⇨ At the mid-year mark, the **overall industrial market occupancy** has increased to **91%** from 89% at the end of the first quarter, with the majority of the vacant bulk industrial space located in the southeast quadrant, including more than 1 million square feet combined in the former Ace Hardware facility in Prince George County and the former GSA building in the Meadowville area of Chesterfield County. Ashley Capital purchased the 800,000 square foot former Ace Hardware property for $21.7 million and will be offering the facility for lease. The **Class A occupancy** rate has increased from 91% to **92%** while the **Class B occupancy rate** has increased from 89% to **92%**.

⇨ Sales and leasing activity through the second quarter is once again a mix of owner/user and investment sales and several large industrial leases. Richmond's strategic mid-Atlantic location along Interstate 95 provides access to 55% of the nation's consumers within two days' delivery by truck, and Virginia has also recently been ranked as the top state for business by CNBC.

⇨ Online auto retailer **Carvana** has filed plans to construct a vehicle inspection and processing center on 183 acres in Chesterfield County, located east of Interstate 95 on Woods Edge Road. Referred to as "Project Utopia," the proposed $40 million development would include multiple surface parking areas to hold 9,000 vehicles along with a two-story, 200,000-square-foot inventory processing center for inspecting, reconditioning and photographing vehicles for online sales. Founded in 2012, Arizona-based Carvana has 18 vending machine locations across the country and has described its business model as "Amazon for cars." The proposed center would employ a total of 500 workers on two shifts.

⇨ Indiana-based **Scannell Properties** is evaluating a 58-acre land site owned by Armada Hoffler in Chesterfield County for a 405,000-square-foot distribution center. The land is part of the 177 acres Armada Hoffler purchased in January, 2018, and is adjacent to the 220,000-square-foot warehouse built for PepsiCo, which was sold along with 55 acres to ElmTree Funds for $26 million earlier this year. The proposed warehouse would occupy 35 acres of the 58-acre site with several bays at the rear and front for large trucks and parking on the eastern and western side of the complex. Scannell primarily focuses on build-to-suit and speculative projects.

⇨ The Hanover County Board of Supervisors approved the rezoning to permit the **Virginia Alcoholic Beverage Authority (ABC)** to move forward with plans to relocate its central operations from the Diamond area of Richmond to portions of a 120-acre site on Pole Green Road at Interstate 295. The property is currently owned by Riverstone Properties, and according to development plans, 871,600 square feet of warehouse space and 101,844 square feet of office space will be built on land previously zoned for agricultural and limited industrial uses.

FEATURED PROPERTY

Seven Hills Logistics Center

Adjacent to Richmond International Airport

Opportunity Zone + Foreign Trade Center (FTZ) Location

~59.6 Buildable Acres Zoned M-2C

Potential 3-Building Industrial Campus: ~671,505 SF Total
Build-to-Suit + Outside Storage Potential
Site 1: Up to 418,735 SF Warehouse (Includes Office)
343 Car Parking + 230 Trailer Spots, Includes Adjacent Trailer Staging Area
Site 2: Up to 96,600 SF Warehouse + 164 Car Parking Spaces
Site 3: Up to 156,270 SF Warehouse + 207 Car Parking Spaces

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INDUSTRIAL CONSTRUCTION PIPELINE

- ⇨ 1.5MM SF Deepwater Industrial Park - BTS Planned (Richmond City)
- ⇨ 461,700 SF Virginia I-95 Logistics - Phase I Leased (Richmond City)
- ⇨ 461,700 SF Virginia I-95 Logistics - Phase II Delivery Q3 2019
- ⇨ 324,629 SF James River Logistics Center - Start 2019 (Chesterfield Co)
- ⇨ 246,760 SF Airport Logistics Center - Start 2019 (Henrico Co)
- ⇨ 238,000 SF Northlake Business Park - Planned Start Q3 2019 (Hanover Co)
- ⇨ 152,000 SF Northlake Commerce Ctr - Under Construction (Hanover Co)

SELECTED INDUSTRIAL TRANSACTIONS

- ⇨ 798,786 SF INV SOLD | 7000 Hardware Drive (Prince George Co)
- ⇨ 221,489 SF LEASED | 4300 Carolina Avenue (Henrico Co)
- ⇨ 109,520 SF INV SOLD | 8001 Greenpine Road (Chesterfield Co)
- ⇨ 134,000 SF SOLD | 10051 Old River Drive (Amelia co)
- ⇨ 82,344 SF INV SOLD | 3008 Mechanicsville Tnpk (Henrico Co)
- ⇨ 58,048 SF LEASED | Enterchange at Walthall (Chesterfield Co)
- ⇨ 38,198 SF LEASED | 11300 Old Stage Road (Chesterfield Co)

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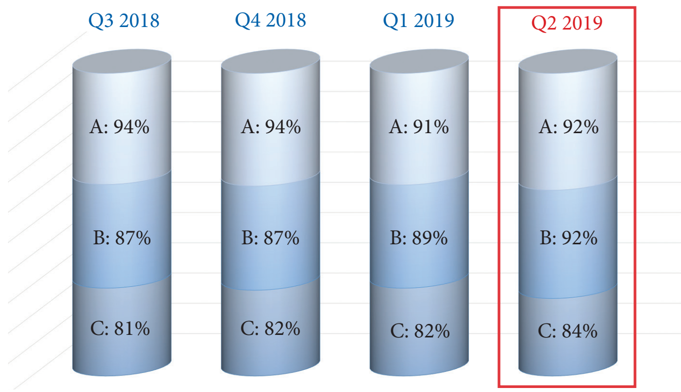
INDUSTRIAL MARKET VACANCY

Q2 2019

VACANT & INVESTOR-OWNED INDUSTRIAL PRODUCT

40K SF MIN RBA* EXCLUDING FLEX & OWNER-OCCUPIED PROPERTIES | *RBA Total: 29.6MM SF in 184 Existing Buildings

COMBINED OCCUPANCY RATES & NET ABSORPTION (CLASS A & B PRODUCT)



The combined industrial occupancy rate of Class A & B product has remained at 92% at the end of Q1 2019.

Net Absorption from Q4 2018: +304,029 SF (Class A/B)
Net Absorption from Q4 2018: +87,947 SF (Class C)

NOTE: CoStar reports an industrial occupancy rate of 96.2%, increased from 95.5% at the end of the 1st quarter of 2019, based on a total 115.8 million square feet RBA in 2,777 existing warehouse properties, and a positive net absorption of 375,969 square feet for the quarter. CoStar's industrial RBA includes both owner-occupied and investor-owned properties, but excludes flex space, defined as 50% minimum office.

Vacancy Rate & Trends
40k < 75k SF RBA
RBA: 2.68MM SF (50 Buildings)
RBA: 9.0% of Total Market

	Class A	Class B	Class C
Total Bldgs	4	28	18
Total RBA	226,043	1,496,600	958,178
Vacant SF	40,043	195,379	46,425
Vacancy Rate	18%	13%	5%

CLASS A	NWQ	NEQ	SWQ	SEQ
Total Bldgs	0	2	1	1
Total RBA	0	132,000	54,000	40,043
Vacant SF	0	0	0	40,043
Vacancy Rate	0%	0%	0%	100%

CLASS B	NWQ	NEQ	SWQ	SEQ
Total Bldgs	9	10	6	3
Total RBA	459,518	519,882	356,820	160,380
Vacant SF	60,000	80,579	54,800	0
Vacancy Rate	13%	15%	15%	0%

CLASS C	NWQ	NEQ	SWQ	SEQ
Total Bldgs	9	3	5	1
Total RBA	500,635	142,170	248,373	67,000
Vacant SF	29,400	12,025	0	5,000
Vacancy Rate	6%	8%	0%	7%

Vacancy Rate & Trends
75k < 150k SF RBA
RBA: 7.58MM SF (71 Bldgs)
RBA: 25.6% of Total Market

	Class A	Class B	Class C
Total Bldgs	23	31	17
Total RBA	2,697,110	3,272,584	1,612,047
Vacant SF	201,703	249,128	290,344
Vacancy Rate	7%	8%	18%

CLASS A	NWQ	NEQ	SWQ	SEQ
Total Bldgs	4	11	3	5
Total RBA	431,144	1.31MM	331,460	627,319
Vacant SF	0	58,065	0	143,638
Vacancy Rate	0%	4%	0%	23%

CLASS B	NWQ	NEQ	SWQ	SEQ
Total Bldgs	2	13	10	6
Total RBA	209,546	1.35MM	1.15MM	562,027
Vacant SF	0	178,128	40,000	0
Vacancy Rate	0%	13%	3%	0%

CLASS C	NWQ	NEQ	SWQ	SEQ
Total Bldgs	4	3	9	1
Total RBA	377,305	229,749	904,993	100,000
Vacant SF	0	82,344	168,000	40,000
Vacancy Rate	0%	36%	19%	40%

Vacancy Rate & Trends
150k SF Min RBA
RBA: 19.37MM SF (63 Bldgs)
RBA: 65.4% of Total Market

	Class A*	Class B	Class C
Total Bldgs	34	19	10
Total RBA	12,873,487	4,198,254	2,299,805
Vacant SF	1,065,595	247,011	440,544
Vacancy Rate	8%	6%	19%

CLASS A	NWQ	NEQ	SWQ	SEQ*
Total Bldgs	4	13	2	15
Total RBA	1.15MM	3.80MM	1.56MM	6.36MM
Vacant SF	0	40,000	0	1.03MM
Vacancy Rate	0%	1%	0%	16%

CLASS B	NWQ	NEQ	SWQ	SEQ
Total Bldgs	2	9	6	1
Total RBA	601,695	1.78MM	1.16MM	450,000
Vacant SF	142,800	77,211	27,000	0
Vacancy Rate	24%	4%	2%	0%

CLASS C	NWQ	NEQ	SWQ	SEQ
Total Bldgs	2	1	5	2
Total RBA	336,138	200,000	958,167	805,500
Vacant SF	0	0	150,000	290,544
Vacancy Rate	0%	0%	16%	36%

*Increase on Overall Class A Vacancy as well as SEQ Class A Vacancy attributed to the now vacant former Ace Hardware complex in Prince George County (798,786 SF Total)

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REPORT: THE EFFECT OF RISING CONSTRUCTION PRICES

Excerpted from Article Published in SIOR Report Summer 2019 Issue | By Steve Bergsman

The official inflation rate for the United States in 2018 was a very modest 2.1 percent and expectations are that general prices will rise just 2 percent this year. Commercial real estate brokers have a right to be suspicious of these numbers because the quantum leap in the pricing of land, materials, labor, and rents has made their jobs much more difficult.

In **Dallas** over the past six and a half years, construction prices have jumped 22 percent, reports Grant Pruitt, SIOR, president and managing director of Whitebox Real Estate, Dallas. In **Indianapolis**, rental rates that used to be $18 to $19 per square foot five years ago are now $23 to $24 per square foot, observes Tim O'Brien, SIOR, president of O'Brien Commercial Real Estate, Indianapolis.

In **Houston**, construction costs vaulted approximately 8 percent in just one year, declares Travis Land, SIOR, a partner with NAI Partners, Houston. In the Research Triangle area of North Carolina, construction costs and rental rates have risen 25 percent to 30 percent in the last 12 months, notes Street Jones, SIOR, principal with Rich Commercial Realty, **Raleigh**. Then there is the situation in Salt Lake City. "What we have found in Utah over the last 12 to 18 months is that the rising cost of construction is no longer running parallel with the current lease rates on new product," says Chris Falk, SIOR, principal and executive vice president at Newmark, Salt Lake City. "Essentially, rising construction costs are beginning to out-pace lease rates for Class A office buildings."

"Essentially, rising construction costs are beginning to out-pace lease rates for Class A office buildings."

Other problems endemic to construction costs have surfaced as well. After the economic downturn of 2008- 2009, a lot of workers left the industry. So, when things started to boom again, there weren't enough people to hire and that resulted in higher labor costs, explains Barbara Johnson, SIOR, first vice president of CBRE, Salt Lake City. "At the same time, the cost of materials increased—some of it, like steel, because of tariffs."

It's a Balancing Act.

Johnson gives the example of tenant improvements, which has become a tightrope walk. "It's been a real challenge for landlords, because if they stayed at the same percentage level of the past, the return on investment would shrink markedly due to the costs of building out the tenant improvements," she explains. "So, landlords are sticking to tight budgets for tenant improvements, which means the tenant will have to come out of pocket for additional costs." The compromise offered by the landlord is for the tenant to increase the length of the lease from—for example—five years to seven or eight years.

REPORT: THE EFFECT OF RISING CONSTRUCTION PRICES

Then the landlord will pay for the overage and amortize that cost over the extra years. The problem is, in Salt Lake City, tenants are generally tech companies who want to preserve capital to hire the best talent, and—because these companies are expanding rapidly—don't want to have a longer lease.

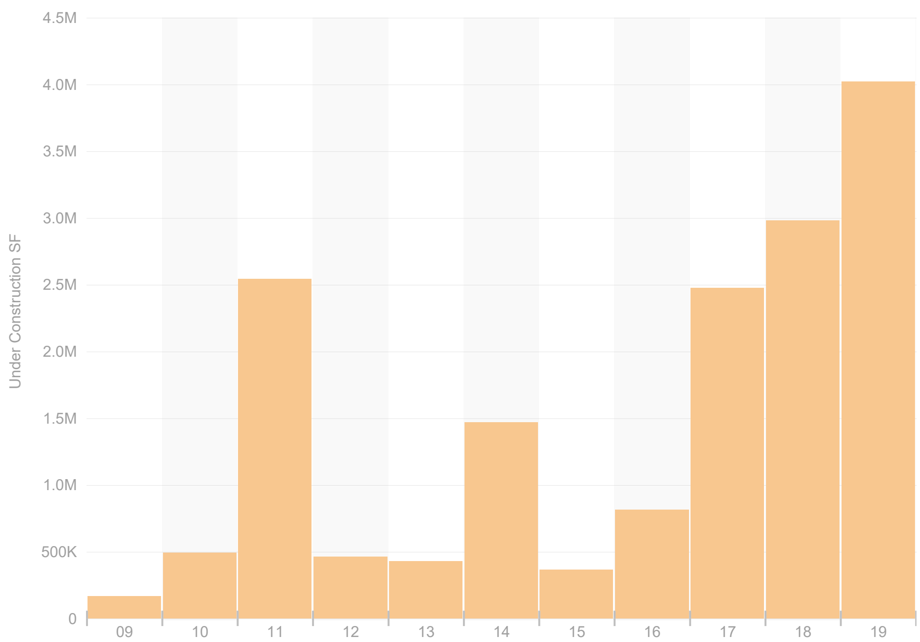
The Compromise Solution.

"The tenants say, 'If I have to commit for eight years, I would like to be able to terminate after five years, paying a penalty for the remaining tenant improvement dollars not yet amortized as well as the leasing commission for the remaining years'," says Johnson. The situation is not very different in Dallas, where Pruitt says, "the cost of construction to get any sort of space [that] people would like has outstripped the appreciation of the rent."

Pruitt adds, "Seven to 10 years ago, we got $50 per square foot in tenant improvements and we could build out the Taj Mahal. That's not the case anymore. Not only have costs increased but in the war for talent, the tenant demands higher quality space than 10 years ago."

All of this means that the tenant now has to come out of pocket to accommodate the needed finish, which has become an impediment to getting deals done. The compromise solution is for the landlord to pay for the more expensive tenant improvements but take a longer lease deal so as to amortize the expenses.

Richmond Industrial SF Under Construction Source: CoStar



"There is a misconception that lease terms are getting shorter," says Pruitt. "But, a recent study shows leases are getting longer [to] allow the landlord time to amortize the more expensive tenant improvements."

In economic terms, an increase in construction costs needs to be assimilated into the financial terms of the deal, explains O'Brien. "Generally, the landlords aren't eager to absorb additional costs resulting in lower returns, so the result is upward pressure on rental rates or longer lease terms so as to accomplish a longer amortization period."

"I would estimate over half of our clients are in growth mode and actively discussing expanding," says Jones. "The rising costs are putting pressure on tenants and affecting the way we approach deals. Twenty-four months ago, a tenant in our market who was going to up-fit a space from shell condition could build that space out for $60 per square foot. That number is now $85 to $90. That poses a challenge for a high growth companies, like tech firms, that want nice space, compete for talent, and expect to increase head count." These kinds of companies don't want to sign long-term deals. "What we try to do is focus on maximizing the tenant improvement allowance, but it no longer covers the total hard cost—so tenants are forced to cover the delta. Luckily—for now—interest rates are still low."

The tenant improvement allowance is only going but so far and the difference is needing to be made up by tenants, says Jones. "In the past, the difference could be bridged one of two ways, by the tenant out of pocket or by the landlord through the addition of a lease term, but operationally, many of our tenants don't want the longer term."

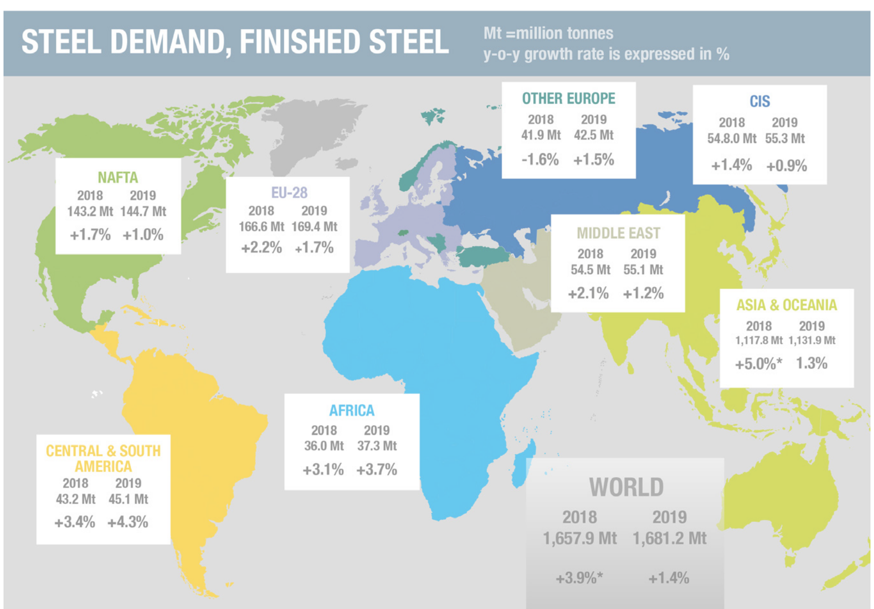
Build-to-Suit Developments Face Similar Issues.

Houston currently boasts 15 million square feet of industrial space under construction—25 percent of which is pre-leased or built-to-suits. As noted, the construction costs have risen 8 percent annually and industrial land prices are rising as well, says Land. "As a result, on spec projects, the asking rental rate required to make the project work is increasing proportionately."

If tenants don't have a very specific requirement, they need to look for other facilities that can be retrofitted versus building new, Land continues. "Tenants will need to [either] go smaller or find second generation space."

> **"I have not seen new projects scaled back because of higher construction costs, but instead, what I have seen are tenants changing to existing space. Tenants, who were dead set on building new, once they received the pricing, decided to focus on existing options that were more cost effective."**

"As we were making the decision on how to value-engineer the project to reduce bells and whistles and save some money, we did one more market review," Land recalls.



"An existing building showed up in our survey with a 30 percent savings compared to ground-up. We had land under contract and were negotiating with builders, but the project was becoming too expensive. The client was very happy that we found a cheaper alternative."

Pruitt was recently working a deal for a 400,000 square foot build-to-suit involving a national search, when his client contacted him on a Friday and said, "Chinese tariffs will be coming into effect on Monday." Pruitt's client realized by three that afternoon he could buy the steel at that day's prices before it went up 22 percent on Monday. Pruitt shares, "We hadn't even signed the lease and my client bought the steel that afternoon, telling us, 'If we don't do the deal with developer, worst-case scenario, we'll just sell the steel to someone else'."