

Logistics & Industrial

Infill Market Spotlight

Opportunities & Challenges to Growth

Q2 2024

- Given sustained occupier demand and a lack of supply, vacancy rates are sharper in infill markets, which has underpinned the outperformance of rental growth. This outperformance is expected to remain as just 13% of the supply pipeline over the next three years is within infill markets.
- Despite the aged profile of warehouse space in infill markets, occupiers have so far accepted this efficiency trade-off as proximity to population and the subsequent transport cost savings to service these households outweigh the downside of an aged facility.
- Delivering warehouse supply in infill locations comes with unique challenges; however, developers have a large opportunity to capitalise on the strength of occupier demand by adding new or refurbished stock to the market. Alternative use conversion and multi-level warehouses are potential solutions to add supply to these precincts and address the ageing stock profile.

WHAT IS INDUSTRIAL & LOGISTICS INFILL?

When talking about industrial land and warehouse space across a metropolitan area, it can broadly be split into infill and non-infill precincts. Infill precincts are those immediately surrounding population centres, have a lack of developable land, and provide ease of access to key infrastructure, including the CBD, ports, intermodal terminals, and airports, in the shortest period of time. Alternatively, non-infill precincts are those in the outer ring of each city where there is greenfield land to facilitate 'big box' warehouse development.

While both are just as important as the other, the composition of demand and stock varies considerably between each. The radius of infill land differs by city. Some infill precincts in Sydney are up to 25 kilometres from the CBD and include Milperra, Yennora, and Chullora, while the radius is smaller in markets like Brisbane and includes Eagle Farm, Rocklea, and Hemmant.

As industrial land expands in outer areas, occupiers are increasingly seeking strategic sites in central locations to facilitate last-mile delivery, both business-to-business (B2B) and business-to-consumer (B2C). The growth of e-commerce has underpinned this trend, and demand for infill warehouse space has been led by transport and logistics and retail trade occupiers. This trend has made infill sites a prime target for logistics and industrial (L&I) Investors, reflecting the sustained interest from occupiers.

INFILL MARKET PROFILE

Infill markets are tightly held, land-constrained markets that currently represent just 32% of warehouse floorspace nationally. Development of new supply is difficult in these locations, led by zoning and planning regulations and fragmented lot sizes and ownership. Accordingly, over the past decade, just 18% of supply additions nationally have been in infill markets. Further, our analysis shows that the average age of warehouses in infill markets is approximately 40 years, while just 7% of the current stock was built after 2010. By comparison, the average age in non-infill markets is 24 years, while 25% was built after 2010.

However, the implications of more aged stock are that a large share of infill warehouse space is unsuitable from an efficiency perspective for most occupiers. The trade-off for occupiers is that they have had to settle for inferior-quality space to be in locations where they need to be.

Most occupiers accept this efficiency trade-off, for now, as proximity to population and the subsequent transport cost savings to service these households outweigh the downside of an aged facility. For example, the occupiers that have been most active in infill markets (transport and logistics and retail trade occupiers) have been those with high throughput volumes, and reduced cubic capacity in these locations is less of an issue as most goods are only stored for a short period of time.

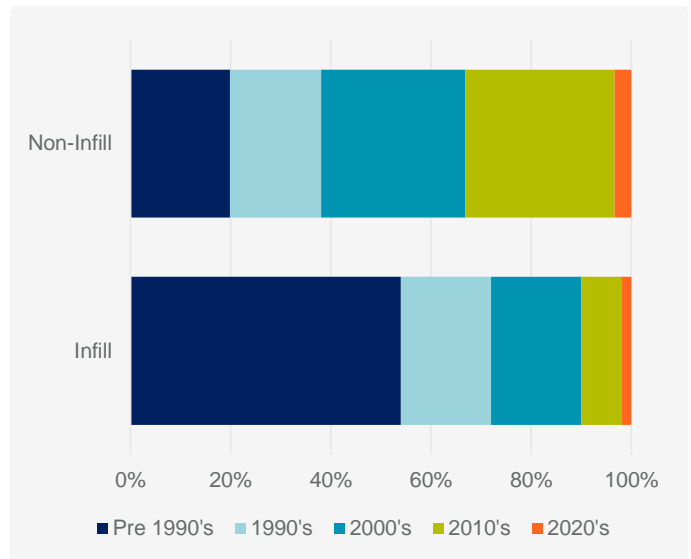
Furthermore, the strategic benefits of these locations are evident when their access to population is considered. Taking Melbourne as an example, a facility in Port Melbourne provides access to 4.0 million persons within a 45-minute drive time and compares to 2.8 million persons for a facility in Truganina for the same drive time. Additional benefits are also derived through a reduction in transport costs, which can represent up to 75% of total operational costs for some businesses such as e-commerce players (typically, it accounts for 50% of costs).

INFILL MARKET OUTPERFORMANCE

As a result of the mismatch between demand and supply, there has been a sharp decline in the infill vacancy rate in recent years. For the East Coast infill markets, the current vacancy rate is just 0.9%, compared to 1.8% for non-infill markets. The lower level of vacancy has translated into the outperformance of rental growth – prime rents in infill markets jumped 22% in the year to March 2024, well above the 14% recorded for non-infill markets over the same period. There is now a 35% rental premium in infill markets.

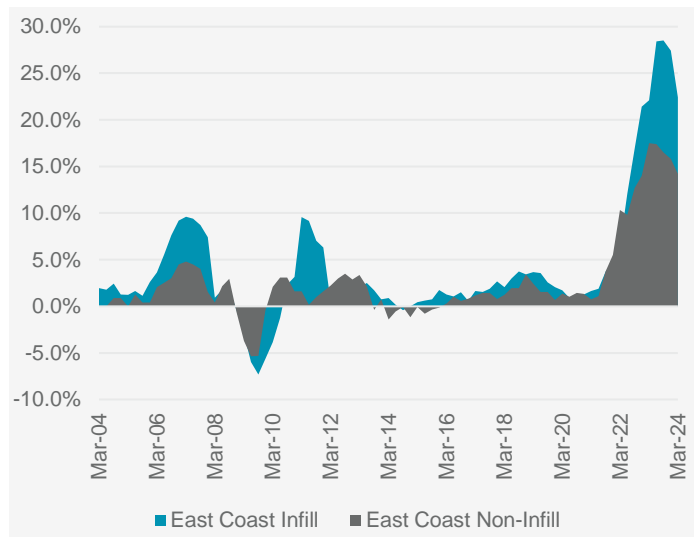
Going forward, this outperformance is expected to remain. At a national level, prime rents are forecast to grow by ~6.0% in 2024, while select infill markets are expected to record growth closer to 8.5% - 10.0%. The catalyst behind this outperformance is the subdued supply pipeline. Over the next three years, just 13% of new supply will be in infill markets (approximately 850,000 sqm in total), and for markets like Sydney, this is increasingly through multi-level developments.

East Coast Logistics & Industrial Building Age by Decade



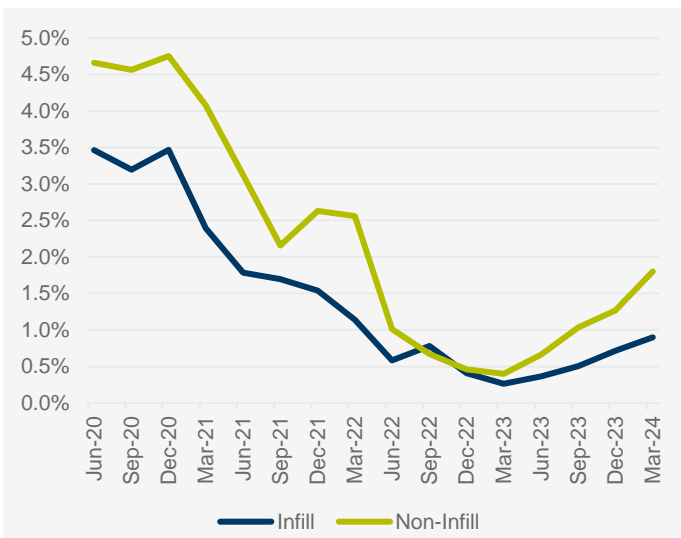
Source: Cushman & Wakefield Research

East Coast Prime Annual Rental Growth



Source: Cushman & Wakefield Research

National Logistics & Industrial Vacancy Rate



Source: Cushman & Wakefield Research

UPGRADING AGEING STOCK

While the current age profile of stock in infill markets has created challenges, particularly for occupiers looking for modern and efficient space, it is creating opportunities for developers looking to capitalise on the strength of the occupier market. Obsolescence has become a key topic. However, delivering warehouse supply in infill locations comes with unique challenges, including limited space availability, higher land costs, and tighter zoning and planning regulations. At the same time, competing land uses and a focus on housing supply further underscores the challenge.

Despite the challenges, the limited level of supply in infill markets provides developers and landowners with a window of opportunity to capitalise on the imbalanced supply and demand fundamentals. Potential solutions or opportunities to add newer and additional supply to the market could include:

- The **re-use or refurbishment** of existing facilities, increasing the scope for owners/developers looking to capitalise on the rise in demand and driving rental growth. This could include the extension of existing assets, refurbishment of current improvements or a phased capex expenditure roadmap that delivers ESG initiatives.
- **Redevelopment** of the site, including multi-level warehouse development, to maximise site efficiency.
- **Alternative use conversion**, such as large format retail centres. While this trend is more pronounced in the US, the planning approval process in Australia will be a challenge, and each site would need to be assessed on its merits. However, select developers are actively pursuing this strategy as most large format retail centres are in infill locations with immediate access to major road networks.

Despite land prices in infill locations often being double those of non-infill locations, the feasibility of projects still stacks up, given the rental premium and economic rents being at a level that still makes sense for occupiers to pay. With these locations starved of new warehouse space, tenants have shown the ability to pay a premium rent for such facilities, given the downstream efficiencies.

Based on current land prices, economic rents in Western Sydney are in the order of \$230-\$240/sqm, while for infill markets in Sydney, they are closer to \$350/sqm. For infill markets in Melbourne and Brisbane, economic rents are closer to \$180-\$200/sqm. Similarly, warehouse construction costs have held steady over the past six months, which has aided the feasibility of projects as rents have continued to grow.

THE FUTURE OF INFILL MARKETS

A solution to deliver additional warehouse space to infill markets could be multi-level warehousing. While multi-level warehouses are still rare outside of Asia, there is a growing pipeline of projects in select Australian markets where there are severe land shortages. While the feasibility of such developments would need to be assessed on a site-by-site basis, it would help alleviate supply pressures currently being experienced by providing additional floorspace than otherwise would be provided.

The multi-level warehouse trend in Australia has been initially focused on the Sydney market, given higher land values and rents, which has made multi-level warehouse projects feasible. Our analysis shows that there is over one million sqm of multi-level warehouse space in the pipeline – all at various planning stages. Close to 700,000 sqm of this space is outside of the South Sydney market, with projects underway or earmarked at Milperra, Revesby, Punchbowl and Macquarie Park, among others.

Despite multi-level construction costs being more than double single-level warehouses at \$3,000 - \$3,700/sqm, the jump in rents has supported development feasibilities and select institutional developers are asking rents of \$450 - \$525/sqm net for projects completing in South Sydney in 2024 and 2025.

For occupiers, the major benefits stem from the ability to occupy new and efficient space, while from an overall occupancy perspective, outgoings for multi-level warehouses range in the order of \$35 - \$60/sqm and compares to \$90-\$120/sqm for traditional warehouses in the same area.

Outside of Sydney, rents need to grow further before multi-level developments become feasible, particularly as construction costs remain similar across the states. However, in the long term, they will become a more viable option for developers and will assist in delivering much-needed supply to markets where tenants want to be.

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