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Despite influx, investors like industrial space

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Similar to the office market, industrial real estate in the Austin area is experiencing an influx of space. A million square feet is under construction or recently completed in the southeast market, and 1 million square feet is under construction or proposed in other submarkets throughout the region, with much of the space coming online in 2008.

While absorption remained healthy in 2007 at nearly 1.8 million square feet, according to NAI Austin, 2 million square feet of new space is poised to have a big impact on the existing 34 million square feet of industrial space in the region.

Several trends are affecting the industrial market in Central Texas: investor interest, the shake-up at **Dell Inc.** and historically high rental rates likely to remain steady.

The development of new industrial space is largely a result of the region's growth trajectory. Investors are looking for solid bets, and commercial real estate continues to promise good returns. Less focused on quarterly ebbs and flows of the local economy, investors see long-term returns. Investors are not naive; they are taking into account the region's absorption rate and influx of space. And to them, Central Texas remains compelling.

The waters are not calm, however. Besides millions of new square feet of space, Dell's recent announcement of a plant closure will eliminate 900 jobs and is beginning to affect the Austin industrial market. The Dell ecosystem, which includes logistics and other service companies in the region, represents a substantial amount of real estate, particularly in the northwest market.

Based on Commercial Texas' initial analysis, more than 300,000 square feet, and rising, of industrial space is becoming vacant as a result of the move. The ramifications of Dell's action will likely unfold over the next year, and the resulting vacancies could easily surpass 500,000 square feet.

Besides the relocation of the Dell plant to North Carolina, the slowdown in the national economy is hitting businesses in the region in a new way. The double whammy will mean companies transition out of Central Texas, decrease their space or take less space for the time being.

Companies are being more cautious regarding their lease commitments. Industrial tenants, worried about the larger economic woes, are doing more with less. Although this may be partly psychologically driven, it's possible that many businesses are seeing reduced demand and orders.

Price per square foot remains high. In the previous six months, about half the industrial rental rates in the region remained stable, while half increased by up to 8 percent, according to a study by Commercial Texas' Industrial and Land Group.

Investors seeking a return are raising prices, while the costs of new developments, materials and land play key roles.

Certain types of industrial spaces are more popular, for now. Flex space, typically one-story buildings with high ceilings, rear loading docks, surface parking and generous landscaping, transitions into office space. The building shells are designed to accommodate office, light manufacturing and/or warehouse space. Because the space tends to be less expensive, office users are drawn to it as an alternative.

Flex space is a double-edged sword for landlords and tenants. Once office rental rates decline, tenants flock to deals. Landlords left holding the converted space, or tenants wanting to move out and up, find it difficult to lease or sublease an industrial space built out for office users.

Absorption in the Austin area averages 1 million square feet per year. With new product coming online, development may temporarily outpace demand, but some areas may be better off than others.

Most commercial real estate experts in the region agree the southeast market was underserved in industrial development. Supply is finally catching up with demand in this part of town, which features attractive land prices and proximity to the airport. Not long ago, being near the airport was about convenience; today, it is also about the cost of diesel.

The industrial real estate market generally lags 18 months behind the office market. It's likely the latter half of 2008 and early 2009 may be sluggish for leasing. But developers remain optimistic about their long-term investments.

Industrial tenants are hoping for rental rates to decline, but it's not likely to happen in the next two quarters. The good news for tenants is they will likely begin to see concessions, which could include some free rent or more tenant improvement dollars.

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