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KEYNOTE INTERVIEW

Small-bay tenants are industrial's unseen engine

Multi-tenant infill industrial offers resilience, stability and rent growth across market cycles, according to Lincoln Property Company's Gary Kobus and Tom Kuhlmann

Small-bay, multi-tenant industrial buildings are compelling investment opportunities as new construction costs and land values for modern infill buildings soar. Buildings under 100,000 square feet, including vintage structures, offer a sweet spot for smaller tenants, including sole proprietors and family businesses, explain Gary Kobus and Tom Kuhlmann, co-heads of logistics with Lincoln Property Company.

Infill tenants value location over building features, breathing new life into logistics sites close to bustling metropolitan areas. With fewer small spaces available, occupancy is stable, demand is high and landlords enjoy sustained rent growth.

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Q What kind of tenants are attracted to small-bay industrial sites?

Tom Kuhlmann: Tenants interested in these buildings often distribute products, food and beverage, consumer goods or building products, commercial storage or light manufacturing… all those high-traffic uses thriving on the efficiency of being in that last mile or critical location. If you think of a hub and a spoke, these are the spoke locations.

Gary Kobus: A distributor of health supplements, for example, would get the product in one side of the warehouse in bulk truckloads and then distribute it to their local clients out the other side of the building in smaller bobtail trucks. Goods come in overnight, they break down the loads, package them up into smaller loads and ship out on the smaller trucks. The building is packed full in the morning but by the afternoon it is empty again. That happens every single day. These infill locations are critical for distributing this inventory efficiently.

Q What makes these infill sites more compelling than larger industrial buildings?

GK: Our investments are primarily focused on infill, multi-tenant buildings for tenants generally in the 20,000-70,000-square-foot range, as opposed to 500,000- to one-million-square-foot bulk distribution buildings. Tenants in bulk distribution buildings sometimes have investment grade credit, but we believe the residual risk in these larger buildings is much greater. We believe the capital markets neither fully understand nor price that risk accurately.

Those large buildings are built to maximize throughput at the lowest cost possible per SKU. Large building users have their own throughput models, impacting things like column spacing, trailer storage, parking ratios, truck court depth, building depth and clear height, but the specifics and mix of those building characteristics change in each bespoke throughput model. Worse yet, even the throughput model of a given tenant is constantly changing as they seek to maximize efficiencies.

When those leases roll (and they will!) another tenant will not necessarily fit well into those buildings. Compounding the residual risk, many of the largest buildings are located in areas with abundant land, and when a tenant's lease expires, they frequently just build a new distribution center that meets the criteria of its newest throughput model. This results in stagnant market rents that can last for decades.

As a result, you may find yourself with no alternative other than to divide the large buildings into smaller spaces to meet the only demand that may exist – an expensive and risky strategy.

Q Are there any infill industrial assets that investors should avoid?

GK: It should not be construed that every building in an infill location is a good buy for this strategy. Even for 1960s-70s vintage buildings, there are fundamental feature requirements we consider non-negotiable.

A building must have a good door-to-floor ratio, flow for inventory and ingress/egress through the dock doors. We look for specific buildings which are in limited supply. Importantly, buildings must meet the preferences of tenants in a local market. Just because a building is in an "infill location" does not mean that building serves the needs of local tenants well.

TK: We have a list of criteria that must be met for us to invest. There are certain features that you must have in all buildings regardless of age. Some buildings have these features, and some do not. And many times, when you experiment with ones that do not, when those tenants roll and you then need to re-tenant the facility, you can run into trouble if you have not checked all your boxes or if you have drifted away from your discipline. After 25 years focused on this segment, we understand what creates durable results, and we hold fast to that quality and discipline.

Buildings up to 250,000 square feet in infill locations near metropolitan areas where land is scarce, and therefore expensive, are our targets. Tenants are smaller, some are as small as 5,000 square feet in these locations, but they need proximity to their client base for last-mile distribution to consumers. Beyond quick delivery, they need access to labor and, quite frankly, to their own homes and quality of life. So, location becomes an overwhelming decision criterion when selecting buildings.

> *"The global financial crisis validated our thesis: infill small-bay, multi-tenant assets, despite the perceived lack of credit tenancy, proved fundamentally resilient"*
>
> **GARY KOBUS**

TK: This is the difference between local distribution and regional distribution. They want to be within immediate proximity of the city. It is not that these tenants do not prefer more function, they do and will certainly take it, but it is just not as critical as location.

Considering that, everything else is forgiving. Replacement is very difficult in infill locations. By its very definition of being infill, land is mostly built out. When you create more sites, you have to make way by demolishing buildings, which we can do, but it is a costly proposition. We find this tenancy is more forgiving on the product type in the desired location, however, we are still very selective with our building criteria.

These tenants' desire to continue in business makes them stickier, and more likely to renew. When buying these buildings, you model their probability of renewal. After operating these types of buildings for 25 years, we can forecast it well.

> *"Infill small-bay industrial does not just weather market cycles, it thrives through them"*
>
> **TOM KUHLMANN**

Q What about the creditworthiness of these smaller tenants, are there any risks there?

GK: One of the critiques of buying infill small-bay, multi-tenant buildings is that many of these tenants do not have investment grade credit. Indeed, some of these companies are literally sole proprietors or family-run businesses.

Tom and I have been buying these buildings since 2000, before it was fashionable to do so. Before the GFC, we were buying these infill buildings readily and easily because we were focused on a different segment of the market than other investors.

When the GFC hit in 2008, it was the ultimate litmus test of our theory. Our occupancy, which was usually in the mid-90 percent range across our logistics portfolios, declined like everybody else.

It was obviously a widespread, severe economic downturn, global in nature and across all industry types. It took four years for our portfolio occupancy to fall to 81 percent, and that was the lowest it got.

But then in 2012, it took just 18 months to recover to the mid-90s. And during that time, we were cashflowing and did not have any debt service problems with lenders. It was really eye-opening.

We thought about why that was, and you can imagine that for these small proprietorships, this location or business is their sole source of income. So, in a tough time, they are literally doing everything they can to survive. In instances where the businesses did fail, we found that it took them a lot longer because they were fighting so hard.

In short, the global financial crisis validated our thesis: infill small-bay, multi-tenant assets, despite the perceived lack of credit tenancy, proved fundamentally resilient.

Q How can investors and managers contain the risks?

GK: That gets to the heart of the misunderstanding of risks in larger and smaller buildings: for larger buildings it is the residual risk and in the smaller buildings it is tenant risk. There is a widely held perception that single-proprietor tenants are not worthy of being placed in an institutional portfolio. Our typical portfolio credit loss is 0.5 percent in any given year, though we underwrite 5 percent to be conservative. During the GFC, our portfolio credit loss got to 3 percent, and that was the worst global downturn in history. That is pretty resilient.

One of the beautiful things about these small-bay distribution tenant portfolios is they are highly diversified by industry classification. So, what you may not get in individual tenant credit, you diversify that risk across many industries.

Combine that downside protection with the lack of available space and scarcity of competing buildings, and you have tremendous pricing power to drive rents going forward.

The same sort of revenue growth year-on-year is always very attractive. You want to minimize the variables that you cannot control and buy into deals that have exceptional ability to generate alpha for investors based on that stability.

When you combine that kind of moderate risk with the high potential to drive revenues and a lack of supply to stave off competition, that is the best place to be.

TK: Taking a generalized approach to this business is problematic. It certainly works if you are allocating into a wave like we had after covid-19. When everything works, it is great to allocate and scale. But to optimally operate through down cycles, corrections and shifts, you need a vertical operation where you understand the product from a management standpoint, leasing standpoint, construction standpoint, buying standpoint and selling standpoint at scale.

Infill small-bay industrial does not just weather market cycles, it thrives through them, and Lincoln's decades deep expertise shows exactly why this overlooked segment remains one of the most resilient and compelling plays in industrial real estate. ■