

# INDUSTRIAL MARKET REPORT

Year-End 2016

Accelerating success.

## Lack of Available Inventory Inhibits Market Growth

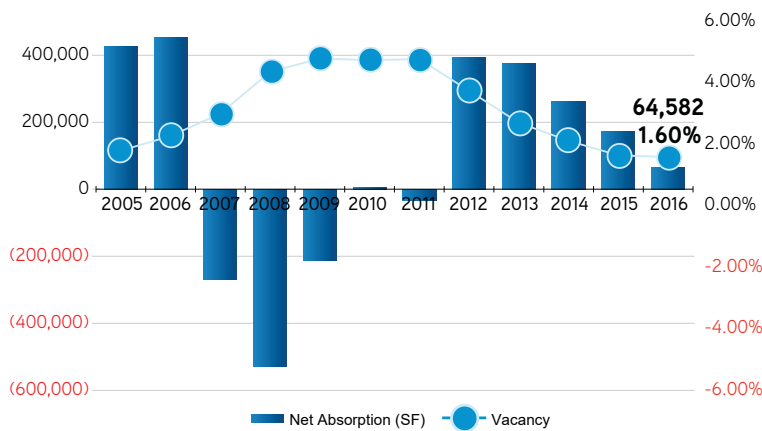
Mike Hamasu Director of Research | Hawaii

The Oahu industrial market posted a positive 74,534 square feet of fourth quarter occupancy growth resulting in 64,582 square feet of year-to-date net absorption for the year. The island-wide industrial vacancy rate declined from 1.65% to 1.60% over the past year. This is the fifth consecutive year of decline in vacancy rates which had declined from 4.78% recorded at the end of 2011.

*“A few speculative new developments will do little to alleviate the pent-up demand that the market has generated. Current conditions are likely to persist into 2017.”*

Alika Cosner (S), Senior Associate

### Industrial Net Absorption vs. Vacancy Rate



### Market Indicators

Relative to prior quarter

Year End 2016

VACANCY	↓
NET ABSORPTION	↑
CONSTRUCTION	↑
RENTAL RATE	↑

### Summary Statistics

4Q 2016 Industrial Market

4Q2016 Net Absorption	64,582 SF
Vacancy Rate	1.60%
Direct Weighted Average Asking Rent	\$1.21 PSF/Mo.
Average Operating Expense	\$0.35 PSF/Mo.

Typically, a market with vacancy rates below 2% is indicative of a market with heightened tenant demand. Oahu benefitted from another record in air passenger arrivals which fueled resort retailer demand for additional goods, which in turn boosted wholesale/distributor requirement for additional warehouse space. A good reflection of the level of warehouse demand is reflected in the elevated amount of cargo that is being shipped through Honolulu Harbor. The State of Hawaii Harbors Division recorded a second consecutive year where more than 11 million short tons were shipped.

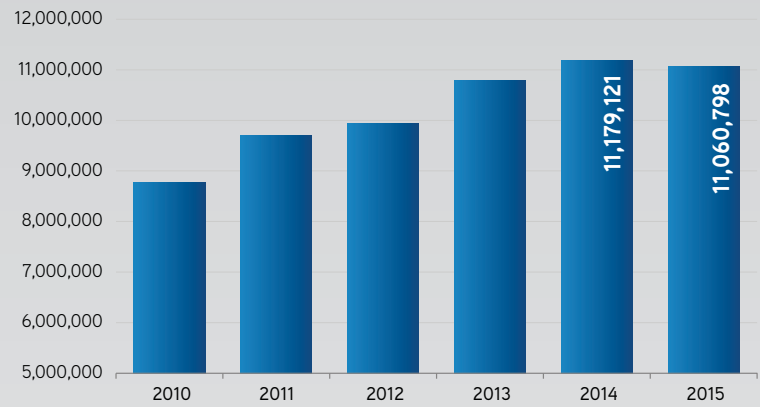
Warehouse demand was also boosted by the surge in construction activity that occurred. For the past two years, the July year-to-date contracting sales for Oahu surpassed \$3.5 billion, which is comparable to the activity recorded during the peak of the last boom cycle in 2007.

While there was a decline in contracting sales volume in 2016, this sector is anticipated to remain healthy with more than \$1.8 billion in permit volume for year-to-date October 2016.

Billions of dollars in new residential tower development is planned or currently being spent in the Ala Moana/Kapiolani/Kakaako corridor. The 10 condo towers proposed or under construction for this area reflect positive signs that construction activity will remain healthy through 2017 and into the foreseeable future.

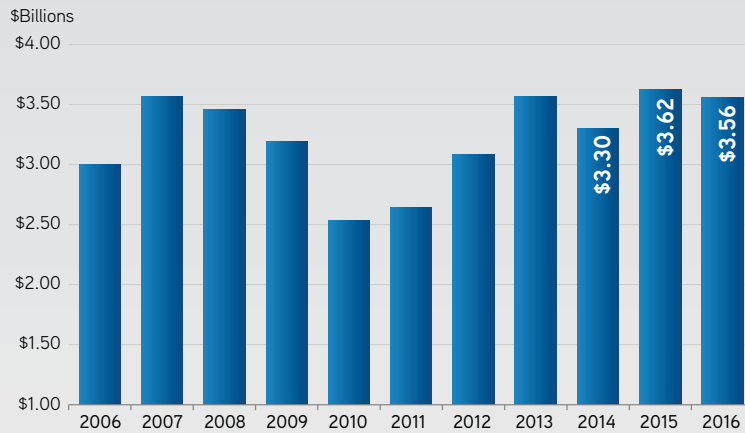
- > Sam Koo's Kapiolani Residence
- > Salem Partners' Heald College redevelopment
- > Mana Olana Partners' condotel
- > Pros Pac Holdings' Keeaumoku condo towers
- > Hawaii City Plaza LP's Hawaii Ocean Plaza
- > MJF Development Corp's Ohana Hale
- > Forest City Hawaii's 690 Pohukaina
- > Howard Hughes' Aeo, Anaha, and Ke Kilohana

### Honolulu Harbor Short Tons (Fiscal Year-End)



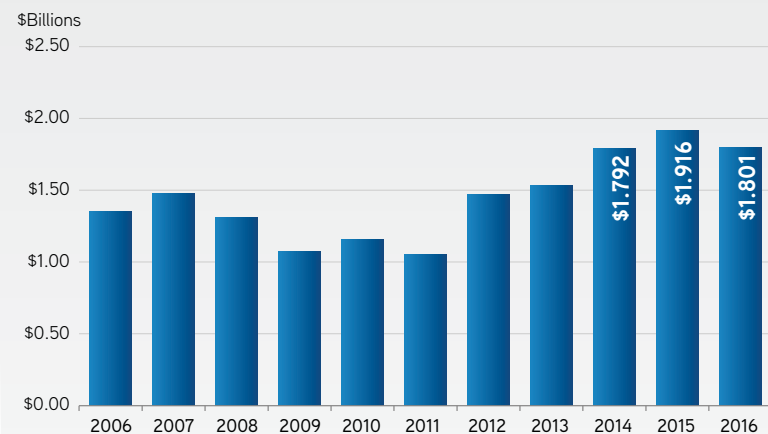
Source: State Harbors Division

### Contracting Sales (July YTD)



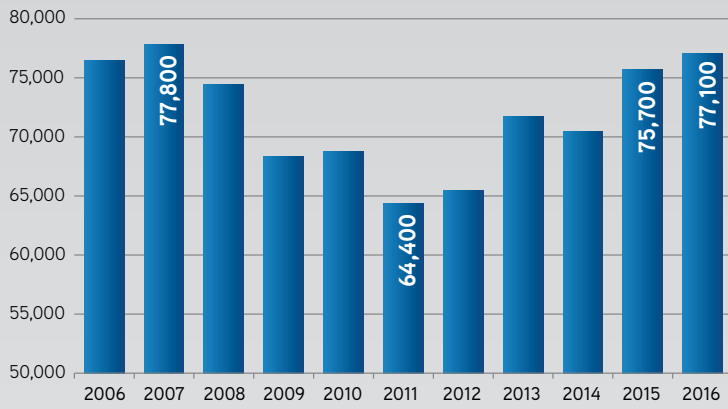
Source: State Dept. of Taxation

### Building Permit Volumes (October YTD)



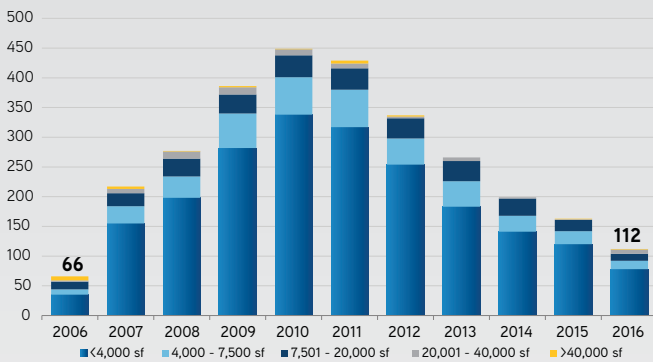
Source: DBEDT

## Oahu Industrial Jobs (October)



Source: DBEDT

## Oahu Industrial Listings by Size Categories



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Industrial businesses employed a total of 77,100 workers for October 2016, nearly meeting the peak levels established in 2007. This sector has steadily gained nearly 13,000 jobs since 2011, which is a robust 19.72% growth rate over the past five years. The construction industry established a new record in October with 29,700 total positions, far surpassing the 27,500 construction jobs registered for July 2008 at the height of the last boom period.

While there are many developments that have garnered funding and have been officially announced, there are also pending projects that developers are trying to figure out how to make financially feasible. With Oahu's unemployment rate falling to 2.9% for November, it has exacerbated the difficulty in finding qualified staff for most industry sectors, especially for skilled construction trades. Shortages in construction manpower contributed to the rapid increase in labor costs that have made Honolulu the most expensive metropolitan market in the U.S. to build in.

With the Federal Reserve planning additional interest rate hikes for 2017, developers will likely encounter more difficulties with keeping their construction budgets under control as borrowing costs begin to escalate. The hope is that Hawaii's inflationary pressures are dampened by rising interest rates which prevent our economy from overheating.

The number of warehouse listings continued to shrink, falling 31% to its lowest level in ten years with 112 availabilities. All listing size categories under 20,000 square feet declined by more than 35% over last year's levels. The listings in the 20,000- 40,000 square foot category rose from one listing to seven listings, while listings over 40,000 square feet in size remained flat with one listing.

## Rental Rates Surge Upward

The island-wide direct weighted average asking base (NNN) rent rose for the fifth consecutive year, hitting a eight-year high at \$1.21 per square foot per month (“psf/mo”). This is a healthy 7.0% jump in rents over the past year and a whopping 31.5% jump since the end of 2011. The high occurred at the peak of the last boom period at over \$1.30 psf/mo when several industrial condominiums were delivered to the market.

While industrial condo development is not anticipated for the near term time horizon, the lack of available space for lease, especially in urban Honolulu, will continue drive warehouse rental pricing upward. It’s not uncommon to find asking rents ranging from \$1.35 to \$1.50 psf/mo for prime locations, which are much higher than the island-wide asking rent.

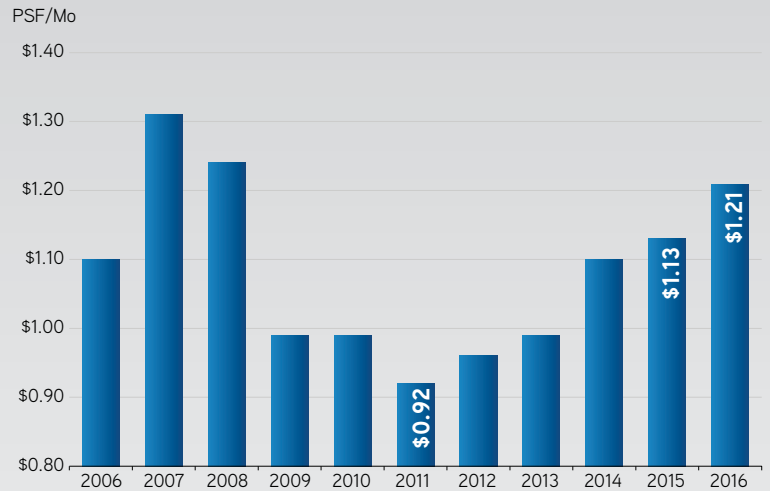
The Oahu Industrial Lease Comparables Regression Analysis chart provided corroboration for the direction warehouse rental rates have taken over the past few years. Colliers plotted negotiated base rents for warehouse leases and identified the trend line for the median base rent. Similar to the asking base rent graph, negotiated rents have moved upward since 2012.

## Urban Honolulu Industrial Land Values Inhibits Development

As average base rents continue to increase, the question arises as to whether or not new warehouse development in urban Honolulu can be justified. Unfortunately, the feasibility of speculative development still remains out of reach due to high land prices in the urban core. In 2016, land values for the Iwilei, Airport/Mapunapuna, and Kalihi/Sand Island markets ranged from \$100 to \$140 per square foot. Market rents would have to double to make development viable.

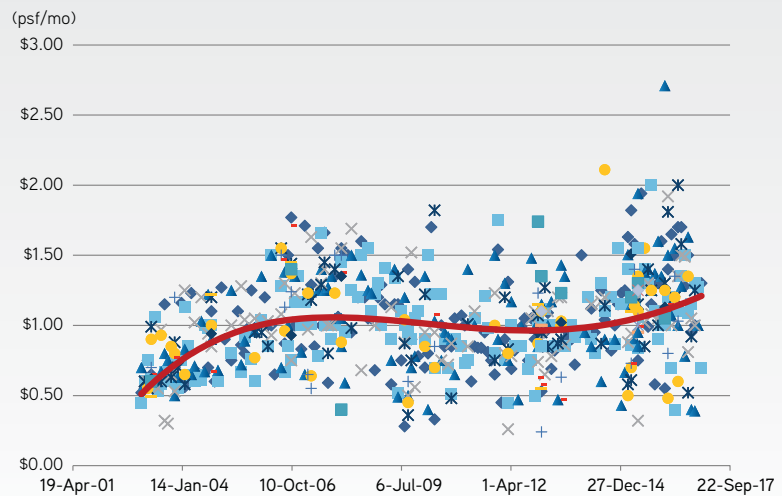
Currently, West Oahu industrial parks would be the only likely alternative for warehouse development. With land priced below \$40 per square foot, developers are beginning to explore speculative development after nearly nine years.

### Oahu Industrial Direct Wtd. Avg. Asking NNN Rents



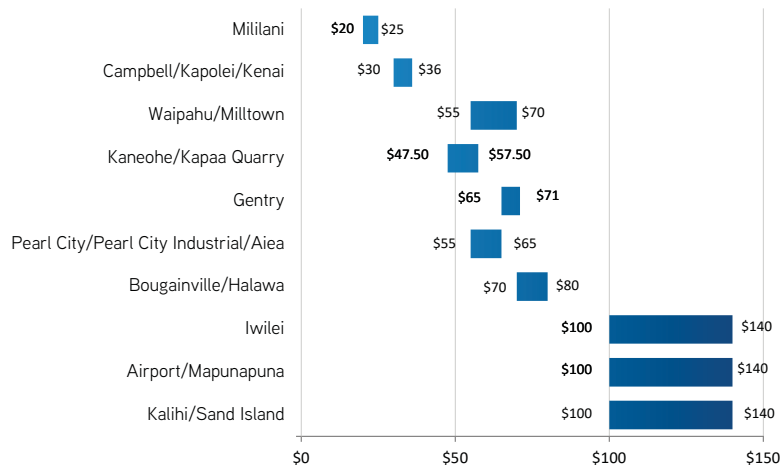
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### Oahu Industrial Lease Comparables Regression Chart



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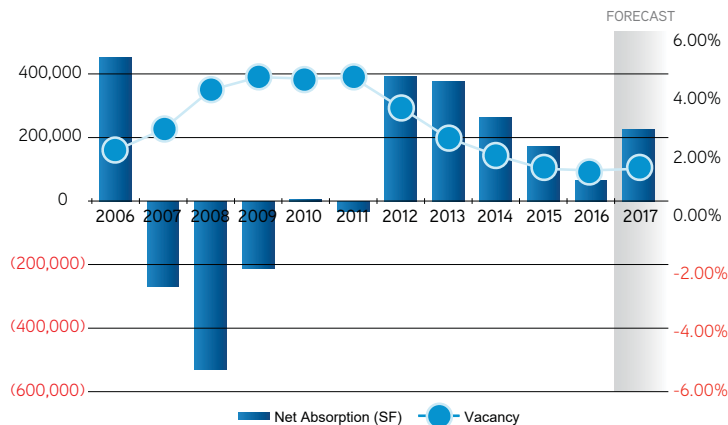
### 4Q2016 Finished Lots Industrial Estimated Land Values



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## Tight Conditions to Persist for 2017

**Industrial Net Absorption vs. Vacancy Rate Forecast**



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this project is noteworthy, more than 400,000 square feet of available space would have to become available in order to increase the island’s industrial vacancy rate by 1%. It is highly unlikely that Oahu’s industrial market will reach equilibrium (where landlords and tenants have equal lease negotiating stances), as more than 1.5 million square feet of warehouse spaces would have to be built for a 6% vacancy rate to be achieved.

Colliers anticipates that tight market conditions will persist for 2017 as industrial warehouse tenants will continue to find it challenging to expand or relocate their businesses. While Oahu’s industrial development cycle is in its infancy, rising rents combined with a growing economy would be the catalyst needed to fuel additional warehouse development. For the near term, Colliers anticipates that vacancy rates will remain near 2% for the rest of the year, and warehouse rents will likely increase by a healthy 7% to 10% for 2017.

After five consecutive years of declining vacancy rates and rapidly rising rental rates, the Oahu industrial market is not likely to see a reprieve until development activity adds much needed inventory. The recent marketing of units for Kapolei Trade Center should provide added options for those tenants seeking the opportunity to purchase an industrial condominium.

The Kapolei market is also primed for the development of its first speculative “for lease” warehouse building. As Scott Mitchell noted, the Avalon/Walton Street Capital will be the first speculative warehouse built since 2007. While



Kapolei Trade Center



Kapolei Business Park 2 Lot 20



## Speculative Development Explored

Scott L. Mitchell (B) SIOR Executive Vice President | Office Services Division

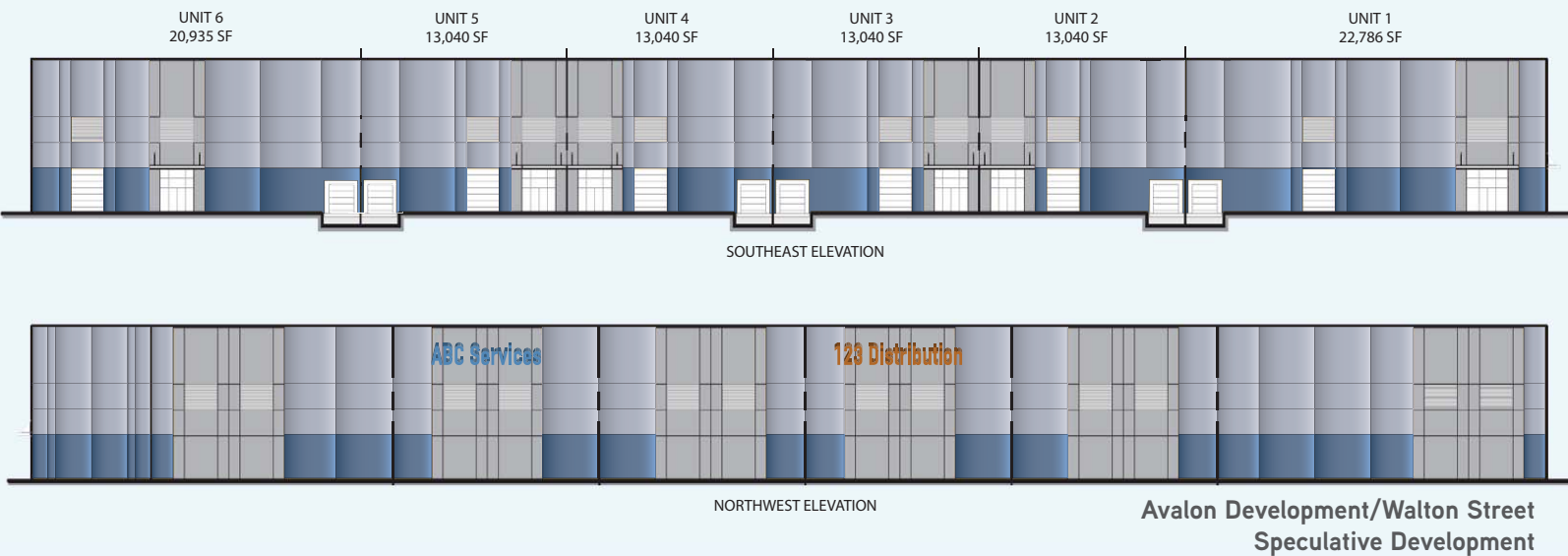
The rising tide of an economic recovery, especially one that has gone on for as long as this one has, normally lifts all ships. In the real estate arena that would mean each of the respective sectors should have benefited by new “speculative development”. Looking around town, it is fairly obvious which ones have benefited the most during this recovery.

The high-rise condominium market has seen its biggest gains, probably in the history of the urban core. Billions have been spent on development. New apartment rentals have been constructed from Hawaii Kai to Kapolei. The retail sector has successfully added everything from small strip centers to regional malls. Even some hotel rooms have been added in Waikiki. The only laggard has been the office market as market conditions are not strong enough to support development.

For the industrial marketplace, I am often asked, “Why is there no new speculative development occurring?”. After all, we really need the space. My answer may be surprising, but in all fairness, that depends on your definition of speculative development.

By my definition, hundreds of millions of dollars have been spent during this recovery cycle. Think about the acquisition, entitlement and development of Malakole Industrial Park, Kapolei Business Park Phase 2, and Kapolei Business Park West. Gentry Homes has commenced construction of a small light industrial subdivision in Ewa Beach across from the Honouliuli sewer treatment plant. All of these are 100% pure speculative developments.

The other definition is one more likely alluded to by those asking the above question and relates to the addition of new vacant warehouse space constructed for lease by end-users. There are two answers here.



The first is quite simple. You cannot build new warehouse space if there is no land available to build on. By the end of the last recovery in 2007, virtually all remnant industrial land around town had been absorbed except for a few scattered parcels. New developable land was well on the way in the parks mentioned above. Then the bottom fell out of the economy in 2008 and those projects were foreclosed on, delaying their delivery.

Ideally, that land should have been delivered as the market was bottoming during the 2008 to 2010 period as will be discussed in the second answer to the question posed.

The formula for successful speculative development relies on the right combination of several key components to occur within the right market timing. Those components are strong demand and rising rents, cycle low land costs, pre-recovery construction costs, low to moderate cost of capital (interest rates) and adequate supply of land. The end goal is being able to construct new product that gives the developer an adequate reward to take on the risk of building.

Each one of these components has a wide variety of nuances that can affect the decision to build and a minimum of four or five components are needed for speculative development to be favorable.

The delays in delivery of the new land inventory when it was needed the most, caused a ripple effect in the “spec-build” decision process. It did not stop owner/users from buying and building new facilities, but during the 5-year delay while the bulk parcel ownerships changed hands, new capital needed to be sourced and planning and construction of roadways and infrastructure had to occur. This meant delivery of the land well into the economic recovery cycle. The result was higher land prices, higher construction costs and, in turn, a higher degree of risk in achieving desired returns. Had the land been available earlier as the market was bottoming and before construction costs began to rise, more land would have sold to speculative investors and the economics would have worked out much better.

Having said all this, some speculative development is still occurring despite the late delivery of land. Avalon/Walton Street Capital is planning to deliver 96,000 square feet of new, high quality, high cube warehouses for lease in Kapolei Business Park. Since they bulk purchased the park, their land basis gives them more room to make the numbers work. Several smaller lot buyers have invested profits earned during the recovery and plan to build warehouses for lease as an additional income source. Lastly, some of the owner/users are building more space than they need and will be leasing the balance out to the open market.

The bottom line is that timing was a little off this cycle because the delivery of needed land was delayed, stretching some of the economic and timing for speculative construction considerations to their limits. We may have to wait until the next cycle to see enough speculative development to impact the record low vacancy and tight market conditions.

# YEAR-END 2016 Oahu Industrial Market Statistics

## INDUSTRIAL MARKET - BY SUBMARKET AREA

	NO. OF BUILDINGS	BUILDING AREA (SF)	TENURE*	AVAILABLE SPACE (SF)	4Q2016 NET ABSORPTION (SF)	YTD NET ABSORPTION (SF)	VACANCY RATE	DIRECT WTD. AVG. NET ASKING RENT (NNN) (PSF/MO)**	AVG. NET OP. EXP. (PSF/MO)
<b>HONOLULU</b>									
Iwilei	97	2,355,935	Fee Simple	87,172	4,103	(31,372)	3.70%	\$1.47	\$0.46
Kalihi	699	9,431,157	Fee Simple	204,983	(32,539)	(19,572)	2.17%	\$1.17	\$0.41
Sand Island	73	569,853	Leasehold	5,500	(5,500)	4,443	0.97%	\$1.36	\$0.30
Mapunapuna	107	4,214,301	Leasehold	8,154	18,250	34,770	0.19%	\$1.20	\$0.35
Airport	125	4,641,933	Fee Simple	35,800	5,300	(973)	0.77%	\$1.02	\$0.28
<b>Total Honolulu</b>	<b>1,101</b>	<b>21,213,179</b>		<b>341,609</b>	<b>(10,386)</b>	<b>(12,704)</b>	<b>1.61%</b>	<b>\$1.23</b>	<b>\$0.41</b>
<b>CENTRAL OAHU</b>									
Bougainville	20	806,460	Leasehold	20,257	0	(20,257)	2.51%	\$1.25	\$0.38
Halawa	84	2,634,833	Leasehold	46,472	(19,665)	(7,792)	1.76%	\$1.25	\$0.25
Pearl City/Aiea	32	1,660,582	Fee Simple	18,700	15,389	9,300	1.13%	\$1.34	\$0.48
Pearl City Industrial Park***	45	762,292	Fee Simple	0	4,760	14,413	0.00%	\$1.23	\$0.37
Gentry Business Park	67	1,778,759	Fee Simple	10,025	48,842	14,743	0.56%	\$0.94	\$0.36
Milltown	36	432,280	Fee Simple	0	2,000	10,900	0.00%	\$1.30	\$0.47
Waipahu	127	2,712,193	Fee Simple	17,000	21,496	36,640	0.63%	\$0.50	\$0.07
<b>Total Central Oahu</b>	<b>411</b>	<b>10,787,399</b>		<b>112,454</b>	<b>72,822</b>	<b>57,947</b>	<b>1.04%</b>	<b>\$0.90</b>	<b>\$0.23</b>
<b>WEST OAHU</b>									
Campbell Industrial Park	121	4,960,296	Fee Simple	49,709	(13,955)	(23,126)	1.00%	\$1.23	\$0.20
Kapolei Business Park	51	1,431,910	Fee Simple	76,823	18,653	23,725	5.37%	\$1.26	\$0.35
Malakole Industrial Park	3	197,000	Fee Simple	0	0	0	0.00%	\$1.23	\$0.20
Kenai Industrial Park	12	90,680	Fee Simple	0	0	0	0.00%	\$1.23	\$0.20
Kalaeloa Industrial	5	47,137	Fee Simple	0	0	0	0.00%	N/A	N/A
<b>Total Kapolei</b>	<b>192</b>	<b>6,727,023</b>		<b>126,532</b>	<b>4,698</b>	<b>599</b>	<b>1.88%</b>	<b>\$1.23</b>	<b>\$0.24</b>
<b>WINDWARD OAHU</b>									
Kapaa Industrial ****	59	619,704	Fee Simple	46,000	8,800	13,129	7.42%	\$1.70	\$0.31
Kaneohe	41	602,851	Leasehold	11,940	(1,400)	5,611	1.98%	\$1.15	\$0.66
<b>Total Windward</b>	<b>100</b>	<b>1,222,555</b>		<b>57,940</b>	<b>7,400</b>	<b>18,740</b>	<b>4.74%</b>	<b>\$1.59</b>	<b>\$0.38</b>
<b>OAHU TOTALS</b>	<b>1,804</b>	<b>39,950,156</b>		<b>638,535</b>	<b>74,534</b>	<b>64,582</b>	<b>1.60%</b>	<b>\$1.21</b>	<b>\$0.35</b>

\*Leasehold tenure associated with industrial parks with 75% or more of land under ground lease

\*\* Weighted average rents are calculated on I-1 and I-2 zoned properties. IMX zoned properties, which can be used for retail have been excluded from this rent calculation.

\*\*\* Pearl City Industrial Park is a submarket associated with Pearl City/Aiea trade area

\*\*\*\* Only gross rents are quoted.

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### TERMS AND DEFINITIONS

- › **INVENTORY** - Industrial buildings greater than 2,500 square feet located on the island of Oahu, inclusive of owner user, and single tenant buildings.
- › **TOTAL SQUARE FEET** - All rentable industrial space exclusive of common areas, yard space and fire escapes.
- › **VACANT SPACE** - Industrial space that is not occupied by a tenant. This includes sublease space that is unoccupied.
- › **VACANCY RATE** - The ratio of vacant industrial space divided by the total industrial inventory square footage.
- › **NET ABSORPTION** - The net change in occupied space over a period of time. Year-to-date net absorption is the difference in occupied space between the end of the previous year and the current quarter.
- › **DIRECT WEIGHTED AVERAGE ASKING RENT (NNN)** - The ratio of aggregate landlord asking rents divided by the total available space within a specific geography.
- › **AVERAGE OPERATING NET EXPENSE** - The average rate of tenant expenses such as building utilities, management fees, building maintenance, real property taxes and insurance within a specific geography.
- › **NNN RENTS** - Rents exclusive of building operating expenses.

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