

As featured in Wealth Management Real Estate's 2023 Midyear Outlook

# Understanding Flex — A Niche Industrial Strategy

As 2023 has progressed, higher interest rates, tighter lending standards, and concerns over a potential recession have combined to dampen transaction activity for commercial real estate assets and impact pricing. However, even in this environment, attractive investment options can still be found. One such option that merits serious investor consideration involves a niche industrial property type called “flex.”

## What are Flex Industrial Properties?

Flex industrial buildings are designed to accommodate tenants that require a combination of office and warehouse space. Flex properties can be fit out with as much, or as little office space as their tenants require, hence the term “flex” – which highlights these properties' flexibility and different uses. Typically, flex properties are multi-tenant, with tenant sizes ranging from 1,000 to 5,000 square feet, and office buildout that ranges from 15% to 30%. Flex properties cater to small to medium-sized businesses and can accommodate a range of uses, including light manufacturing, medical and pharmaceutical research, conventional R&D, showrooms, storage, distribution processing, and design and repair work. Flex properties are sometimes referred to as “incubator” space and are commonly found in industrial or business parks.

## Why Invest in Flex Industrial?

Supply growth for flex properties has been limited because of stringent zoning laws and high construction costs relative to other industrial properties. These factors make developing flex properties infeasible in many markets, creating a supply-demand imbalance that has led to low vacancy rates and consistent rent growth. This imbalance has exacerbated over time because



developers have increasingly opted to build large warehouses to support ecommerce instead of flex properties on industrial-zoned land. Future development of flex properties could also be curtailed by changes to zoning regulations as communities that are grappling with housing shortages consider rezoning industrial areas to accommodate new residential developments.

Flex properties have also performed well in downturns relative to other types of real estate, particularly if they have a low percentage of office buildout. This pattern was reinforced following the brief downturn caused by COVID-19, when, according to Real Capital Analytics, cap rates for flex properties held firm in 2021 and 2022, while cap rates for traditional warehouses increased by 30 bps. On a percentage basis, sales activity for flex assets also outpaced trades for warehouses during this period, reflecting healthy levels of demand and a fluid market for flex properties.

Lastly, despite a large inventory of flex properties in most major markets, ownership remains highly fragmented and often includes unsophisticated operators. As such, opportunities often arise to acquire a flex property that has been under-managed, and to increase its value through professional ownership practices.



## What to Consider When Investing in Flex Industrial

Most flex property investors deem it critical to acquire assets with low levels of office finish because flex properties with higher levels can compete with Class B office space, resulting in higher maintenance and turnover costs, increased competition for tenants, and higher cap rates upon exit. The property's appearance, age, location, parking availability, truck loading capacity, and other external features should also be considered when investing in flex industrial buildings. Attractive locations for flex investments include infill locations in major MSAs and secondary markets experiencing above average population, employment, housing, and income growth. Experienced real estate professionals who can effectively source and diligence flex industrial properties will be well positioned to take advantage of investment opportunities for this property type and obtain the benefits these investments can provide.

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