

# INDUSTRIAL INVESTOR SENTIMENT REPORT

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OCTOBER 2019

The U.S. industrial sector shows many signs of strength heading into 2020, given the ongoing expansion of e-commerce and strong market fundamentals, including rising rents, record absorption and low vacancy rates. On the capital markets side, allocations are increasing, there is plenty of capital waiting to be deployed, and there is optimism that cap rates could compress further. These are the key findings of the 2019 RCM-SIOR Industrial Sentiment Report.

There are headwinds, however, as commercial real estate investors, brokers and owners adapt to the threat of ongoing U.S. trade wars and signs of a slowing economy. While the commercial real estate industry often focuses on cycles, the consensus among many experts is that the industrial sector is moving on its own trajectory—and not following a traditional cycle.

Against this backdrop, industry experts are mindful of the global economic and political concerns of an economic slowdown. Investors are looking more strategically at the markets they target and the assets they consider. Some are focusing on land constrained markets, for example, as a way to best position themselves for rental growth. Some are retreating back to core markets and core assets. Still others are looking to capitalize on the potential for additional cap rate compression in secondary markets.

While there are definite shifts in the market heading toward 2020, the tone remains one of optimism, according to investors and brokerage professionals surveyed and interviewed for this RCM-SIOR Industrial Sentiment Report. This positive outlook is largely due to market fundamentals, long-range corporate growth projections and the many ways e-commerce is transforming the economy.

### Key Findings of the 2019 RCM-SIOR Industrial Sentiment Report:

- **10% annual growth** expected in e-commerce, which is driving warehouse and distribution activity.
- **Speculative construction still strong**, with concerns about overbuilding in select markets, according to 51% of survey respondents.
- **Land constrained markets expecting rent growth** are Miami, NYC/New Jersey, and parts of Southern California, among others.
- Further **cap rate compression** expected in select markets.

“The significant expansion in e-commerce and the ongoing need for realignment of the corporate supply chain continues to shape the industrial sector and helps position it as a top asset class for investors, now and moving forward. There is also a significant push to tap into consumers in large, urban population pools, which is driving considerable warehouse and distribution activity.”

Tina Lichens, Chief Operating Officer - RCM



“Fundamentals are still very strong in the industrial sector. We have active leasing in most major markets and construction has been kept mostly in check except for some markets where there is a hint of overbuilding.”

Tom Fishman, Executive Vice President of Acquisitions and Dispositions  
Hillwood Investment Properties

## Industrial Investments: Fundamentals are Strong

Few product types have propelled an economic recovery as much as industrial real estate. According to research provided by Real Capital Analytics (RCA) and various other industry sources, a variety of U.S. benchmark statistics from September 2019 depict a positive picture for this sector.

- **Cap Rates\*:** Since 2015, national average cap rates have continued to compress from 6.8% in 2015 and 2016 to a current level of 6.3%. While the rate of compression has slowed some, experts say the prospects for further reduction are strong. Some transactions in key markets are seeing cap rates in the 4% to 5% range, for example.
- **Vacancy Rates:** Speculative development continues to add new inventory across many U.S. markets, but is being balanced by strong net absorption, according to industry research. This has produced a national vacancy rate of approximately 5%, with many top performing markets recording rates as low as 3% to 4%.
- **Sales Volume\*:** At first glance, total sales volume, in dollar amounts and in square feet, can be misleading due to peaks and valleys that have taken place for one of real estate’s favored asset classes. For example, year-to-date industrial sales are \$41 billion, but compared to last year’s total of \$85 billion, 2019 sales are only reaching 48% of last year’s total thus far.
- **Most Active Buyers\*:** Private Investors continue to be the largest pool of investors acquiring industrial real estate, accounting for 38% of total acquisitions year-to-date in 2019. Institutional investors finished second in three of the last four years.

\* U.S. industrial properties of 50,000 SF or greater



## 2020 Outlook

The current economic expansion has brought record-setting leasing, construction and investment activity to many markets across the country. Businesses continue to refine their supply chain strategies to expand operations, reach customers more quickly, tap into new e-commerce opportunities, and improve overall efficiencies. With these changes, comes a need to redefine their industrial space needs.

### Survey results: What is propelling industrial investment into 2020?

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|---|-----|
| Continued expansion in e-commerce & its long-term support of consumer buying patterns | 44% |
| Need for corporate supply chain realignment and updating of facilities                | 13% |
| Amount of dry powder looking to be placed in the market                               | 24% |
| Potential for more stable return than in other investment options                     | 19% |

There are two factors that separate industrial from other sectors, said Fishman. “The first is the growth in e-commerce and the increasing need for industrial space as more product needs to be stored in a warehouse instead of in a retail store. The second is the significant amount of capital looking to be placed in the industrial/logistics sector. I think there is more international capital than ever before.”

While there is significant activity from corporate occupiers, the e-commerce sector continues to have the most transformative impact on the industrial sector. With projected annual growth that could reach 10%, e-commerce is changing everything from large distribution spaces to last-mile facilities. The reach goes beyond buying goods on Amazon to include cold storage warehouses for food delivery to urban population centers and port-centric warehouses that tie into global trade routes.

“No one could have predicted the impact that e-commerce would bring to the supply chain, our industry, and the global economy. I am often asked when will the music stop. I don’t know, and I don’t think anyone does. No one really knows the maximum potential of e-commerce.”

JoJo Yap, Chief Investment Officer  
First Industrial Realty Trust, Inc.

## 2020 Outlook (cont'd)

Industry estimates suggest that e-commerce reflects 10% to 11% of the economy and could grow to 20% or higher. "There is nothing that points to e-commerce growth being flat or even negative and that's good for the industrial real estate investment market," Yap said.

*"Like most sectors, industrial real estate remains a very localized market asset. E-commerce has brought a globalized focus to this sector, and may be a constant thread across the country, but the majority of markets also are driven by the local market users, needs and economic considerations."*

Mark J. Duclos, SIOR, CRE  
President, Sentry Commercial

Robert G. Thornburgh, SIOR, CCIM, CPM, Regional President of Kidder Matthews suggested that the long-term view will remain strong. "As we look ahead and evaluate a softening in the market, we can still expect strong demand to continue for the foreseeable future. Further down the road, the corresponding rise in values, construction, labor and talks of a recession—while not new topics—could clearly develop into sizable headwinds."

Anthony Lydon, CSCMP, a National Director in the Phoenix office of JLL agrees with the general assessment that the state of the industrial marketplace is a bit of a mixed bag, but nothing truly surprising.

"We see continued growth, but at a slower pace compared to the past 24 months," Lydon said.



# Investment Pricing

Investor sentiment on pricing levels is also strong, as it has been for the last three years of this RCM-SIOR report. In 2019, 94% of survey respondents believe that pricing levels will at least remain the same, comparable to the last two years. However, 59% believe that prices will go even higher, by as much or more than 5%. This level of optimism, while still strong, is down from 68% one year ago.

## Survey results: Where will industrial pricing go over the next 12 to 18 months?



Participants in the 2019 report are more bullish about the prospects for further compression of cap rates than they were in 2018 and 2017—and by a level of nearly two to one. In 2017 and 2018, the prognosis for cap rate compression ranged from 17% to 18%. Today, in 2019, nearly 32% believe further compression is likely in the next 12 to 18 months.

Jack Fraker, SIOR, Vice Chairman, Managing Director, Industrial, Capital Markets of CBRE in Dallas believes there is still room for cap rate compression, in part because of the low interest rate environment. Investors are comfortable with these initial low cap rates because the demand for space is outpacing supply.

“With rental rate growth projected to remain strong, people are willing to pay near record prices. They are marking rents to market levels two to five years down the road and improving returns.”

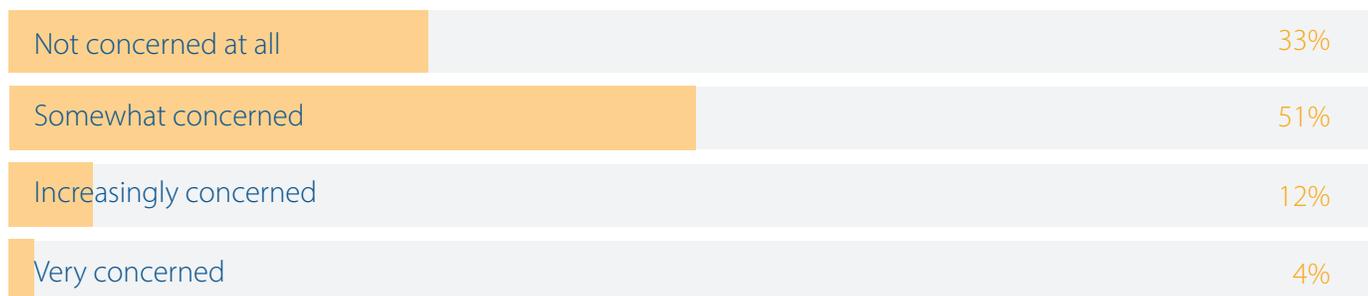
Jack Fraker, SIOR  
Vice Chairman, Managing Director, Industrial, Capital Markets - CBRE



# Spec Construction: Still Filling The Pipeline

The industrial sector has seen a significant building boom over the past five years, with millions of square feet added in markets such as Atlanta, the Inland Empire, Chicago, Dallas, Los Angeles, and many others. That construction has been tempered by a lending environment that is focused on a more balanced supply/demand scenario. Most markets have benefited from that discipline.

## Survey results: What's the level of concern about overbuilding/oversupply?



"In most markets across the country, we are seeing an appropriate level of development activity," Yap said. "With fundamentals where they are, I expect the market will continue to add supply and that the steady pace of demand we're seeing will fill those spaces. We don't want to invest in markets where we believe there is the possibility that the addition of supply will outpace demand."

Among the markets where land availability is limited is the Inland Empire, which consistently ranks as one of the top industrial markets in the country and has seen record development, absorption and investment. Cap rates in the Inland Empire and nearby Los Angeles are hovering around 4%, said Erik Foster, Principal and leader of Avison Young's National Industrial Capital Markets Group, based in Chicago.

There are also some markets with coveted submarkets that are seeing increased land and investment pricing. One example is in Chicago's O'Hare submarket where institutional investors have pushed land prices up to more than \$30 psf. Core investment property in that submarket

has reached around \$125 psf in some instances, said Foster.

The industrial market also is seeing examples of tenants investing significant capital to customize a building to their needs, creating a mission critical facility that ultimately could be viewed more favorably by the investment community. One example of an increased level of customization is in Goodyear, AZ, according to Lydon.

Lincoln Property/Goldman Sachs recently sold a building to Nike for \$75 million. Nike in turn is spending millions of dollars to customize the building to manufacture its patented Nike Air gel system for its athletic shoes that are assembled elsewhere. This project shows the level of customization and sophistication today's users are willing to undertake as they look long-term at their industrial needs.



“Expect more surprises as our industry scrambles to keep pace with consumer demand. Low coverage sites in densely populated urban centers will capture the most attention. Land values will continue to increase, bringing with it additional multi-story development.”

Robert G. Thornburgh, SIOR, CCIM, CPM  
Regional President, Brokerage - Kidder Matthews

## Greatest Opportunities

According to Yap, land constrained markets present the best opportunities for rent growth today. First Industrial is highly focused on opportunities in land constrained coastal markets in California, Florida and Northern New Jersey, for example. In certain markets like Southern California, a scarcity of land is coupled with a lengthy entitlement process that serves to further restrict development.

While much of the discussion on industrial investment focuses on bulk distribution properties in primary and coastal markets, other investors see great opportunity in secondary and tertiary markets. Further, their focus is on buildings and tenants that are more utilitarian.

Pendleton White, President and Chief Investment Officer of Plymouth Industrial Realty in Boston says, “We believe, and have for some time, that the risk adjusted return metrics for Class B properties in secondary markets are better than Class A properties in primary markets.”

He notes that there hasn't been as much cap rate compression in secondary markets and there is still plenty of opportunity to acquire fully leased assets at 7.5% to 8.5% cap rates with annual rental rate growth of between 5% and 7%.

Plymouth's portfolio is primarily oriented to utilitarian operations, where companies manufacture or assemble goods that are distributed through the supply chain. These employers are considered highly stable and part of the fabric of the community that serves to support long-term investment.

“If there are thunder clouds on the horizon, these types of companies adjust from three shifts a day to two,” Pendleton adds. “They still pay the rent and aren't going anywhere. Then, when things improve, they are back to three shifts.”

Other investors are looking long-term at last mile delivery. Thornburgh said there remains tremendous opportunity in this segment, as its influence on the industrial landscape has only just started.

# Greatest Threats

Among the greatest economic threats noted by survey respondents include the ongoing potential for tariffs and escalating trade wars, which have caused volatility and increased materials pricing. This concern was noted in the survey by a margin of almost three to one over lower corporate growth rates and interest rate changes. However, most brokers and investors admit that tariffs and escalating trade wars are beyond their control.

The ongoing labor shortage—both for workers in general and for those with specific manufacturing, computer and related skills—is having ripple effects throughout the U.S. There are markets that are severely constrained by the lack of a qualified workforce and others where the shortages may be the result of required licenses for certain types of positions.

Lydon notes that Arizona has taken steps to ease that burden, approving a reciprocity agreement that allows some workers licensed in other states to work right away. The state is adding approximately 200 people per day, many of whom are qualified and licensed professionals in another state.

## Survey results: What is the greatest non-economic threat to further opportunity in industrial real estate?



According to the survey, the greatest non-economic threat to the industrial market is equally balanced between lack of supply of quality assets and unrealistic seller expectations and, to a lesser degree, overbuilding or oversupply. Given the volume of product that has traded over the last several years, investors have been consistent in the RCM-SIOR survey in citing lack of supply as a concern. Concern about unrealistic seller expectations has been on the rise, as sales activity has continued at a steady pace. The average price per square foot for U.S. industrial assets has increased from \$66 psf in 2015 to \$85 psf year-to-date in 2019, according to RCA statistics.

Fraker says that while oversupply typically has been one of the biggest concerns within the industrial market, there also are external macro market factors that could send the economy into decline. “We live in a consumer-based economy,” Fraker said. “A decline in consumer sentiment that would significantly change their buying patterns could temper growth.”

## Greatest Threats (cont'd)

The industrial sector is poised to perform well even in a market downturn, however, due to its stability and lower capital investment, Fishman says. "The tenant improvement costs in office versus industrial are dramatically different. In a recessionary period, industrial has historically appeared to be more resilient. Even if you have slower GDP growth and retail sales, the continued growth in e-commerce will provide a buffer against a decrease in logistics space needs."

While Duclos agrees with many of the warning signs that point to shifts in the industrial sector, he remains positive in the outlook. "People are showing more concern for the "R" word, and with good cause," Duclos adds. "Yet the continued growth of e-commerce, positive trends in the on shoring of certain manufacturing operations and a general lack of overbuilding point more to taking the foot off the gas pedal than anything else."

## Markets To Watch

Moving into 2020, survey respondents believe that industrial activity will continue to be strong in core markets, such as the Inland Empire, Dallas, Chicago, and Northern New Jersey. Markets that are land constrained and that tie into port activity, such as Miami, will also perform well, as there is a limited amount of land for development, which will put upward pressure on rents and investment pricing.

Among the markets to watch are those with a strong business climate, a solid logistics infrastructure, and labor pools that are also close to large population pools. Others noted the importance of evaluating the tax and regulatory environment in a market. Business-friendly states that have reasonable regulatory oversight and legislation, and moderate tax structures are ideal for supporting business growth. Among the states that meet those criteria are Arizona, Nevada, Texas, Florida and Tennessee. Many occupiers will avoid states with high tax structures, due to the burden it places on profitability, Lydon says.

"Markets such as Columbus, Charlotte, and Reno are outside of the core industrial markets but well suited to provide access to strong consumer populations that support long-term growth."

Erik Foster, Principal  
National Industrial Capital Markets Group, Avison Young

# Conclusion

The industrial real estate market remains one of the strongest, most fundamentally sound and consistently popular sectors in commercial real estate. It is a sector whose trajectory has benefited tremendously from the explosive growth that e-commerce is providing. At the same time, the sector has greater depth and breadth to it, given its ties to the overall supply chain.

While the general sentiment is strong heading into 2020 and the appetite for further development and investment appears to be solid, there are lingering questions and causes for uncertainty. There are elements to those concerns that are real and being experienced in the marketplace. Yet at the same time, with a cycle that has been as long and strong as it has been, this is on some levels new, uncharted territory.

“The industrial property investment market has been so good for so long which could lead some to believe that conditions are too good to be true, and change may be on the horizon,” said Steve Shanahan, Executive Vice President of RCM. “Yet at the same time, the basic fundamentals and the capital ready to be deployed points to a solid, long-term outlook.”

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- Anthony J. Lydon, CSCMP  
*National Director, JLL*
- Robert G. Thornburgh, SIOR, CCIM, CPM  
*Regional President, Brokerage, Kidder Matthews*
- Pendleton P. White, Jr.  
*President, Chief Investment Officer, Plymouth Industrial REIT*
- JoJo Yap  
*Chief Investment Officer, First Industrial Realty Trust, Inc.*

RCM regularly surveys industry professionals to gauge the current commercial real estate market. Visit [rcm1.com/reports](http://rcm1.com/reports) to view a list of past studies.

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To date, RCM has executed 72,000+ assignments with total consideration exceeding \$2.4 trillion. Approximately 50% of all U.S. commercial assets sold, over \$10 million, are brought to market using RCM's online marketplace annually.

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