

INDUSTRIAL INVESTOR SENTIMENT REPORT

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“How much runway is left?” That’s a common question as the industrial sector moves through another year of strong investment activity. The strength is fueled by record and diversified demand, low vacancy rates, high levels of absorption, and balanced construction in many markets across the United States.

The answer, according to participants in the **2018 RCM-SIOR Industrial Investor Sentiment Report** is that there is plenty of room left, thanks to the depth and reach of the industrial market, the growth in e-commerce, and an expanding economy, among other factors.

Nearly 92 percent of the survey participants expect strong investment activity to continue into the foreseeable future.

There remains a significant amount of capital allocated to this sector from global institutional and non-institutional players around the world. During this cycle, investors have moved into the industrial sector in force, drawn by the prospects of stability and long-term growth.

Real Capital Markets (RCM) surveyed and conducted interviews with investment, leasing, and development experts across the country to gauge their insights on the market and key issues facing this sector. The report showed that industry experts are even more bullish on the outlook for the industrial market than they were in 2017.

Key Findings of the 2018 Industrial Report:

- **Growth in e-commerce**, including expansion in the grocery delivery space, is fueling optimism about leasing, development, and capital markets.
- Based on the perspectives of industry experts, there is **no reason to believe activity will drop off** significantly in the foreseeable future.
- **Interest rates are the number one threat** to the industry, followed by trade tariffs—most notably in terms of how tariffs affect the price of construction materials.
- **Last mile facilities are seen as the greatest growth opportunities** and the critical next stage for e-commerce companies looking to tap into next-day and same-day deliveries.

“The ongoing evolution of the industrial market, as developers and investors adapt to the changing needs of users, further elevates the position of industrial real estate—a trend that shows no sign of slowing.”

Steve Shanahan, Executive Managing Director
Real Capital Markets



“Domestic players continue to play, while international players are just as active. Perhaps the one exception is that Chinese money has backed off for a variety of competitive and political reasons.”

Geoffrey Kasselmann, Executive Managing Director
Newmark Knight Frank



Year Over Year Comparison

Questions in the 2017 and 2018 RCM-SIOR Industrial Investor Sentiment Reports tracked participants' perceptions of three key barometers: investment activity levels, pricing, and cap rates. The answers underscore the sentiment that the market remains on solid footing, even if there is a slight tempering of enthusiasm. Comparing 2018 to 2017, the following sentiments are most notable:

- **Activity:** Industrial professionals are optimistic about the remainder of 2018 and moving into 2019. More than 48 percent now suggest that activity will remain at or about the current level whereas one year ago the figure was 43 percent. Additionally, in the most recent survey, 43 percent now expect an increase in activity; one year ago, the sentiment was slightly higher at 48 percent.
- **Industrial Pricing:** The projection for industrial pricing also provides interesting year over year comparisons. More than 38 percent of respondents in 2018 anticipate pricing increases of five percent or more; in 2017 that number was 34 percent. Yet at the same time, in 2017, 66 percent believed pricing would increase, slightly higher than the 65 percent in 2018.
- **Cap Rates:** The area with the greatest difference year over year is the expectation for cap rates, which are as low as 3.5 percent in Los Angeles. More people in 2018 (44 percent) believe cap rates could go higher; in 2017, only 35 percent predicted an increase.

Anthony Lydon, CSCMP, a Managing Director for JLL in its Phoenix office explains, “Activity is impressive by any standards. I am very encouraged and don’t see a bubble on the horizon.” In fact, Lydon said he is optimistic that there is 24 to 36 months remaining in this run.

Year Over Year Comparison (cont'd)

One commonly held belief is that because the market has been so strong for so long, we've come to expect a certain level of activity. Yet even a slight tapering of activity maintains what has been a very healthy market.

"A pause and potentially sideways activity down the road is inevitable as the market re-adjusts to some new direction. When is anyone's guess," says Robert Thornburgh, SIOR, CCIM, CPM, Executive Vice President, Kidder Mathews. "However, with extremely solid fundamentals and continued build-out of the e-commerce logistics system by many different players, industrial product will not lose its newfound utility value in our new world any time soon."

Erik Foster, principal and leader of Avison Young's national industrial capital markets group, based in Chicago, is in agreement on industrial's value and staying power.

"There is a tremendous amount of capital being deployed in the industrial sector and that activity will continue for the foreseeable future. The industrial sector has risen to the top of many investors' wish lists and is seen as a strong long-term investment and a safe haven against global currency and market fluctuations."

Erik Foster, Principal
Avison Young

Andrew Boulton, a principal with California-based Cardinal Industrial, is optimistic, but thinks we'll eventually see upward pressure on cap rates and pricing decreases as interest rates continue to increase.

"We've been lucky so far that spreads have come in and lending rates have mostly maintained between 4 and 5 percent, but if rates continue to move, that may change, forcing cap rates up and prices down." He emphasizes, however, those changes will only be marginal.



The Powerful and Impactful One-Two Punch

According to industrial real estate professionals, the importance of e-commerce, and its significant impact on the future of industrial real estate, is perhaps even more certain than death and taxes. Sustained growth in e-commerce and the general state of the economy have been a powerful one-two punch for the industrial market over the last two years, as consistently noted by over 70 percent of survey participants.

Survey results regarding greatest impacts on industrial investing:

General Strength of the Economy	38%
Growth & Expansion of E-commerce	33%
The Availability of Investment Capital	16%
Other	8%
Restraint by Developers	5%

“E-commerce is evolving daily and everyone is trying to find the best way to deliver products and grow market share, which is fueling a lot of the industrial activity,” comments Steve Poulos, CEO and Co-Founder of Chicago-based Bridge Development Partners, which focuses on last mile and other development in core, supply constrained markets, such as Los Angeles, New Jersey and New York.

One factor driving that debate is the future of retail usage. While Poulos and others agree that bricks and mortar stores are here to stay, in one form or another, there is considerable debate about how much retail space use will continue to shift to e-commerce. Some survey respondents say that 20 percent of all retail is e-commerce and that it might reach 50 percent. That leaves a lot of room on the industrial runway.

While statistics are difficult to find, some market projections show e-commerce growing at a rate that translates to demand for approximately 180 million square feet of logistics space by 2020.

“The continual shift and conversion from retail space to warehouse is greatly impacting the growing demand for industrial space,” said Barbara Rea, Director of Investor Relations & Operations for BKM Capital Partners in Newport Beach, CA. “As consumers expect products delivered to their doorstep faster, this trend will only continue.”

As developers continue to feed the pipeline, many of those new distribution and warehouse spaces will be snapped up by investors. “Demand is being driven by e-commerce and related uses,” says Don Schoenheider, a Senior Vice President of Hillwood Investment Properties, a real estate development and investment firm based in Dallas. “There is a lot of runway left in that part of the equation.”

Additional Industrial Growth Drivers

The overall economic environment right now is very favorable. With a 4.2 percent GDP growth rate and national unemployment at approximately 3.9 percent, the force of the U.S. economy has been unleashed. Many believe the economy is being further fueled by the federal government's actions to reduce taxes and government regulations.

Survey participants note that these efforts are impacting business confidence and spending, and are supporting the growth of small and mid-size businesses. "The reduction of corporate income taxes is expected to return trillions of dollars from foreign shores," says Lydon. "That's a big deal and has unleashed a willingness on the part of companies to invest in their businesses and facilities."

Another factor driving industrial activity, according to Foster of Avison Young, is the growing U.S. port system and its ties to foreign trade. From Los Angeles to Miami to New Jersey,

industrial assets that feed into the port system are in high demand. Land and buildings near seaports are commanding premium pricing, as they allow for quick access and flow through the supply chain. In South Florida, for example, developers are scrambling to find land that can support efficient industrial space near PortMiami and Port Everglades, Foster comments.

This leasing and development activity translates to considerable demand from investors who want to tap into the growth.

"We see tier one and tier two cities with access to ports and modern inland distribution centers to be an area for growth and focus."

Barbara Rea, Director of Investor Relations & Operations
BKM Capital Markets



Emerging and Expanding Opportunities

While multi-story industrial facilities, high-tech manufacturing properties and certain other product types make for interesting discussions, market experts view last mile and infill development product as the most prominent, highly sought-after opportunities.

Survey results regarding emerging opportunities:

Last-Mile Facilities	52%
Traditional Manufacturing Facilities	16%
High-Tech Manufacturing	13%
Multi-Story Warehouse/Distribution Facilities	12%
Other	7%

Reflecting the popularity and intense focus of “last mile”, Thornburgh of Kidder Matthews says he is hearing it referred to as the “first-mile” more and more, which highlights the importance and emphasis being placed on these locations.

“Users want to get as close as they can to population centers in order to fulfill same day, later in the day and next day orders,” says Schoenheider, while also noting that these opportunities also are among the most expensive.

According to Kasselmann, while certain markets offer proven locations by which to achieve local, regional and national e-commerce fulfillment (i.e. Columbus, OH; Indianapolis, IN; Lehigh Valley, PA), every MSA with 500,000+ residents is enjoying some e-commerce-related activity. This could even trickle down to MSAs of 100,000 to 200,000 residents.

Last mile properties are particularly important for the burgeoning grocery/food delivery needs. Following Amazon’s acquisition of Whole Foods, numerous other retailers, such as Walmart and Kroger, are also offering delivery services requiring

last mile facilities to fulfill orders. The challenge, however, is finding sites that are suitable for today’s needs such as parking, truck traffic, and dock usage.

Kasselmann notes that last mile expansion is still in somewhat of a “beta” mode as no one has yet to achieve proof-of-concept on a global scale basis. “The first order of business for anyone interested in providing same day or next day delivery is to figure out how to serve the critical mass of consumers in any urban environment or location, starting with the biggest tier one cities and then working down the list from there,” he says.

Each city has unique challenges that range from terrain to infrastructure to zoning/code issues. As a result, it is very hard to simply replicate how last mile logistics are handled from one urban environment to the next. It has been widely reported that 50 percent of all supply chain costs are in the last mile. So as long as that is the case there will be a disproportionate amount of investment attempted to address, solve, or improve it.

Greatest Threats—Lack of Supply

The industrial market has experienced a record level of activity over the past several years, as investors moved into this sector in search of stable, long-term returns. In fact, industrial assets are now competing head to head with multifamily and office assets for many investors' attention.

At this point in the market cycle, many of the premier industrial assets have already traded, leaving a shortage of assets in some markets. The end result is a shortage of quality assets despite considerable demand, and an influx of foreign and domestic capital chasing deals. These dynamics have pushed investors into secondary and tertiary markets, and prompted some to buy Class B and even Class C assets to gain a foothold in this sector. As investment activity ebbs and flows between core and non-core markets, those high-quality assets that do trade are doing so at higher prices.

Del Markward, SIOR, President and CEO of Markward Group in Allentown, PA, believes that the lack of quality product is a "threat" to the marketplace. "There are fewer quality options because investors are opting to hold onto the quality assets they own; it's providing a good return," Markward says. "Investors don't want to dive into a five cap."

"The competition for existing product and development sites is intense among institutions, private development firms, foreign investors and with owner-users."

Peter Schultz, Executive Vice President
First Industrial Realty Trust

Schultz continues, "With rental rates increasing in response to higher construction costs, and land prices rising at rapid speeds, we see prices continuing to increase and cap rates maintaining or even coming down a bit."

In contrast to the 2017 report, 12 percent of respondents in 2018 are much less concerned with the threat of overbuilding, as compared to 24 percent in 2017. However, some expressed that in select markets, overbuilding could be a problem.

In assessing any possible threats, Schoenheider of Hillwood says there is nothing to lose sleep over. "Capital has been very smart," he said. "Lenders have long memories from 10-12 years ago when the market was at its worst. As a result, developers and capital sources are very disciplined which means we're not seeing overbuilding."



Greatest Threats—Geopolitical

As strong as the industrial market and overall economy are performing, investors and brokers do have concerns about the market—the top two being. The top two non-industry concerns include the slow but steady upward movement in interest rates and the impact of the trade wars and tariffs that are becoming more and more real. However, the opinions vary on the impact of everything from taxes to tariffs.

Schoenheider said the climate for further increases in interest rates doesn't concern him in the short term; Lydon countered, saying it could be disconcerting if interest rates have increased 100-125 basis points over the next year. But the greater risk he pointed to is the potential for inflation as the economy heats up.

“It's the typical assortment of political and economic topics that could adversely affect activity and result in a consumer spending slowdown and in the process dent the e-commerce growth curve.”

Robert G. Thornburgh, Executive Vice President
Kidder Matthews

About 29 percent of survey participants believe the greatest threat could in fact come from ongoing trade wars and tariffs, which impact the general economy as well as real estate construction costs. Over the last five to seven years there has been a tremendous amount of new development activity as the industry has worked to catch up on significant pent-up demand.

As building owners and developers, First Industrial has potential exposure to the tariffs and trade wars on multiple fronts—tenants doing business with countries where there now are tariffs, and construction projects that could be impacted by increasing costs. Schultz says the company is not seeing a negative impact of tariffs on its tenants as of yet, but is seeing some impact to construction materials, especially steel.

“The impact of higher steel prices on overall construction costs has not yet been that significant, and rental rate increases have more than kept pace with increasing construction costs,” Schultz said. “Increasing land costs are having a bigger impact, especially in high growth coastal markets where land is in particularly short supply.”

The greatest issue associated with tariffs and trade wars is the uncertainty that it creates. And most companies, regardless of size, dislike uncertainty as it can create an inability to plan with a level of confidence that is required to make well-informed decisions. “The wild card is the tariffs,” says Markward. “The economy can probably withstand a 10 percent tariff, but the impact of that going to 25 percent is another question.”

Manufacturing Sector—It's Not All E-Commerce

While e-commerce activity often makes the headlines, there are other forces driving the industrial sector. Many companies are leasing and owning distribution space for their own products, which may or may not tie into e-commerce, but are focused on supporting the sales process.

"As active investors and developers across the country, we are very encouraged by the broad-based demand we're seeing, demand that is net new growth," says Schultz. "These companies are truly expanding and taking new space, not just moving across the street to save five or ten cents."

Additionally, the manufacturing sector is seeing a rebound, with companies expanding and/or bringing jobs back to the U.S. According to Lydon, many regions of the country are seeing an upward tick in manufacturing.

In the Phoenix market, for example, Ball Enclosures completed a significant land transaction and is starting a new facility after contemplating a move to Mexico. The project will create 120 jobs.



Conclusion

As we head toward 2019, Foster expects more medium to large portfolio sales to dominate the industrial sector, as institutional investors, REITS, and various funds continue to build their market share. The acquisition of DCT by Prologis and Gramercy Property Trust by Blackstone earlier this year are two examples of investors looking to immediately expand their presence with dominant industrial entities. Those patterns should continue as investors clamor to expand their industrial holdings and ride out whatever opportunities arise from e-commerce, last mile delivery, and other market segments driving industrial facility usage.

Markward expects that while the pace of activity could taper, sale prices and cap rates will remain strong, due in part to the level of foreign capital looking to find a home. "The U.S. remains the safest place to put capital," he says.

"The industrial market and those who invest in it have experienced an incredible, long run because of the industry's ability to adapt to the needs of specific users and subsectors, and embrace the ongoing evolution of the global economy", says Tina Lichens, Chief Operating Officer, Real Capital Markets. "Given this performance and consistency, we have every reason to believe there is plenty of runway left."

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- Robert G. Thornburgh, SIOR, CCIM
Executive Vice President - Kidder Matthews

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