INDUSTRIAL REPORT

VIEWPOINT 2018 / COMMERCIAL REAL ESTATE TRENDS

By: Hugh F. Kelly, PhD, CRE

Without a doubt, industrial stands head-and-shoulders above the other commercial property types as we enter 2018. A multi-year pattern of double-digit total returns, coupled with absorption rates exceeding the pace of new development, have bolstered occupancy levels and rent growth in the majority of U.S. markets. Even a slow pace of economic growth has supported strong improvements in net operating income, as older leases are re-set to market rates. Demand across the gamut of size ranges should continue to spur leasing, with older urban warehouses filling the role of "just in time" fulfillment for retailers promising next-day or even same-day product delivery.

Over the past eight years, industrial properties have produced double-digit total returns, the only property type tracked by NCREIF that can make that claim. Over the 12 months ending September 2017, industrials registered a total return of 12.8%, of which the appreciation component was 7.4%. In part propelled by ecommerce, and in part by global trade, warehouse and distribution facilities have been high on the buy list for a wide variety of investors, including REITs, international investors, private equity firms, and even owner-users. Nothing succeeds like success, they say, and as other property types see greater caution in acquisition activities, industrials continue to be a capital magnet based upon performance characteristics and solid user-market fundamentals.

Transaction Volume & Operating Economics

It almost seems like a misprint: RCA's tally of industrial transactions through the first three quarters of 2017 was up 23% over 2016 measured by dollar volume ($51.8 billion), and up 18% in deal count (4,866). Here is one instance where a counter-trend is more than a case of divergent patterns "netting out" positive. Every single region in RCA's analysis was up in industrial transaction volume, which set a national record for any January – September period in RCA's database. Contributing to this were no fewer than 17 individual markets which also set first-three-quarters records. These included some of the nation's largest industrial markets (Los Angeles, Chicago, Dallas, and Atlanta). But also included were some formerly struggling cities (Detroit, Hartford, St. Louis) as well as some hot "new economy" markets (Denver, Charlotte, Nashville). And, presumably riding the wave of ecommerce distribution in large urban markets, some suburban markets adjacent to the big cities (Northern Virginia and Westchester) were also included.

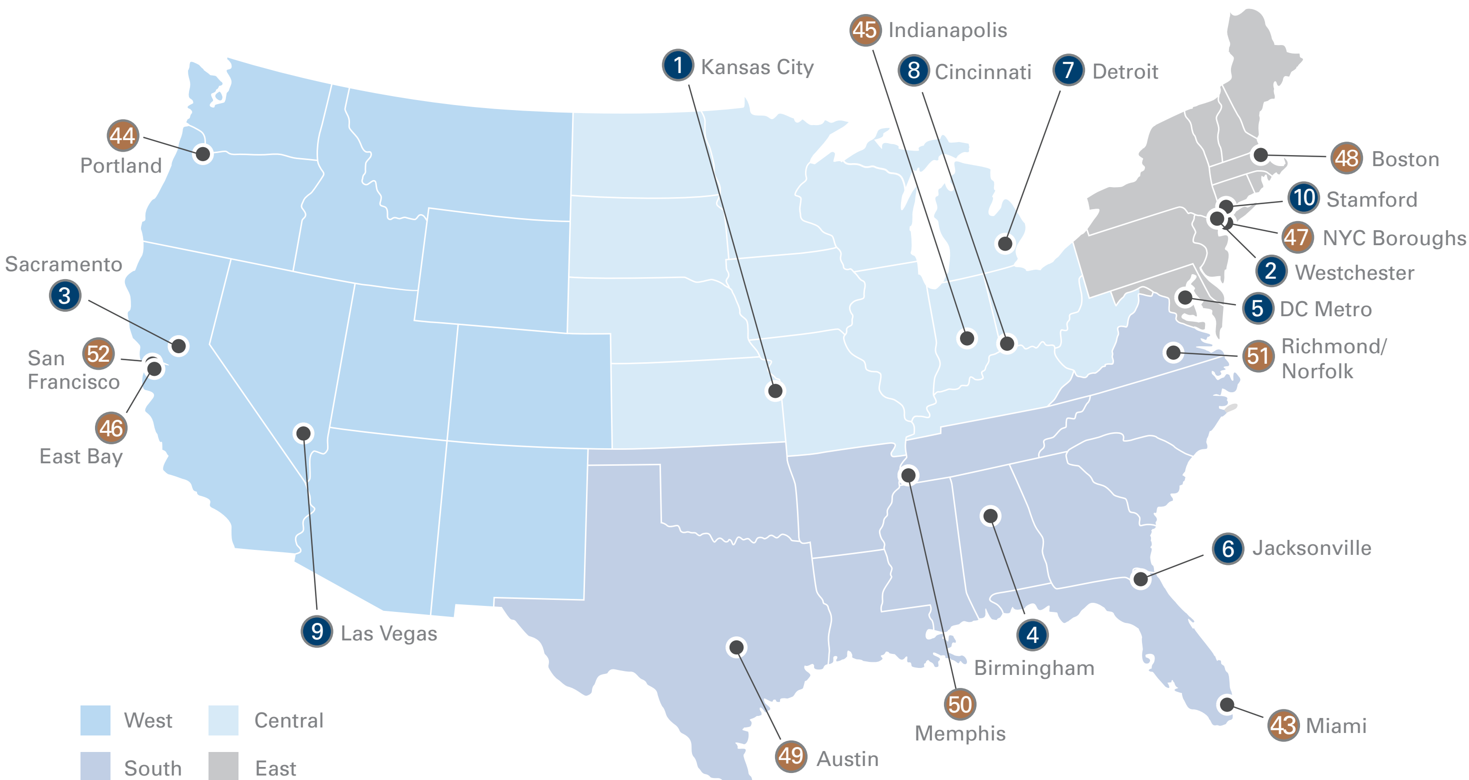
Looking ahead, investors seem to be concluding that the operating economics of basic industrial real estate are good now and will be getting better. On average, Warehouse/Manufacturing markets are calling for a 2.64% increase in market rents and an increase of 2.55% in expense growth rates through 2018.

By contrast, flex industrial markets are calling for a 2.25% increase in market rents and an increase of 2.54% in expense growth rates through 2018. This helps us understand why tech-heavy markets like San Jose, Raleigh, Austin, and Boston do not appear on the list of record-setters for January-September 2017.

5%+

Four markets are expecting 5%+ market rent growth: Cleveland, Hartford, Naples, and Seattle

TOP MARKETS BY INDUSTRIAL TRANSACTION VOLUME BASED ON YOY PERCENTAGE CHANGE



Bulls (Top 10)

YOY Rank	City	YOY Change	Total 4Q16-3Q17	Vol. Rank*
1	Kansas City	183.5%	$635.8 M	30
2	Westchester	170.8%	$1,275.0 M	14
3	Sacramento	162.3%	$873.7 M	22
4	Birmingham	134.4%	$89.6 M	51
5	DC Metro	119.0%	$3,190.6 M	3
6	Jacksonville	79.6%	$309.5 M	44
7	Detroit	78.7%	$815.8 M	23
8	Cincinnati	77.5%	$745.0 M	27
9	Las Vegas	65.2%	$735.2 M	28
10	Stamford	52.8%	$191.2 M	48

Bears (Bottom 10)

YOY Rank	City	YOY Change	Total 4Q16-3Q17	Vol. Rank*
43	Miami	-31.9%	$1,016.9 M	19
44	Portland	-33.9%	$654.6 M	29
45	Indianapolis	-34.2%	$628.3 M	32
46	East Bay	-36.5%	$1,407.1 M	12
47	NYC Boroughs	-37.0%	$1,354.5 M	13
48	Boston	-40.0%	$1,173.8 M	17
49	Austin	-44.1%	$388.7 M	41
50	Memphis	-54.0%	$425.6 M	39
51	Richmond/Norfolk	-54.6%	$222.7 M	47
52	San Francisco	-59.6%	$535.4 M	36

* Volume Ranking is based on the overall transaction volume among 52 markets nationally

2.64%

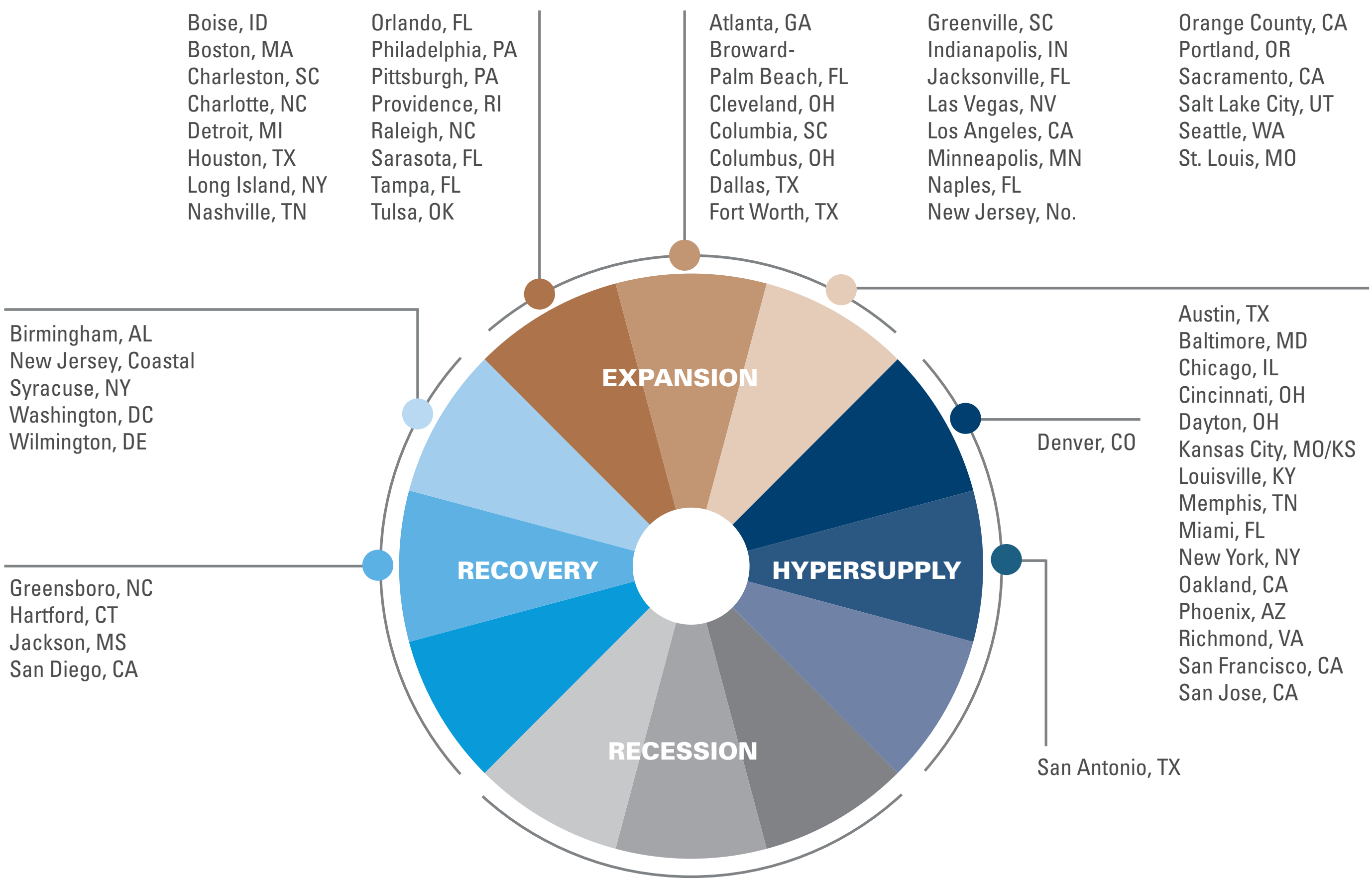
Increase in market rents anticipated for traditional industrial properties in 2018

Cyclical Conditions

Perhaps unsurprisingly, given the foregoing data, 83.8% of all industrial markets (52 out of 62 in Integra's tally) are considered to be in the Expansion phase of the market cycle. Nine of the remaining 10 are categorized as in recovery (which means falling vacancy that has not yet spurred much new construction or robust rental growth). Only Denver and San Antonio, which are both characterized as being in hypersupply, are labeled as being out of balance to any significant degree.

Breaking things down by region, all 11 markets in the Central states are deemed to be in expansion. In the West, only San Diego ranks as being in the recovery phase. The South finds three markets in recovery:

INDUSTRIAL MARKET CYCLE



EXPANSION

Decreasing Vacancy Rates
Moderate/High New Construction
High Absorption
Moderate/High Employment Growth
Med/High Rental Rate Growth

HYPERSUPPLY

Increasing Vacancy Rates
Moderate/High New Construction
Low/Negative Absorption
Moderate/Low Employment Growth
Med/Low Rental Rate Growth

RECESSION

Increasing Vacancy Rates
Moderate/Low New Construction
Low Absorption
Low/Negative Employment Growth
Low/Neg Rental Rate Growth

RECOVERY

Decreasing Vacancy Rates
Low New Construction
Moderate Absorption
Low/Moderate Employment Growth
Neg/Low Rental Rate Growth

Birmingham, Jackson, and Greensboro. The East has the greatest number of such markets, five of 13 (38.5%): Syracuse, Wilmington, Hartford, Coastal New Jersey, and Washington DC.

Taken as a whole, industrials appear to have the opportunity to sustain strong cyclical momentum through 2018, and even beyond

As a sector, this property type seems to be more in a mid-cycle than a late-cycle stage. This, perhaps, helps explain why industrials are running contrary to the trend of diminishing investment volume afflicting the other major property types. Everyone, it seems, loves a winner.

Cap Rates & Value Outlook

The strength of industrial investment property is its ability to produce relatively stable income returns, especially in the core warehousing/ distribution segment. This is a function of the norm in leasing: long-term, triple-net contracts inked with high-credit tenants. The trade-off is that there is usually not much in the way of appreciation expected during the investment holding period. So, cap rates tend to be high. And, indeed, that is the case for the major regional averages revealed in this year's IRR survey: from a low 5.9% in the West to a high of 7.3% in the Central region. The range for Flex properties – which have more volatile income streams and less stable demand characteristics – extends from a low in the West of 6.6% to a high of 8.0% in the Central. Such high cap rates go a long way to explaining the multi-year streak of double-digit returns in the NCREIF data.

REGIONAL RATES COMPARISON - INDUSTRIAL

	Cap Rate	Discount Rate	Market Rent ($/SF)	Vacancy Rate	4Q16 - 4Q17 Cap Rate
South Region					
Flex Industrial	7.70%	8.76%	$8.82	8.15%	▼ -8 bps
Industrial	6.99%	8.11%	$5.08	6.86%	▼ -6 bps
East Region					
Flex Industrial	7.40%	8.47%	$10.32	9.02%	▲ 2 bps
Industrial	6.48%	7.62%	$6.58	8.24%	▼ -10 bps
Central Region					
Flex Industrial	8.01%	9.01%	$7.57	9.86%	— 0 bps
Industrial	7.30%	8.35%	$4.24	8.28%	▼ -3 bps
West Region					
Flex Industrial	6.57%	7.89%	$12.25	8.54%	▼ -4 bps
Industrial	5.89%	7.25%	$7.36	5.73%	▼ -4 bps
National Averages/Spreads					
Flex Industrial	7.44%	8.55%	$9.67	8.71%	▼ -3 bps
Industrial	6.69%	7.86%	$5.75	7.14%	▼ -5 bps

What is the outlook? IRR's respondents think it is favorable.

Virtually all (92%) of the core industrial markets expect values to increase in 2018. For many of these, the value increase is significant: 62% are predicting an increase in asset value growth of greater than 2% over the next 12 months. The West leads in anticipated value growth, and several warehouse markets (Los Angeles, Portland, and Seattle) expect appreciation of 4% or more in 2018.

Meanwhile, 41.3% of flex industrial markets anticipate asset value growth of greater than 2% over the upcoming 12-month period, while 17.5% of flex industrial markets do not expect any increase in values next year. Las Vegas is the sole flex market predicting value growth above 4%. So it is natural that going-in cap rates are higher for the flex product.

62%

of industrial markets predict an increase in asset value growth of +2% over the next 12 months

Comprehensive Commercial Real Estate Market Research, Valuation and Advisory Services

About IRR

Integra Realty Resources (IRR) is the largest independent commercial real estate valuation and consulting firm in North America, with over 158 MAI-designated members of the Appraisal Institute among over 580 professionals based in our 49 offices throughout the United States and the Caribbean. Founded in 1999, the firm specializes in real estate appraisals, feasibility and market studies, expert testimony, and related property consulting services across all local and national markets. Our valuation and counseling services span all commercial property types and locations, from individual properties to large portfolio assignments.

About Viewpoint

IRR's Viewpoint represents the compilation and presentation of Commercial Real Estate (CRE) rates, market conditions, and forecast data. The rates, market conditions, and forecast data is generated via IRR's Viewpoint Survey. IRR's Viewpoint Survey requests market experts consisting of Appraisers and Consultants, each of whom have deep CRE expertise, to provide insights on over 60 U.S. markets. Viewpoint data is collected across five asset classes including Multifamily, Office, Retail, Industrial, and Hospitality.

Viewpoint's rates data (Cap Rates, Discount Rates, Reversion Rates, Vacancy Rates, etc.) reflects an expert's opinion based on recent market activity experienced in the past 6 months. Viewpoint forecast data represents a 12-month outlook based on current market conditions. The data in Viewpoint reflects rates data and forecasts based on stabilized properties in the respective U.S. marketplace. Where referenced, all regional and national averages are based on simple average calculations and are not weighted.

IRR's Viewpoint Survey is conducted through a proprietary data survey tool, and all data is checked both manually and by a specially designed computer editing procedure. While we do not guarantee that the survey is statistically accurate, the Viewpoint data provides, what we believe, is the best, clear-sighted insights into the CRE marketplace.

Sources

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Top Markets by Industrial Transaction Volume Based on YOY Percentage Change
Source: Real Capital Analytics

Market Cycle
Source: Integra Realty Resources

Regional Rates Comparison
Source: Integra Realty Resources