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Source: David Bodamer
National Real Estate Investor (NREI)

There's little dimming the outlook for the industrial sector, according to National Real Estate Investor's latest study on the sector.

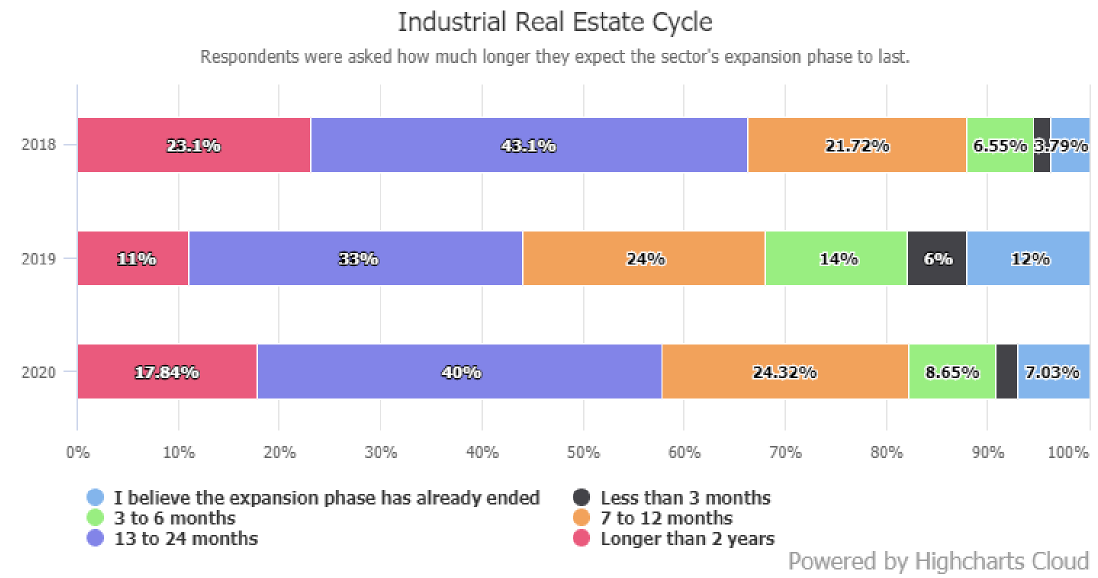
Neither ongoing international trade disputes, nor the warning signs of a potential recession, nor the uncertainty that's emanating from a particularly fraught U.S. presidential election year are enough to dim the enthusiasm for the industrial real estate sector, according to the NREI's sixth annual study.

In the 2019 survey, sentiment was also strong for industrial fundamentals across the board, but there were some signs of trepidation, with bullishness on many metrics a tick below where it had been in previous years. This year that sense of caution has evaporated. The unexpected shift to an economic climate with falling interest rates has served as a boost to all commercial real estate sectors and industrial is no exception to that trend.

One respondent wrote, "The momentum that has happened fuels even further expansion. The sight of a completed project stimulates the vision of more." Another described the industrial sector's conditions as "markets are not overbuilt, capital is available, the fundamentals of the overall economy are still strong and the retail shift to efficient delivery models is still in early stages."

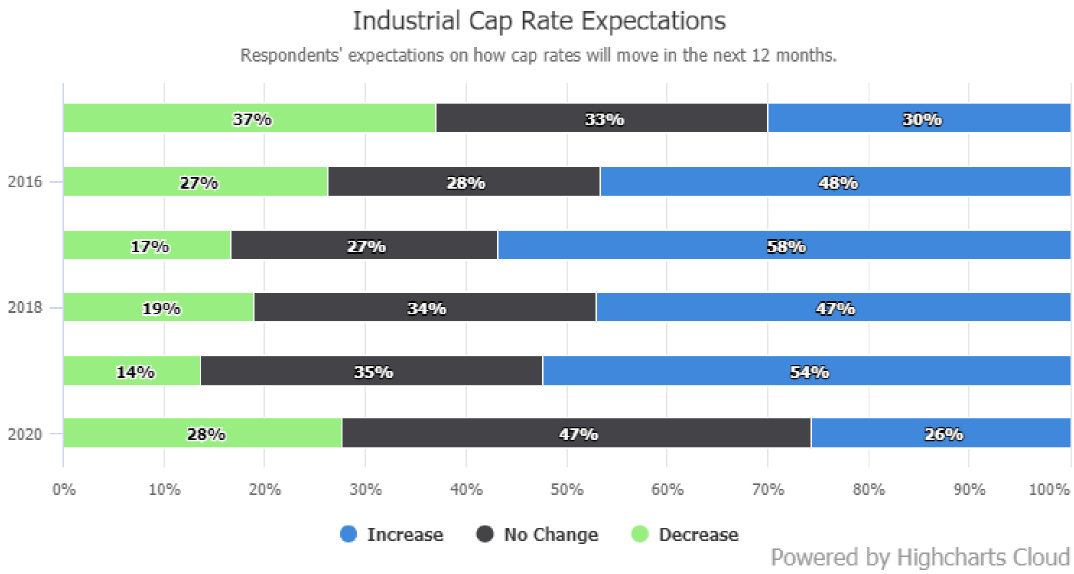
One relative gauge of readers' comfort with the sector is that a majority of respondents said they think the current expansion cycle will last another 13 to 24 months or longer. In all, 57.8% of respondents answered "13 to 24 months" (40%) or "longer than two years" (17.8%). Last year, the combined figure for those responses was 44%. To put that another way, despite 12 months having passed, industry participants see a longer runway ahead for the industrial sector today than they did a year ago.

At the other end, a small minority (7%) said the "expansion phase has already ended." In the 2019 survey that number was 12%.



According to respondents, cap rates in the sector tightened. Most estimate industrial caps at sub-6% in their regions (5.8%) and nationally (5.9%). The regional figure had held steady at 6.1% for the previous three years. That dovetails with industry data. According to CBRE's most recent U.S. cap rate survey, industrial cap rates nationally stood at 6.13% as of the second half of 2019. That included cap rates of 4.89% on class-A assets, 5.80% on class-B assets and 7.87% on class-C assets.

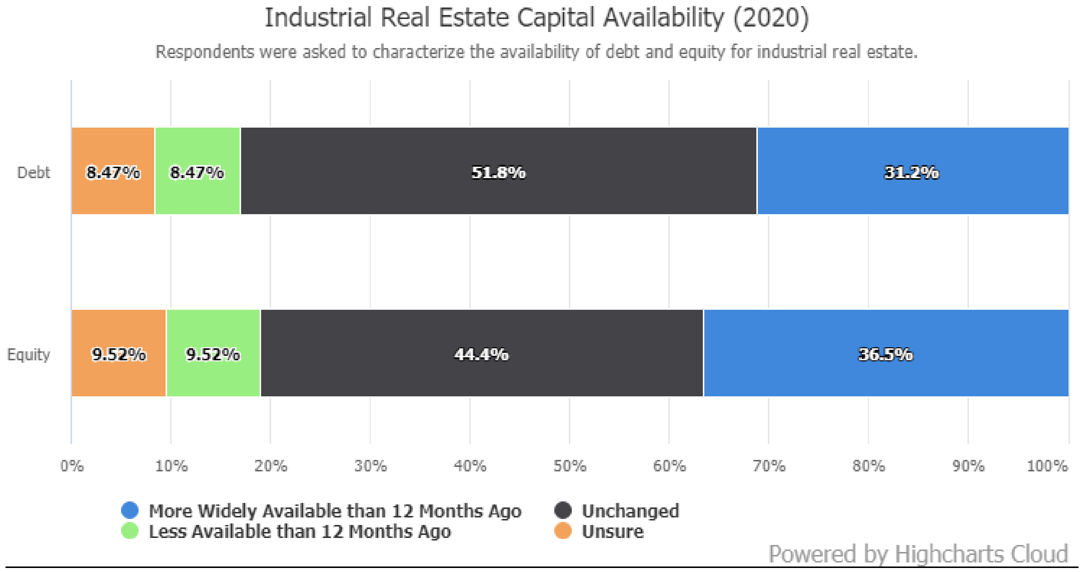
One major change from last year's survey is that we've gone from a rising interest rate environment to one where the Fed has now been steadily reducing rates. As a result, expectations on cap rates have shifted considerably from past surveys. In most previous years, a majority or plurality of respondents expected cap rates to rise and another chunk of respondents expected cap rates to remain flat. Generally, fewer than 20% of respondents have predicated lower cap rates. This year, however, the numbers have shifted. Only 26% of respondents this year expect cap rates to rise in the next 12 months- the lowest figure the survey recorded in the last six years. A plurality (47%) expect stability. Meanwhile, 28% expect cap rates to decrease- the largest figure seen since the 2015 survey.



The Financial and Investment Picture

Survey respondents see a stable picture on the capital markets front.

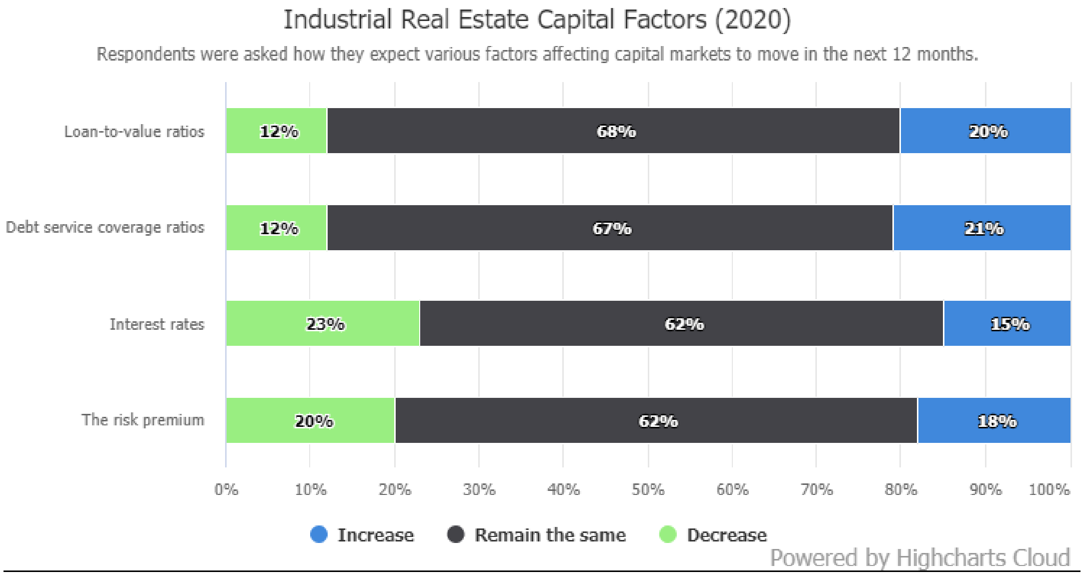
For equity, 44.4% of respondents said the availability of capital was unchanged from a year ago (the figure has been consistent now for the last three years). An additional 36.5% said capital was more widely available (up marginally from last year's 33%). Meanwhile, only 9.5% said less equity capital was available (down from 15% a year ago).



The picture is nearly the same on the debt side, where 51.8% said it was unchanged (up a hair from the 47% in 2019), 31.2% said it was more widely available (up from 27%), and only 8.5% said it was less available (down from 15%).

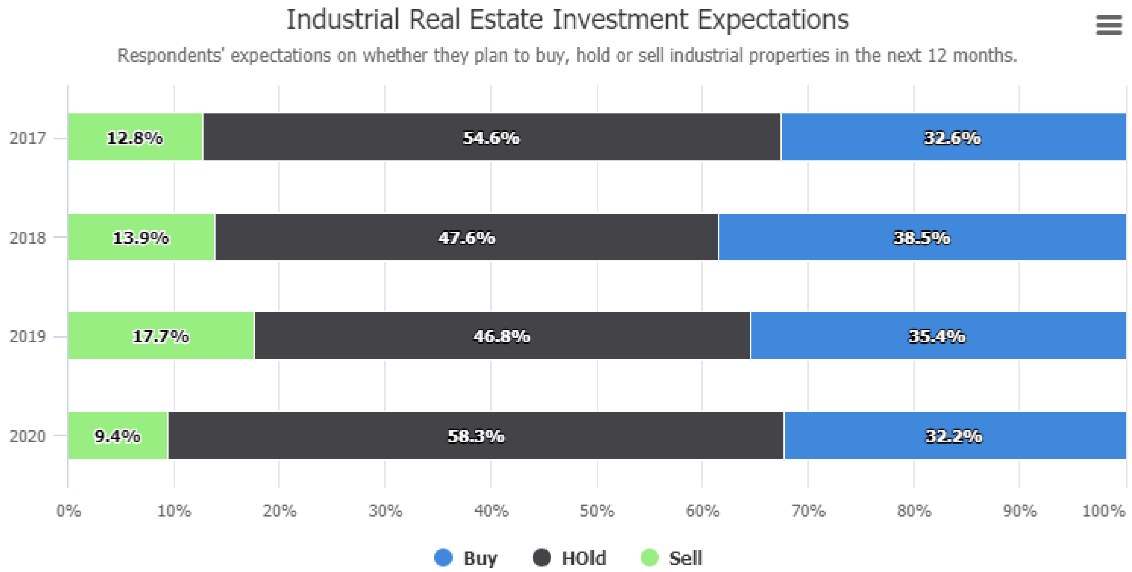
A respondent added, "There are still several years to go in the double-digit growth rate of e-commerce, there has not been overdevelopment in most markets, and there is an overabundance of debt and equity capital interested in this sector."

As for the macro factors that impact capital markets, the only significant change, unsuprisingly, pertains to interest rate expectations. A year ago, nearly four-fifths (79%) expected further interest rate increases, while only 1% said they expected rates to decrease. It turns out the 1 precentors were correct. This year, 62% see interest rates staying flat. About one-quarter (23%) see further decreases ahead and now just 15% expect interest rates to tick back up in the next 12 months.

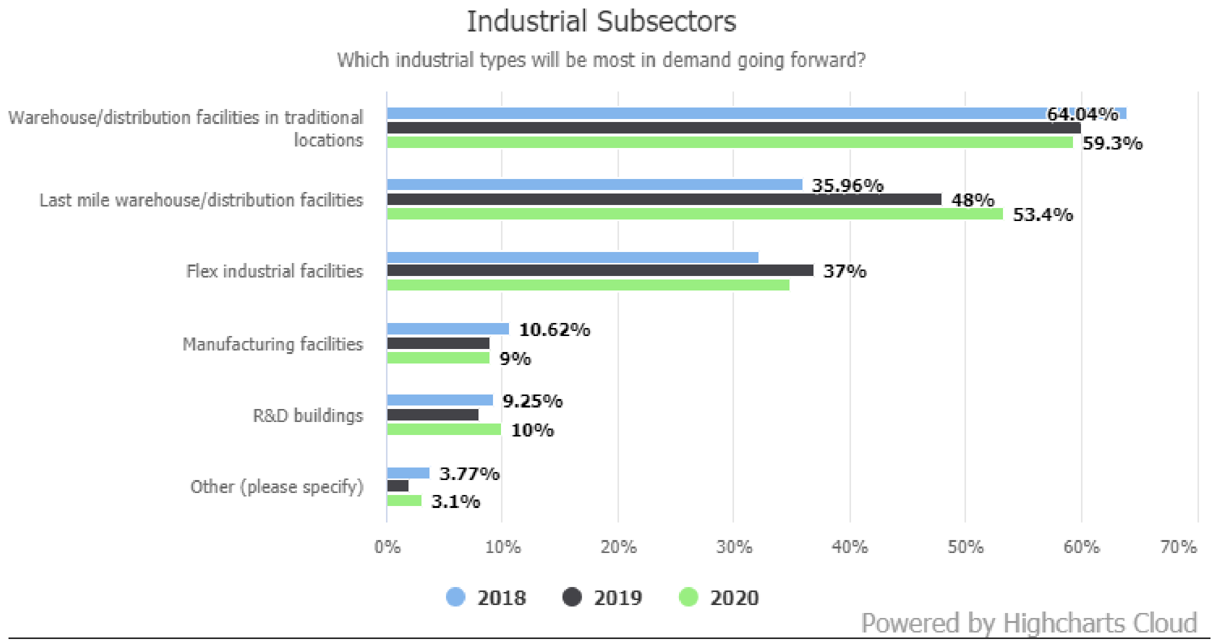


For the other factors, the numbers were fairly consistent, with between three-fifths and two-thirds of respondents seeing loan-to-value ratios (68%), debt service coverage ratios (67%) and the risk premium (62%) all remaining stable in the year ahead.

When it comes to investment activity, respondents have shifted to more of a "hold" mentality (58.3% this year, up from 46.8% in 2019). About one-third (32.2%) said they plan to buy- which is down just slightly from a year ago (35.4%). The real movement came on the sell side, where just 9.4% said they plan to sell industrial properties in the next year- a level nearly half of what it was a year ago (17.7%) and the lowest in the four years the survey asked this question.



Respondents had some thoughts as to where the activity will occur. There's been a growing preference for "last-mile" warehouse and distribution facilities. This year, 53.4% said they think that sub-sector will be in most demand, representing 14.7 percentage points of growth in the past two years.



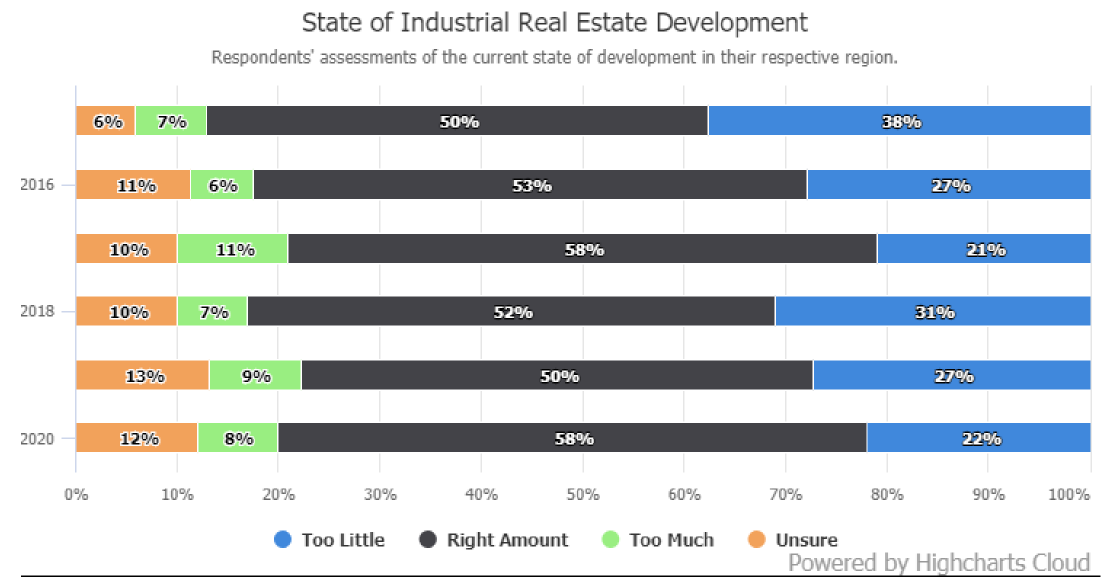
As one respondent described it, "There is still such a strong demand for industrial and distribution, in particular for last-mile space, given how much consumers are spending on e-commerce. Retailers need to get their products out quickly."

Meanwhile, traditional warehouse/distribution facilities still top the list at 59.3%. But the gap between those two types has shrunk from 28 percentage points in 2018 down to less than six percentage points in this year's survey.

Healthy Demand Endures

Despite industrial real estate's long bull run and a robust pipeline that delivered more than 330 million SF of new space in 2019 in North America and is projected to deliver more than 300 million SF of space this year, according to figures from Cushman & Wakefield, respondents largely remain unconcerned about the potential for overdevelopment.

In all, 58.3% of respondents said the level of development is about right for the sector, up from 50% last year. And just less than one-quarter of respondents (21.9%) indicated there is too little development occurring (down slightly from 27% last year). Meanwhile, only 7.8% said too much development is taking place.

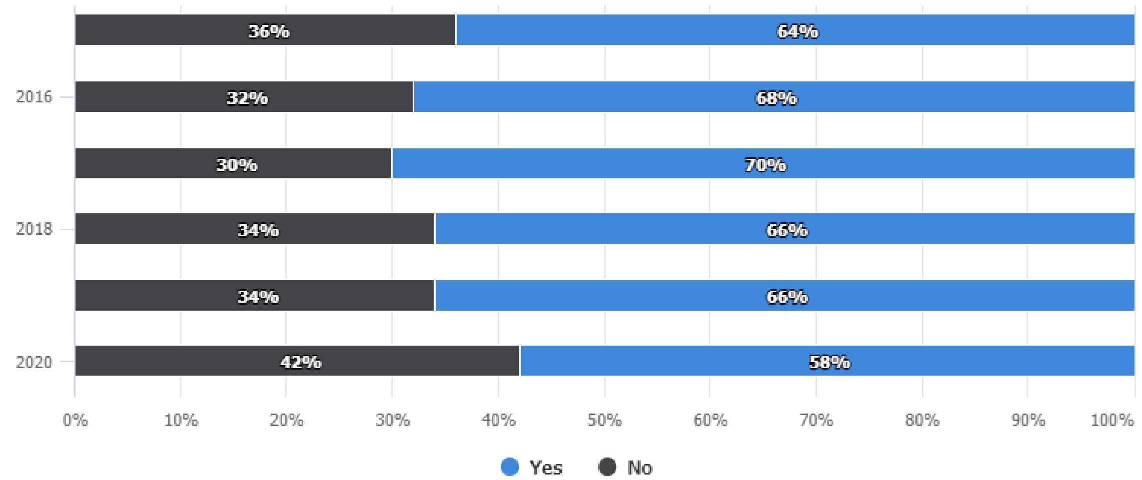


However, respondents' estimates about how much additional supply their markets could absorb shifted some from previous years. Last year marked a high with 24% or respondents saying that their markets could take on new supply equal to 25% or more of current inventory levels. That number dropped to just 14% this year. Instead, roughly half of respondents pegged the level at 10% to 14% of current inventory (28.6%) or 5% to 10% of current inventory (21.4%).

For it's part, Cushman & Wakefield said that deliveries did outpace net absorption in 2019 and that is likely to occur again in 2020 and 2021. The net result is the vacancy rate for industrial properties in North America will likely tick up from current levels of 4.6% to about 5.2% in the next two years.

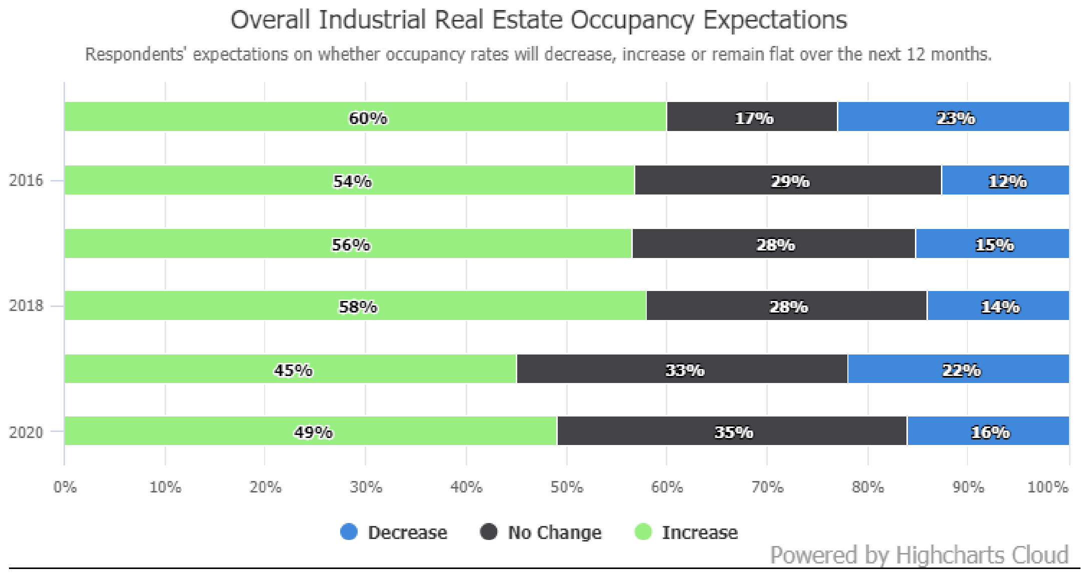
"This sector does have approved projects that match the demand being created by growth in several important sectors: biotech; technology; warehousing," one respondent wrote in. "The absorption rates will continue to be strong and expansion will continue in the sector."

As in past years, NREI continued to gauge how the conversion of old industrial boxes into other uses is affecting industrial real estate fundamentals. Overall, 57.6% of respondents said that this activity is taking place in their markets- the lowest level in the six years we've been asking the question.

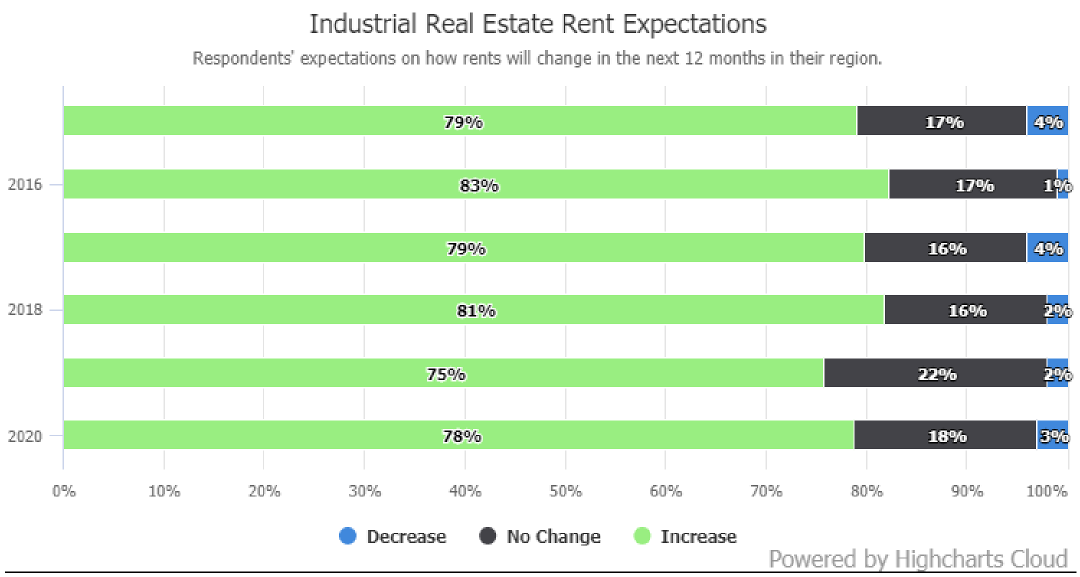


Respondents are also seeing these conversions having less effect on the market. In the past, surveys indicated that this activity was leading to lower total inventory in the industrial space. The number peaked at 53% in 2015, but has fallen to a new low of 23.9% in this year's survey. Now, a clear majority says these conversions are either being balanced by new construction (46.8%) or that new construction is outpacing the loss of space to conversions (29.4%). Both of these figures represent new highs.

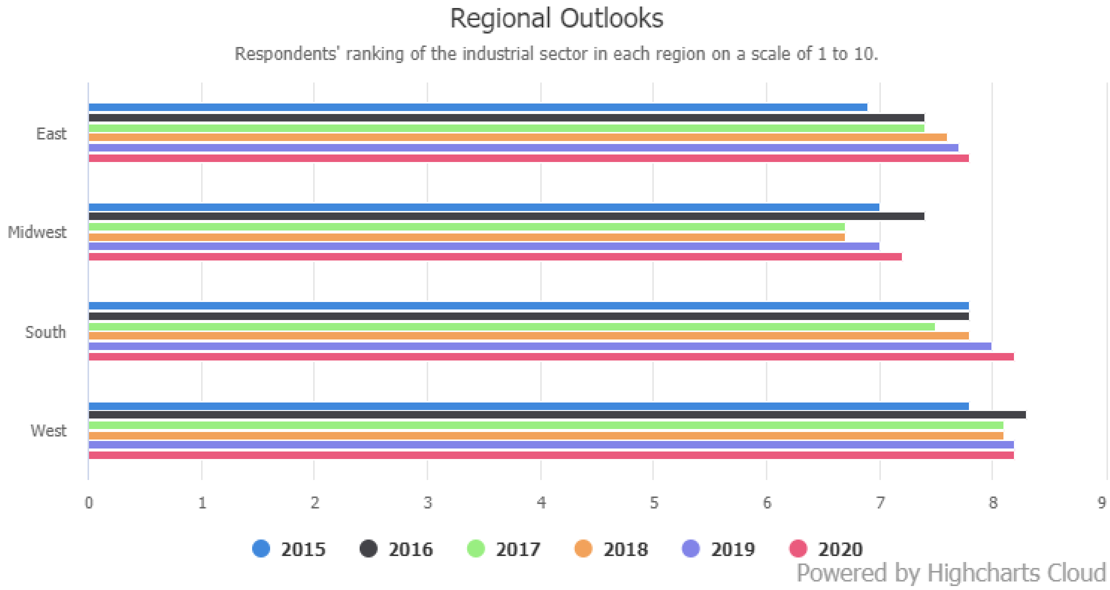
Meanwhile, in terms of overall occupancy rates, numbers were consistent with last year's levels. In all, 49% said they expect occupancy rates to rise in their region this year (up slightly from 45% in 2019). An additional 35% expect no change (virtually unchanged from 33% last year). And, 16% said occupancy rates will decrease- down four percentage points from last year's figures.



One other fundamental, rents, respondents' expectations remained virtually identical with levels from past years.



The majority of respondents (approximately 78%) said they expect rents to rise in their region in the next 12 months. The figure has been around 80% in all six survey's. A mere 3% said they think rents will decline. That level has never topped 4% in any of NREI's studies. Meanwhile, 18% said rents will be flat- down some from the 22% who answered that way in 2019.



Lastly, respondents were asked to rank the relative strength of their regions. The results were similar to past years (on a scale of 1 to 10)- with the West (8.2) and the South (8.2) continuing to top the East (7.8) and Midwest (7.2). The numbers for all four regions were within 20 basis points of the figures from last year's survey.

Survey Methodology

The NREI research report on the industrial real estate sector was completed via online surveys distributed to readers of the National Real Estate Investor in January 2020. The survey yielded 207 responses. Recipients were asked what regions they operated in (and were allowed to select multiple regions). Overall, 46.9% said they operated in the South, followed by the West (45.3%), East (44.8%) and Midwest (32.8%). Approximately half of the respondents are investors and developers. About half of respondents (41.7%) hold the titles of owner, partner, president, chairman, CEO or CFO.

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