The U.S. industrial market has been on a strong run since 2012, drawing investors with stable returns and long-term growth potential. Buoyed by growth in e-commerce, corporate expansion of distribution spaces, and overall momentum in the nation’s supply chain, the industrial sector has become the darling of many investors.

In light of this vibrant investment cycle, Real Capital Markets (RCM) joined with the Society of Industrial and Office Realtors (SIOR) to gauge how the market was faring from an investment standpoint. How much room is left in this cycle? How is expansion in e-commerce filtering through the supply chain and affecting leasing, development, and capital market sales? What will investors see over the next 12 to 18 months? This study was compiled through a survey of RCM principals, SIOR members and subsequent research.

Highlights of the industrial study include:

- Activity should be strong into 2018 Tom Powers of Cushman & Wakefield in Cincinnati, expects a big push to get deals done through the end of the year, with the focus on active listings.
- Pricing is expected to increase over the next 12 to 18 months. Many survey respondents predicted at least a 5% growth rate and possibly twice that level.
- E-commerce is not going away and will continue to shape the future of industrial space usage and capital market sales, notes Geoff Kasselman, SIOR, of NKF in Chicago.
- Brokers were, in general, more optimistic than the principals surveyed. Just over half (51.8%) of brokers said they expect activity levels will increase, even if only nominally. Another 39% believe healthy activity will be the norm for the next 12 to 18 months.
- Activity is spread across all types of buyers, including recognizable institutional investors, REITs, private investors and many foreign investors. Jack Fraker, SIOR, of CBRE in Dallas, noted that many large deals are attracting more than 100 potential buyers (signed NDAs) interested in examining the offerings.
Industrial Activity: Is there Room on the Runway?

This industrial cycle, and the record expansion in leasing, construction and capital market sales, has been striking in its longevity. Investment sales volume has been strong since 2011, with demand outstripping supply in many core markets in recent years. The big question is — “How long will it last?” According to those surveyed, there appears to be no end in sight, at least for the next 12 to 18 months.

“We are not at the record levels of 2015, but activity is at least on par with and will likely surpass 2007, the second-best year of all time for industrial investment,” Fraker said. “We are seeing significant volumes of activity throughout the sales and marketing process because the fundamentals—absorption, vacancy and rent growth—are so compelling. I don’t see anything slowing down in 2018—not deal flow, fundamentals or the economics.” That sentiment was shared by 90 percent of the respondents in the survey. Approximately nine in 10 believe investment activity will remain the same or increase in 2018.

<table>
<thead>
<tr>
<th>Outlook for industrial investment levels for next 12 to 18 months</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase above current levels</td>
<td>19.3% (Brokers: 19.1% / Principals: 19.6%)</td>
<td></td>
</tr>
<tr>
<td>Increase, but only nominally</td>
<td>28.5% (Brokers: 32.7% / Principals: 23.7%)</td>
<td></td>
</tr>
<tr>
<td>Remain at the current level</td>
<td>42.5% (Brokers: 39.1% / Principals: 46.4%)</td>
<td></td>
</tr>
<tr>
<td>Decrease from current level</td>
<td>7.3% (Brokers: 7.3% / Principals: 7.2%)</td>
<td></td>
</tr>
<tr>
<td>Decrease, but only nominally</td>
<td>2.4% (Brokers: 1.8% / Principals: 3.1%)</td>
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</tr>
</tbody>
</table>

Overall market fundamentals are strong, said Allen Gump, SIOR, CCIM, Executive Vice President with Colliers International in Dallas, TX. “The dynamics of the market are all favorable—the availability of investment property, a plethora of buyers in the market, a strong economy, lots of development and equally strong leasing activity. Investor sentiment is positive!”

Investor Andrew Boulton, Principal at Cardinal Industrial in Sherman Oaks, CA, says his firm, like many others, is focused on quality assets that meet specific criteria. Cardinal’s concentration on a specific asset type—single tenant, net leased industrial properties with 10 plus years of term left—is challenging when opportunities are limited, he noted. “It’s like waiting for a fastball but only seeing curveballs and sliders.” In general, deals are there, waiting to be made and tenants are expanding. “One concern is that it may not keep up.” Boulton continues, “We hope the expansion hasn’t peaked.”

That ongoing question of when the market will peak can also create some angst and lead to a cautious pullback by some investors, said Andy Bennett, one of the founders of Biynah Industrial in Minneapolis, MN. “We expect activity levels will continue as they have been, but with a slight decrease in velocity,” he said. “For some, the psychology is that we are deep into the cycle, which creates a natural, cautionary outlook.”

With this deep and prolonged investment cycle, there have been several shifts in geographic focus, as lack of supply, strong investor demand and other factors pull investors from primary markets to secondary and tertiary markets. Supply is particularly tight in diverse markets such as the Inland Empire, Miami, Seattle, Detroit and Northern New Jersey, according to Scott McKibben, Chief Investment Officer and Managing Principal, Brennan Investment Group in Chicago, IL.
Industrial Assets: Pricing Them Right

Pricing of industrial assets has been strong for several years and is at record levels in some core markets. The study found that principals and brokers believe pricing has not yet reached a true plateau, though that level may be on the horizon.

**Outlook for industrial pricing over the next 12 to 18 months**

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stay about the same</td>
<td>26.6%</td>
</tr>
<tr>
<td>Increase 5% or more</td>
<td>33.8%</td>
</tr>
<tr>
<td>Increase less than 5%</td>
<td>32.4%</td>
</tr>
<tr>
<td>Decrease 5% or more</td>
<td>3.4%</td>
</tr>
<tr>
<td>Decrease less than 5%</td>
<td>3.9%</td>
</tr>
</tbody>
</table>

(Brokers: 22.7% / Principals: 30.9%)
(Brokers: 38.2% / Principals: 28.9%)
(Brokers: 33.6% / Principals: 30.9%)
(Brokers: 2.7% / Principals: 4.1%)
(Brokers: 2.7% / Principals: 5.2%)

“This cycle feels different to me. During the last cycle, it began to feel like the market had been sustained for too long. It doesn’t feel like that today.”

Scott McKibben, CIO
Brennan Investment Group

“For the first time in a long time, industrial is the preferred asset class for investment and virtually every institutional investor wants more of it,” said Bo Mills, a managing director with JLL in Los Angeles, CA and Head of Industrial Capital Markets for the firm’s Western U.S. region.

Well-located, efficient industrial space is being competitively bid at extraordinary levels, said Robert Thornburgh, SIOR, CCIM, CPM, Executive Vice President, Partner at Kidder Matthews in Long Beach, CA. “The primary challenge is there isn’t nearly enough supply on the market to meet demand. With inventory so scarce, simply put, you will see more investors competing for fewer deals.”

Other survey respondents had a different perspective on pricing levels, however. Boulton suggests that pricing levels have already started to come down a bit, along with the level of indebtedness, a sign for him of souring economic times.
Putting a Cap on Cap Rate Compression

While overall activity and pricing levels are always of interest, the investment conversation often turns to expectations for cap rate movement. Approximately 17 percent of brokers and principals surveyed believe that cap rates could experience further compression. However, the vast majority of that number—16.9 percent—believe that any compression would only be slight.

Some markets, including Los Angeles, South Florida and Northern New Jersey, are seeing continued cap rate compression given the rent growth potential although there may be little room for further movement, Fraker said.

“Real estate professionals seem to have mixed opinions on where cap rates will go from here,” Thornburgh of Kidder Matthews said. “Interest rates certainly have direct influence on this for non-cash buyers. However, combine a limited supply with heavy investor demand and it almost goes without saying, cap rates will continue to see some level of compression—something that is hard to believe considering today’s investment climate.”

**Outlook for cap rates over the next 12 to 18 months**

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
<th>(Brokers: % / Principals: %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remain about the same</td>
<td>46.9%</td>
<td>(Brokers: 49.1% / Principals: 44.3%)</td>
</tr>
<tr>
<td>Increase slightly</td>
<td>34.8%</td>
<td>(Brokers: 33.6% / Principals: 36.1%)</td>
</tr>
<tr>
<td>Increase fairly significantly</td>
<td>1.0%</td>
<td>(Brokers: 0.9% / Principals: 1.0%)</td>
</tr>
<tr>
<td>Compress slightly</td>
<td>16.9%</td>
<td>(Brokers: 16.4% / Principals: 17.5%)</td>
</tr>
<tr>
<td>Compress fairly significantly</td>
<td>0.5%</td>
<td>(Brokers: 0.0% / Principals: 1.0%)</td>
</tr>
</tbody>
</table>

“We’ve reached the upper limits of pricing and would be surprised by any meaningful compression in cap rates. It would be nice if there was a healthy adjustment upward in cap rates, but I don’t see that happening for a couple of years.”

Andy Bennett, Founder
Biynah Industrial
Technological Impacts

The expansion of e-commerce and the general strength of the economy are key factors fueling industrial investment activity. Overall, 37.4 percent of respondents identified e-commerce as having the greatest impact.

Single greatest impact on industrial investments

<table>
<thead>
<tr>
<th>Impact</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developer discipline</td>
<td>1.9%</td>
</tr>
<tr>
<td>E-commerce growth/expansion</td>
<td>37.4%</td>
</tr>
<tr>
<td>Strength of economy</td>
<td>34.5%</td>
</tr>
<tr>
<td>Availability of investment capital</td>
<td>16.4%</td>
</tr>
<tr>
<td>Other</td>
<td>9.7%</td>
</tr>
</tbody>
</table>

Over the past 10 years, e-commerce has become a giant force that is driving 20 to 30 percent of the leasing activity in warehouse and distribution spaces across the country, Mills of JLL said. This expansion is likely to continue as Amazon.com and others push further into grocery deliveries and the overall “last mile” segment that includes same and next-day delivery services.

Geoff Kasselman of NKF believes the importance of e-commerce, and specifically the way Amazon is changing the marketplace, cannot be overstated. “Everyone needs an Amazon strategy,” said Kasselman. “If you are considering a particular property, you need to assume that Amazon wants it too, and may outbid you for it. If you are located near an Amazon facility, there will be great competition for labor, and it too could cost you more than you think. If that isn’t enough, are you partnering with them, using their data services, or are they coming for your industry next?”

Others see e-commerce as an important part of a broader industrial marketplace. “E-commerce definitely has played a role in the dynamic run of 30 consecutive quarters of positive absorption in the U.S.,” said McKibben of Brennan Investment Group. “But, we have to be careful to not overemphasize its role, because it is not solely responsible for the success of the industrial market.”

According to McKibben, the other key contributors include the robust housing industry (specifically multifamily), the comeback of the auto industry (both of which have long supply chains), and the “onshoring” of industrial manufacturing back to the U.S.

“There is manufacturing going on and no one sees it because it’s not your typical manufacturers. There are no smokestacks.”

Allen Gump, SIOR, Executive Vice President, Colliers International
The impact of a strong auto industry, for example, is not just being seen in Detroit, but also in markets such as South Carolina and Nevada, where BMWs and Teslas, respectively, are being manufactured. McKibben noted that the U.S. saw a net gain of over 200 manufacturers moving into the U.S. in 2016 and he expects that number to be even larger in 2017. Part of Brennan’s portfolio includes 200 manufacturing buildings in 25 states.

“Manufacturing is a much bigger driver than people realize,” McKibben said, noting that increasing use of robotics in many manufacturing applications have replaced some low paying jobs. Those savings, combined with lower transportation costs, are helping to drive manufacturers back to U.S. shores.

There also are some “invisible” increases in space utilization in other areas, growth and expansion that people aren’t even necessarily seeing, Gump of Colliers noted. In Dallas, for example, he’s seeing manufacturers of plastic containers, plastic bags and t-shirts, among others, that may require anywhere from 100,000 to 300,000 square feet of space in a distribution facility.

Too Hot and Overbuilt?

<table>
<thead>
<tr>
<th>Greatest threats to industrial real estate</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Overbuilding/oversupply</td>
<td>23.8% (Brokers: 9.1% / Principals: 40.6%)</td>
</tr>
<tr>
<td>Lack of supply of quality assets</td>
<td>33.0% (Brokers: 46.4% / Principals: 17.7%)</td>
</tr>
<tr>
<td>Unrealistic seller expectations</td>
<td>18.5% (Brokers: 14.6% / Principals: 22.9%)</td>
</tr>
<tr>
<td>Capital issues (cost, availability, etc.)</td>
<td>9.2% (Brokers: 11.8% / Principals: 6.3%)</td>
</tr>
<tr>
<td>Functionally obsolete properties</td>
<td>3.9% (Brokers: 3.6% / Principals: 4.2%)</td>
</tr>
<tr>
<td>Other</td>
<td>11.7% (Brokers: 14.6% / Principals: 8.3%)</td>
</tr>
</tbody>
</table>

The greatest threat for principals, by a level of almost 2:1, is overbuilding/oversupply of industrial product. In the survey, 40.6 percent of all principals identified overbuilding/oversupply as the greatest threat compared to unrealistic seller expectations (22.9 percent).

In identifying threats to industrial investment, Powers of Cushman & Wakefield is less concerned about a short-term trend, such as unchecked construction that leads to overbuilding and changes market dynamics for a time. Instead, he’s concerned about “events and activities that aren’t at the front of the mind, but are there; things that could turn the market real quick.”

Powers specifically cited what could happen if tensions in North Korea or Iran escalate and there was a stock market crash. “I am concerned about significant events where people get spooked.”

Gump, however, believes that the threat of unrealistic seller expectations can’t be overlooked. “You always run into that time when buyers hate to pay nose bleed prices and sellers want what everyone else has been getting,” he said. “There is a mismatch. But the question sellers have to answer for themselves is: ‘Can I wait for someone who will pay the higher/extra price?’

Interestingly, the market’s strong run of success can also be slowing some investment sales. Fraker notes that some investors are holding onto assets as they look ahead to the prospects of further rent growth. If NOI will be greater in a year, why sell now?
Politics at Play

Due to the nature of the industrial market, many companies and regions are intertwined with broader political issues, such as global trade policies. While the survey focused on U.S. investment activity and market dynamics, many respondents called attention to political issues and their potential impact on the industrial sector.

Cardinal Industrial’s Boulton said there is some nervousness about the overall political climate, including U.S. and foreign policy issues. Cardinal, like many other owners and developers, has a significant portfolio of industrial property in locations such as Laredo, Texas, which has a strong connection to Mexico.

“We love it in Laredo (Texas). We own eight buildings and have 13 tenants. But we are very nervous because of the current trade dialogue,” Boulton said. “Any type of trade issue, talk or tariffs or ending NAFTA that affects us, affects our tenants. It could disrupt demand.”

“This isn’t just happening in Laredo; the challenges are all over… anywhere that trade is an important part of the economy.”

Andrew Boulton, Principal
Cardinal Industrial

Kasselman of NKF also believes that the greatest threat is geopolitical in nature; an event that could compromise the market and the industry.

Yet when simply looking at the industrial real estate sector, he finds risk in oversupply. He specifically cited a suburban Chicago submarket where there are at least five newly constructed inventory or “spec buildings”, each over 1.0 million square feet, plus several others over 500,000 square feet. Yet he noted there only has been one recent transaction of greater than 500,000 square feet in the past few quarters. “There will be some nervous people there,” he said.
Aside from occupancy, location, and market conditions, investors are also evaluating assets based on the fundamental construction characteristics that can help dictate a building’s long-term viability. Mid-size industrial buildings equipped with modern features, for single and multi-tenant use, are viewed as the most attractive investment opportunity by both principals and brokers participating in the study.

Of those two offerings, mid-size, multi-tenant buildings were clearly viewed as the most attractive investment opportunity. Buildings with multiple tenants are often preferred because they provide a buffer against losing an income stream when vacancy occurs.

At the same time, perhaps some of the greatest values in industrial investments are the mid-size, infill development opportunities. Buildings that embrace the “last mile” concept and are in close proximity to labor may provide the greatest values.

Boulton of Cardinal Industrial concurred that the most attractive opportunities as being mid-size buildings with modern features that are flexible for either distribution or light manufacturing users. “If you are in a market that is solid enough, these ‘cookie cutter, high-clear modern buildings’ are easier to re-tenant than a specialty building,” he said.

Interestingly, infill redevelopment opportunities—often associated with so-called “last-mile” strategies—are essentially viewed as attractive as mid-size, single-tenant assets.

Lately, some of the most successful investments have been infill opportunities. Because they may have been built in the 1980s and may have lower clear heights, shorter truck drives, etc., they may be more ideally suited for “last mile” considerations. Especially for smaller tenants, or for the use of the building, modern features aren’t quite as critical.

Powers of Cushman & Wakefield is not necessarily a fan of infill development due to the inherent issues with older buildings and markets that are on the fringe. “Infill may be more talk than opportunity. Some use the term infill development to give greater importance to fringe suburban areas. It may be more hype and not much reality.”

**Most attractive industrial investments**

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Percentage</th>
<th>Brokers</th>
<th>Principals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newly-built, high cube distribution facilities</td>
<td>28.0%</td>
<td>35.5%</td>
<td>19.6%</td>
</tr>
<tr>
<td>Mid-size, modern, single-user facilities</td>
<td>16.9%</td>
<td>19.1%</td>
<td>14.4%</td>
</tr>
<tr>
<td>Mid-size, modern, multi-tenant facilities</td>
<td>35.8%</td>
<td>30.0%</td>
<td>42.3%</td>
</tr>
<tr>
<td>Infill redevelopment</td>
<td>16.4%</td>
<td>11.8%</td>
<td>21.7%</td>
</tr>
<tr>
<td>Other</td>
<td>2.9%</td>
<td>3.6%</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

“The greatest, most attractive investment opportunity in many markets is the flip that occurs after the design-build project has been completed and is occupied.”

Mark Duclos, SIOR, President
Sentry Commercial
The industrial market continues to outperform predications and appears poised to continue this growth cycle for at least another 18 months, according to respondents who participated in the RCM/SIOR Industrial Investment Sentiment Study. Strong fundamentals—robust leasing, rising rental rates, and tempered construction activity in most markets—all bode well for the investment market.

Investors continue to look down the road, however, with a mindful eye on any potential shifts that could lead to a slowdown, immediate or gradual. Any major geopolitical issues, including substantive restrictions to trade policies or the potential for international issues could adversely affect certain markets or industry segments, or perhaps even upset the market overall.

For the meantime, however, all eyes are on the many facets that keep this industrial cycle moving, including those that are obvious and easy to identify, such as e-commerce. The industry will also be mindful and responsive to growth in corporate distribution centers; overall supply chain dynamics; improvements in the manufacturing sector, including additional movement toward on-shoring; and space users’ ability to significantly curtail costs through reduced energy savings and transportation costs.

Combined, these market forces reinforce the decisions of investors—from institutional to foreign to entrepreneurial—to have industrial real estate as part of their real estate portfolios.

“Industrial real estate has achieved a level of equilibrium that is or has been more sustainable than in some certain other commercial sectors. That equilibrium and other market dynamics make industrial investment properties a preferred option among a wide range of investors, from entrepreneurs to institutions. We don’t foresee a dramatic shift in the near term.”

Steve Shanahan, Executive Managing Director
Real Capital Markets
Acknowledgments

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• Andy Bennett
  *Founder - Biynah Industrial Partners*

• Andrew Boulton
  *Principal - Cardinal Industrial*

• Mark Duclos, SIOR
  *President - Sentry Commercial*

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

• Allen Gump, SIOR, CCIM
  *Executive Vice President - Colliers International*

• Geoff Kasselman, SIOR, LEED AP
  National Industrial Practice, Chairman
  *Executive Managing Director - Newmark Knight Frank*

• Scott McKibben
  *Chief Investment Officer - Managing Principal, Brennan Investment Group*

• Bo Mills, SIOR
  *Managing Director - Jones Lang LaSalle*

• Tom Powers, SIOR, CCIM
  *Executive Managing Director - Cushman & Wakefield*

• Robert Thornburgh, SIOR, CCIM, CPM
  *Executive Vice President, Partner - Kidder Matthews*

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Founded in 1999, Real Capital Markets (RCM) is the global marketplace for buying and selling CRE. RCM increases the speed, exposure, and security of CRE sales through its streamlined online platform. Solutions include integrated property marketing, transaction management, and business intelligence tools to unify broker-level and firm-level data and work flows.

RCM has executed approximately 53,000 assignments with total consideration in excess of $1.9 Trillion. Over 50% of all U.S. commercial assets sold, over $10 million, are brought to market using RCM’s online marketplace annually.