INDUSTRIAL REPORT

VIEWPOINT 2017 / COMMERCIAL REAL ESTATE TRENDS
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Growing Consumption Fuels the Industrial Sector

IRR research indicates that more than half of U.S. industrial markets should expect value increases of 2% or higher in 2017. The outlook is especially optimistic for major ports and distribution centers, where e-commerce demand is booming. Goods production and transportation, fueled by U.S. consumption growth, has steadily improved economic fundamentals for industrial properties, two-thirds of which are basic warehouse/distribution facilities. This bread-and-butter segment posted a 50
basis point improvement in vacancy rate, to 7.6%, while the flex/R&D sector tightened vacancy by a full percentage point, on average, to 9.1%.

From 18-wheelers, to panel trucks, to local delivery vans, America’s thoroughfares testify to the volume of goods coming to market. E-commerce growth is undoubtedly playing a large part, but even what is sold online does not ship directly from the factory. As stores themselves morph more and more into showrooms, the inventory chain is becoming even more critical and time-sensitive. Ironically, as we have putatively become a “knowledge economy,” our yen for stuff has never been greater. Go figure.

Transaction Volume

We need to look carefully at the industrial sector’s numbers. For the 12 months ending September 30, 2016, transaction volume was up 2.7% from the prior year, at $67.9 billion. But the final quarter of 2015 was huge – nearly $27 billion – owing to a cluster of portfolio and entity transactions. Absent that quarter, we find industrial investment slowing significantly in 2016.

The patterns are even more complex than that, since single-asset deals are up modestly, somewhat compensating for a pullback in megadeals. The flex sector was actually up 13% in the first three quarters of 2016, even as warehouse purchases fell 30% in dollar volume. And specifically, R&D/Tech/Telecom buildings jumped an eye-popping 74%, albeit on just $3 billion in aggregate price. Thus, markets like San Jose, Boston, suburban Maryland (health sciences) and suburban Virginia (defense-related IT) saw transaction volumes edging up, as data from Real Capital Analytics show.
YOY transaction volume was up 2.7%, but absent 4Q 2015, the Industrial investment slowed significantly in 2016
Warehouses fit a sweet spot in investors’ portfolio needs, as these properties are low-volatility income generators whose triple-net lease structure affords long-term inflation protection. Cap rates tend to be higher, as appreciation is a lesser component of total yield. And so, distribution facilities account for $27.5 billion of the total $41 billion in industrial transactions over the first three quarters of 2016.

Valuations are generally expected to rise in 2017, according to IRR’s research, which finds 54% of all markets expecting increases of greater than 2% this year. Las Vegas (flex), Los Angeles, Seattle, Portland, and Northern New Jersey (warehouses), and Miami (all industrial) anticipate value increases of 4% or more. Baltimore, on the other hand, could see industrial values pull back in the year ahead.
Market Cycle

IRR sees 83% of all markets in the expansion phase; last year close to 25% of markets were in recovery, and heading into 2017, only 17% of markets are in recovery. Markets such as Providence, Cleveland, Phoenix, and Sacramento have moved along the cycle to the expansion phase. No markets are in the hypersupply phase, and no markets are rated as being in recession.

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Measured against supply/demand equilibrium, 58% of industrial markets are in balance compared with 40% of flex industrial markets. Over 33% of markets are more than two years away from being in balance. The cycle still has some time before peaking.

There are a handful of warehouse markets with particularly strong rental increases expected: Cleveland, Hartford, Miami, Orange County, and Seattle are all projected at 4% growth or more. For Hartford and Seattle, this outlook does not extend to flex (but it does for the others). Broward/Palm Beach flex space joins the club in anticipated 4% or higher gains in market rents.

Cap Rates

While rates moved marginally lower in 2016, the shifts were just 10 bps for flex space (to 7.5%) and only 8 basis points for warehouses (to 6.75%). Such moves are as likely to be statistical noise as they are real adjustments. Pricing in the industrial space can best be termed “steady” this past year – which is not bad given the softening in transaction volume.

75% of markets expect Cap Rates to remain stable in 2017

National averages, of course, mask considerable variation from market to market. Warehouse cap rates range from a low of 5% in New York, Seattle, Orange County, and Oakland to highs in Greensboro and Providence of 9.25%. Another sign of steadiness in this sector is the expectation of stable cap rates in 2017 in about 75% of the markets. On the flex side, the spread is somewhat narrower with a low of 6% (New York and San Jose) and a high of 8.75% in the Deep South markets of Birmingham and Jackson. Cap rate stability is anticipated to continue for about three-quarters of the flex markets as well.

Conclusion

The uncertainty surrounding the U.S. elections, and the fairly widespread volatility worldwide during 2016, may have played a part in reducing capital inflows into industrial real estate. If nothing else, the financial markets seem to express an emerging consensus of greater short-run economic growth and stronger corporate profits in 2017. If so, that augers well for both supply/demand fundamentals and transaction volumes for the industrial property market in the coming year.
**About IRR**

Integra Realty Resources (IRR) is the largest independent commercial real estate valuation and consulting firm in North America, with over 191 MAI-designated members of the Appraisal Institute among over 600 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

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