

Industrial Market Roundtable

Panel Expects Recovery Late 2010, Early 2011

As the U.S. economy continues to shed jobs — 1.3 million in the first 11 months of 2009 — consumer spending and demand for industrial space is shrinking. The national industrial vacancy rate hit a 15-year high at 10.3 percent in the third quarter, according to Cushman & Wakefield reports. But with the recession officially over, the industry is showing some small signs of recovery as well. According to the Federal Reserve, industrial production during the third quarter of 2009, surprisingly reported the largest quarterly gain in more than four years. And, significantly, the Institute for Supply Management's (ISM) manufacturing index, and important measure of the economy's overall strength, reported 52.6 in September, indicating some economic growth, albeit slow growth.

To give our readers a deeper perspective on the industrial market, we invited expert panelists **Lewis Friedland**, founder and managing partner of Cobalt Capital Partners and **Guy Jaquier**, president of private capital at AMB Property Corp., and **Maria Sicola**, senior managing director and head of research at Cushman & Wakefield, to share their views. Below is an excerpt from the conversation:

Each of the property markets have been impacted by the economic downturn to some extent. How is the industrial market fairing?

Maria Sicola: The industrial sector has certainly not been insulated from the downturn in the economy. We are looking at vacancy rates that are at their highest level in about 15 years. Construction activity is off 45 percent year-over-year, and that includes both speculative as well as build to suite. Leasing is also off significantly. We've seen declines of roughly 30 percent from where we



The Panelists: (from left) Lewis Friedland, founder and managing partner of Cobalt Capital Partners, Guy Jaquier, president of private capital at AMB Property Corp., and Maria Sicola, head of research at Cushman & Wakefield.

were a year ago. There are a few markets that are actually performing fairly well and have indicated and demonstrated an increase in activity — Oakland, the San Francisco peninsula, Florida, and Long Island, for example — but overall, in terms of leasing, and construction completions investor sales, we are seeing declines just as we are in the office market.

Guy Jaquier: If you look at our operating portfolio we started out the beginning of the year with an occupancy rate of about 95 percent. That came down to a low of around 90 percent in the course of the year. We've been stabilized and sort of bumping along at 90 to 91 percent rate, and we think that's the bottom. Internationally, the trends are similar to those in the United States. In Western Europe, the recession happened a bit later and was not as deep as in the United States. The industrial occupancies there are actually higher than in the United States and are at a 94 to 95 percent range. We think the recovery in Europe will lag the U.S. market a bit and won't be as steep coming out, because the recession wasn't as pronounced there.

If you go to places like Japan,

really the industrial play is more on consolidations and cost reductions than total economic growth. We are still seeing interest in those areas. In China the economy has been doing fairly well all year, and it's cheaper than other places in the United States right now.

Are there any signs of recovery yet in the industrial market?

Lewis Friedland: Technically, we've come to the end of recession. The declines to GDP have slowed which is a positive sign for the industrial market. Inventories have really hit rock bottom; They really can't go much lower than they are today. Another positive sign for the industrial market is that U.S. factory orders, which really impact industrial space, are starting to increase. The index that we track, the ISM manufacturing index is at its highest level since June 2007.

Big picture, all of those things are favorable for industrial but real estate in general is a cyclical business. When we enter a downturn like this the first thing that will happen is that supply shuts off, and constrains pretty significantly. Industrial supply

has fallen faster and to a lower level than any of the other major property sectors. Right now, there's only about 7 million square feet of industrial under construction, and that's in an 11.5 billion square foot institutional real estate market. There's virtually no new space being built. There's actually more hotel space under construction right now, than industrial space which is pretty amazing.

That will set up the recovery because there won't be any new construction for several years and occupancy according to PPR, one of the forecasters of supply and demand, is expected to bottom out at 85-86 percent early next year. With increasing demand and no new supply coming online, occupancy is expected to reach the 91 percent level in three to five years, which is a relatively healthy market.

Guy Jaquier: There hasn't been a lot trading, but having said that we are seeing a pick up in the number of deals coming to market. Actually it's been a bit of a fourth quarter 2009 phenomenon, primarily in just the last couple of weeks. And we are seeing signs that institutional capital is coming back to the market and seeing some relatively decent pricing based on where we see bids coming out on deals.

Speaking of institutional capital, how are institutional investors viewing the property sector?

Lewis Friedland: Industrial real estate in general is still viewed fairly favorably by institutions because it's kind of a stable long-term investment compared to other property types. There's a lot less stress than there is in other sectors. Lower vacancy rates lower financial defaults. A fairly large portion of the sector is owned by institutional investors, and as a result it doesn't have the high leverage that we saw in some of the other sectors, such as the office and hotel sectors, for example.

Guy Jaquier: In first quarter 2009, we were having a lot of conversations with institutional investors who were very nervous and wanted to know what was going on in the portfolio.

They wanted to hear the problems. They were interested in finding out what the risks were. In second quarter 2009, we'd go talk to them, and really, they didn't have a lot of time to talk to us because they were so busy putting out fires and dealing with problems in other portfolios they had. It was like, "Ok you're not going to be a big problem for us, so we don't have a lot of time to talk to you." During third quarter 2009, the conversation moved to: "OK, I have to make a report to my investment committee to my board, to my CEO, on what we're going to do in the future because the world didn't come the end and the denominator effect has started to reverse and so we have to formulate a strategy. Can you come tell us where the opportunities are?" Then, in fourth quarter 2009, the conversation turned much more deal-centric. This is money that may be coming in first quarter or second quarter next year. Those conversations, especially with the more leading dedicated real estate investors with dedicated staff, who are usually at the front end of that curve, have already begun.

Maria Sicola: We're seeing the same thing in our side of the business. There's a lot of information seeking right now on the equity side and we are seeing an appetite for industrial. Historically, when we see investors coming back in after a downturn, they're interested in office, but this time when we have also suggested industrial, many have said they would be open to it.

Lewis Friedland: So much of what we do is driven by the credit markets, and if you look at the amount of distress by product type there is so much less debt and distress on industrial than anything else and that has an impact on availability of debt for new industrial business. Retail has \$35 billion of distress, apartment and office each of about \$22 billion. Industrial has under \$4 billion. It's such a small percentage of the total amount of debt, again relative to the other sectors, which will be a real positive for the sector. Equity investors like the product type want to invest in it and the lenders have the same thought. Most of the large life

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Cobalt Capital Partners

insurance companies are very much underweight to industrial, partially because of the smaller deal size; it's hard for them get a large mass of loans out there.

We were visiting with one lender last week who has about a 10 percent position in industrial loan portfolio which they said they would like to grow to 30, but they're having a hard time finding enough quality industrial space to lend on. For the folks that are in this business that's a real positive.

Many investors are looking to acquire properties from distressed sellers in 2010. How far have industrial property prices fallen from their peak?

Guy Jaquier: Pricing from the peak is down 20 to 40 percent. We've seen pretty strong movements in the positive direction in the U.K. market for prime end class A space. We've started to see some firmness in France as well. It hasn't yet filled out to all of Europe, but we're seeing it in the leading markets. In the United States, I think we've reached a pricing floor. Cap rate expansion has stopped, and while there are still people reworking the underwriting for reduced operating fundamentals, I think we're just about through that process. We've seen some indication that prices may even go up a bit, but not a big amount. In places like Japan, we never really saw prices in industrial come down that much, part of that is that there's such still low interest rates.

Lewis Friedland: Pricing has changed a lot in the course of the last 12 months. At the beginning of the year when everyone was

looking at the apocalypse there was a lot pressure to generate liquidity, particularly among some of the open end institutional funds, some of the public REITs before they issued additional debt and stock offerings, so we were very attracted to acquisition opportunities in the first quar-

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AMB Property Corp.

ter of the year. During the second quarter there was a lot more liquidity in the market, everyone felt better, and the flood of activity that everyone expected later didn't materialize. That's been an issue. A lot of the historic sellers, don't have the distress that we expected. The other side of the equation is that there is not much distress in the debt market on the industrial product side and so we're not seeing a lot of distressed opportunities at the bottom of the year.

The big world of real estate with a lot of the problems we're reading about everyday— foreclosures and bankruptcies — are things the industrial market is just not experiencing, which is good news if you own a large portfolio, and might be not as good if you're trying to take advantage of a distressed market.

Guy Jaquier: Lewis brings up a good point. I can remember having a discussion earlier on this year with some REIT analysts who were saying, "Gosh, by our analysis, cap rates should be 10-12 percent probably closer to 12 for the equity." I'd ask them, "How do you get to that conclusion?" They'd say, "Well, I can buy debt on the secondary market

at 10 cap rate, so equity should be higher at 12 cap rate." My response was, "Well, if you can buy debt at 10 percent cap rate that tells you a lot about the distress of the lender, but doesn't tell you anything about the distress of the borrower, who isn't going to sell you anything at a 12."

What we've seen now, as we've had more pricing transparency, let's call it a floor, is that cap rates have settled at about an 8 today. You are seeing now non-distressed sellers, motivated sellers, looking at an 8 percent cap rate and considering a deal. Maybe they'll try to hold out for 7 and a quarter, but if they have a near term need to generate some liquidity, they're probably willing to take a portfolio to the market and do a deal.

Lewis Friedland: Debt spreads have compressed a lot as well in the last three to six months. You can borrow today in the 6.25 to 6.5 range. If you can buy quality industrial at 8 or an 8.5, that's a very positive leverage.

What other opportunities are out there for investors?

Maria Sicola: Investors should be looking at big picture global economic trends and the whole concept of trade on a global basis. They should be thinking about what's going to happen in terms of cost of fuel and getting goods to customers more quickly. I think we need to look seriously at Mexico. I think Mexico markets will become of interest again, because of the lower labor costs and their proximity to those pockets of growing U.S. populations. I think we'll see quite a bit of activity there in the short-term.

There also may be good opportunities in the research and development or flex space, which really have correlate with the health and life sciences and technology industries, which could do reasonably well in the short term. We're looking at a growth in the baby boomer segment of the population and expect a rise in demand in the health care and pharmaceuticals areas. Also, software companies and certainly the high tech industry is growing. So, markets that have concentrations of either of those two industry components

could do very well. We're seeing that already in the Silicon Valley in the suburbs in Boston, and Portland.

What big picture trends are you keeping an eye on?

Guy Jaquier: We are seeing tenants begin to rethink where they are going to locate their warehouses. In most cases, they factor in labor costs, rent, transportation costs, and solve for the best equation. Now that the cost of fuel is on the rise, tenants are willing to pay more rent to be located closer to the market. Especially when oil prices were above \$100 a barrel. That is starting to drive the market toward infill real estate.

Similarly, we're seeing tenants factor into the equation a carbon cost, either a real dollar cost or just a imputed social cost. Tenants have started saying they want to reduce carbon by taking trucks off the road. That will de-facto drive them toward more infill real estate which, even though rent may cost a little more, it's a better solution for those logistics companies overall.

Lewis Friedland: Our business [light industrial space] is a little different. It is driven by population concentration because our tenants tend to distribute in metropolitan areas rather than internationally. We look at areas where population growth is taking place. For example, in the past 12 months the four cities with the highest population growth, in terms of people moving to the area, are Dallas-Fort Worth, Houston, Phoenix and Atlanta. Those are markets people want to live in. They are low cost markets to live in, low cost markets to operate your business in, the weather is generally pretty good and the population is growing. The population growth is coming not just from U.S. citizen who are relocating but also from people from other countries that are settling in these areas. That population base is the direct consumer of the goods produced by our smaller tenant spaces.

What are the immediate challenges the industry is grappling with?

Maria Sicola: I think the biggest challenges are going to be around

employment. There's a lot of speculation over whether this is going to be a jobless recovery or something a little more robust than that. We tend to think it there will be some job growth in this recovery. Never the less, low employment rates, and subsequently, low consumer spending and low consumer confidence are certainly big threats to the industrial market.

Lewis Friedland: I'd add to that, the health of the overall retail sector, which is of course an outgrowth of that consumer demand that Maria was talking about. A lot of industrial space, particularly the bigger buildings, is leased by retailers. I just saw an article this morning that said that the majority of pain for retail might not occur until 2012. Everyone's thinking things are firming up now and that the recession is over and we're beginning an uptick, but if that retail impact is delayed until 2011 and 2012, it will put a damper on industrial property recovery as well.

What's your outlook on the industrial market for the year ahead?

Maria Sicola: I'd say its going to be slow and steady for the first six months. We'll start to see growth in the second half of the year. We'll see employment numbers going up in some regions of the country and I think that will bode well for industrial. I think we'll start to see vacancy rates decline by the end of 2010 in certain markets. We expect demand, in terms of leasing and pricing, to be fairly flat for the first 6 months and gradual growth in the second half of 2010.

Vacancy rates, for warehouse distribution and for flex and R&D space will probably climb a little bit more next year, but it won't hit the highs that we're going to see in the office market next year. The demand/supply situation is going to remain much tighter. Once we start to see a recovery in the overall economy, and I think everyone is very optimistic that we'll see that next year, we'll start to see some recovery fairly quickly in the industrial space.

Guy Jaquier: In our forecast, based on what we're seeing on the ground and internal research, we think the

industrial market will pick up second half of 2010. But I think we have another couple of quarters of bumping along before we get there.

There are a couple reasons for that. The first reason is the utilizations of the space. We have rent paying tenants who aren't using all their space right now. So even though you are starting to see an uptick in the economy, there's going to be a bit of a lag factor before you see an uptick in the industrial market.

Second, the big driver of demand that we're going to start to see is inventory replenishment. That hasn't yet happened. During the first half of 2009, we saw the entire supply chain empty out as retailers distributors, everybody just sold what they had on the shelves for cash flow, basically drew down inventory. Around April and May, we saw people ordering replenishment stocks, basically if one unit sells they order one unit more. We haven't yet seen the big pick up where retailers are confident enough to start building inventory.

Having said that, the leading indicator to watch is usually cargo. When retailers see sales start to pick up they will request what's called "emergency stock" and order it with more expensive shipment. It's not until these cargo shipments pick up that you'll start to see people use the regular shipping lanes, which takes a bit longer but is cheaper.

We're just getting some indication from Fed Ex today that there has been a pick up in international air cargo. That's modestly encouraging at this point, I would say.

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Cushman & Wakefield

Lewis Friedland: I think you have to look by segment of the market. The smaller tenant spaces were very slow at the beginning of 2009 and then we had one of the largest quarters of new leasing activity we've ever had in the third quarter, which was surprising. It seemed like there was a lot of pent up leasing demand in the 300,000 to 500,000 square foot space. I think we'll have solid demand going into the first half of 2010. We're starting to see that happen already. It won't be very strong but it will be OK. Then, the market will pick up in mid 2010 and into 2011. By 2011, I think we can expect some very good rent growth because we'll basically have two to two and a half years of no new supply, and at that point we'll have reached an inflection point. The market will be able to rise fairly steadily from that point in the next couple of years. ❖