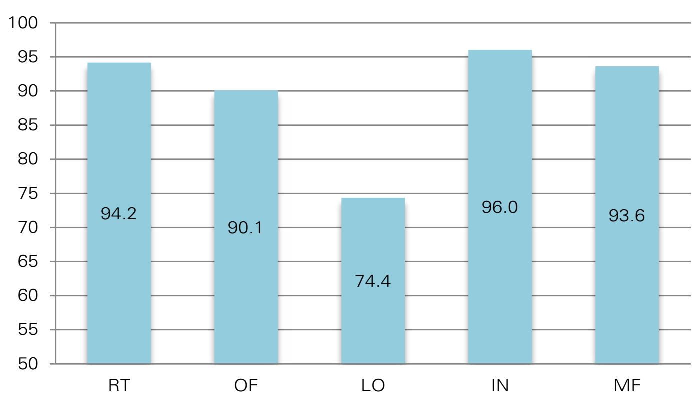
Is There an Undersupply in the Industrial Sector?

Industrial real estate is no longer exemplified only by steel mills or storage warehouses. For example, research and development facilities, data centers, and showrooms for automobile manufacturers all fall under the classification of industrial. Growing companies rely on the critical functions of industrial properties for the vital tasks of e-commerce fulfillment and global distribution. In addition to those factors, demand for these spaces continues to rise thanks to increased import levels. The number of manufacturing jobs has been on a steady incline since early 2011, so external factors point to a healthy sector. In CMBS, that same sentiment can be shared as average occupancy for industrial properties climbs, delinquencies have been down, and credit quality of newly issued loans is sterling. Still, there are factors at play for market participants to monitor in the near term.

Market Trends: Industrial Properties Keep Filling Up

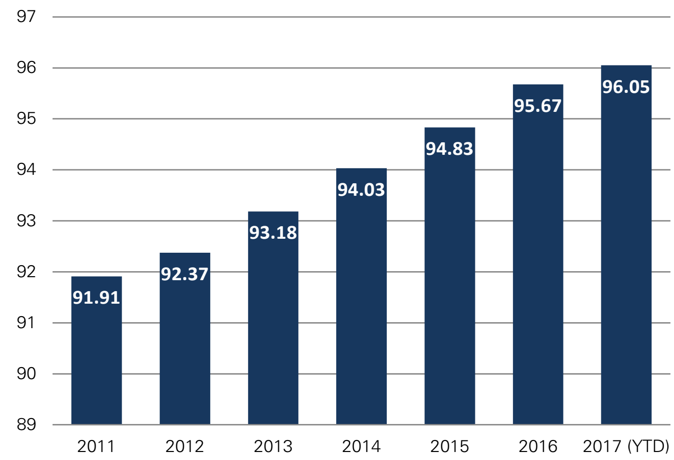
In a recent market survey conducted by Xceligent, 74% of participants said their greatest concerns for the commercial real estate industry over the next 12-24 months are supply and demand issues. Many of the survey participants commented that the industrial segment has been noticeably more active, and sector-wide vacancy is very low. Several have voiced concerns that there is an undersupply of industrial space. According to Trepp data, the average occupancy rate for industrial CMBS loans has increased annually over the past five years. Average loan occupancy rose from 91.9% in 2011 to 95.7% in 2016. As of last month, the industrial sector continued to average the highest occupancy among all major property types at 96.0%. With occupancies ascending, the level of supply could be reaching an inflection point.

Current Average Occupancy



Source: Trepp

Average Occupancy by Year: Industrial Loans



Source: Trepp

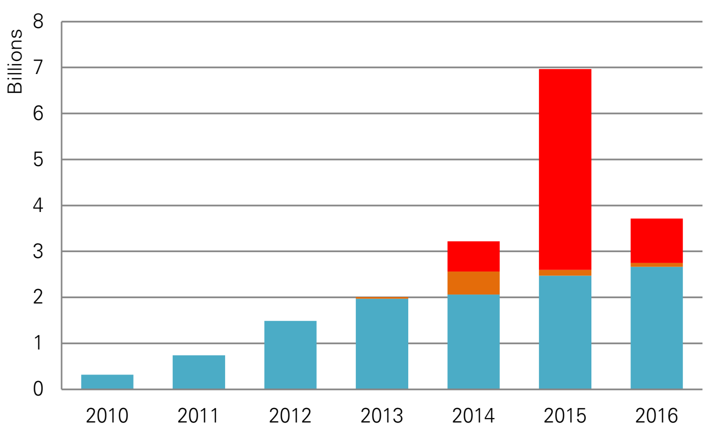
The boost in industrial demand and activity can be accredited to larger market trends, such as the ever-growing e-commerce sector and an upsurge in imports. According to Seeking Alpha, import volumes (the metrics with the highest correlations to demand for industrial space) have increased across the country, due to the strong US dollar and amplified consumer spending. Industrial facilities are generally cheaper than other property types and back a smaller portion of outstanding CMBS, yet they are an invaluable conduit in the supply chain as goods are received, assembled, manufactured, and/or sent via industrial properties. With higher import volumes, the need for industrial facilities has escalated.

The rise of e-commerce is another major factor driving industrial performance. In the Xceligent survey, 54% of participants said that the e-commerce boom is beneficial for CRE and the economy, while 20% said that it is good for the economy, but bad for real estate. The mixed reviews correspond to the varying effects of online shopping on different property types. While e-commerce can hurt brick-and-mortar retail properties in the short run, it has augmented demand for industrial facilities such as warehouses, distribution centers, and storage space.

Issuance: Single-Asset Deals Comprise Large Piece of the Pie

While the volume of 2016 industrial issuance trailed the prior year's total, it still eclipsed the $3-billion mark, a feat that has been achieved annually since 2014. The number of industrial properties securing private-label CMBS loans shot up to 1,055 in 2015, which is well over the amount securitized for the previous three years combined.

Industrial Issuance by Deal Type



Source: Trepp

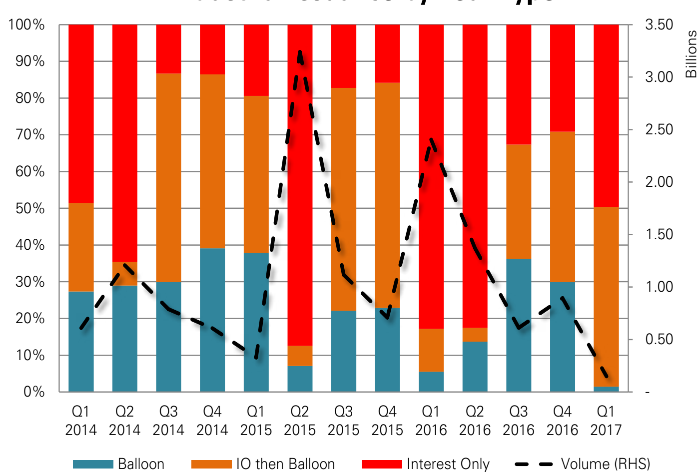
Trepp data shows that single-asset/single-borrower (SASB) transactions have been a major contributor to industrial CMBS activity over the past two years, accounting for 62.7% of private-label issuance in 2015, and 26.1% in 2016. The flood of 2015 issuance was driven by seven huge SASB loans ranging from $250 million to $1.34 billion in size. There was only one SASB industrial loan issued in 2016: the $970 million Lineage Cold Storage Portfolio loan (GSMS 2016-ICE2), which is secured by 43 industrial properties in various states. Aside from that, the majority of 2016 industrial loans are smaller, conduit portfolio notes that focus on a single market.

For 2017 YTD, the largest industrial loan issued is the $42.5 million FedEx Ground Portfolio, which represents 4.35% of the BACM 2017-BNK3 conduit. The collateral is comprised of three FedEx centers across New York and Pennsylvania. At securitization, DSCR (NCF) and occupancy were measured at 3.16x and 98%, respectively.

Leverage Low, Cap Rates Tight for Industrial Loans

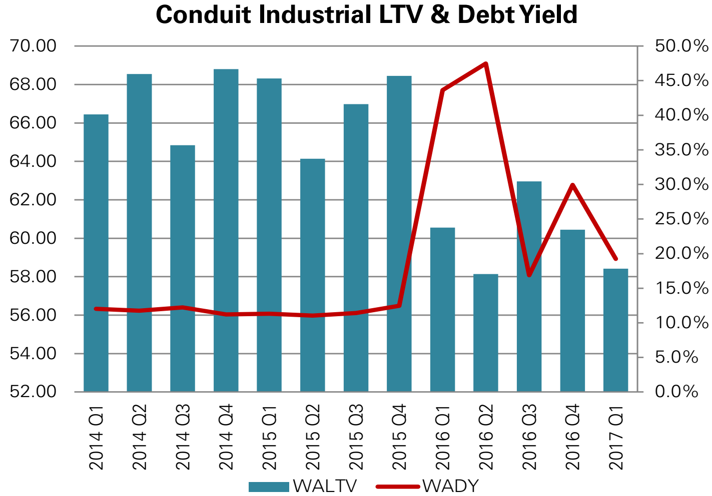
Conduit industrial loans from the 2016 vintage boasted a low weighted-average LTV of 59.1%, compared to 67.6% in 2015. This trend continued into Q1 2017, as the weighted-average LTV for new conduit loans came in at 58.4%. This may be an indication of tighter credit standards that began in early 2016 in anticipation of the new risk retention rules. NOI soared last year thanks to e-commerce growth, which pushed the weighted-average debt yield for conduit industrial loans in the first and second quarters of 2016 sharply higher.

Industrial Issuance by Loan Type



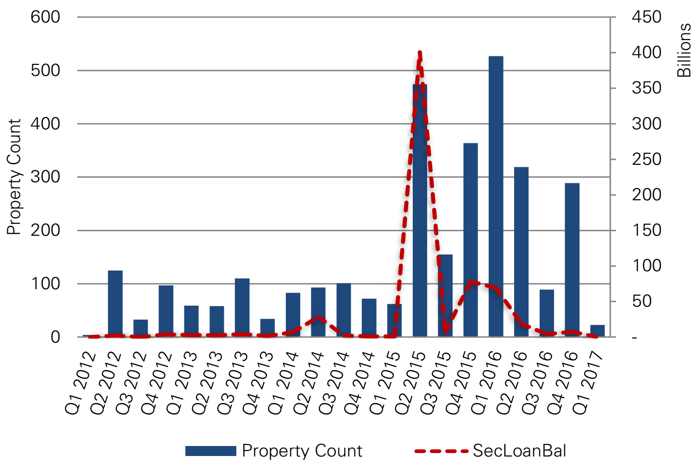
Source: Trepp

Conduit Industrial LTV & Debt Yield



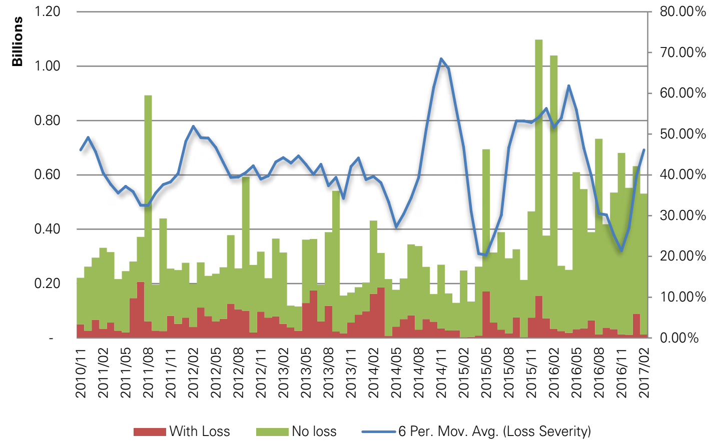
Source: Trepp

Securitized Industrial Property Count & Balance



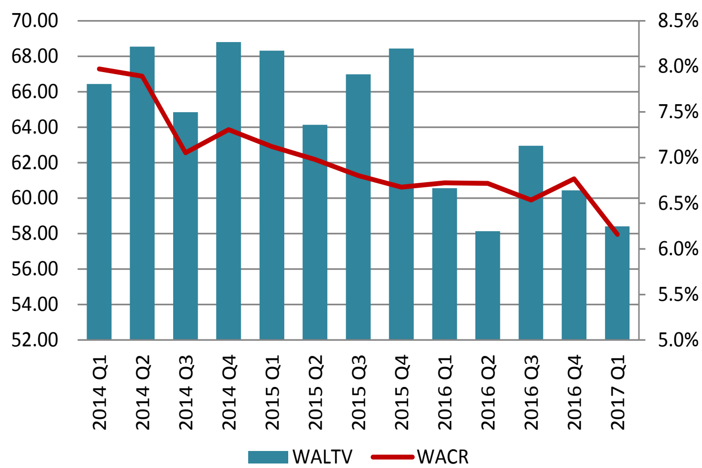
Source: Trepp

Losses on Disposed Industrial Loans



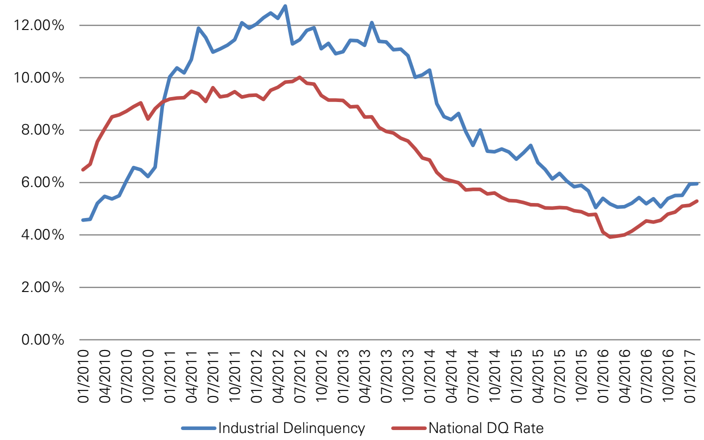
Source: Trepp

Conduit Industrial LTV & Cap Rates



Source: Trepp

Industrial Delinquencies



Source: Trepp

With aggregate property values rising alongside NOI, the weighted-average cap rate remained compressed for the past two years, stabilizing around 6.7%. However, the weighted-average cap rate dropped to 6.2% in Q1 2017.

Loss Severity and Delinquencies Drop

The industrial delinquency rate has fallen significantly in the past two years, and came in at 5.94% last month. This is a substantial improvement from its peak of 12.7% in 2012. Industrial demand had its most acute uptick begin in 2015, which translated to highly elevated issuance levels and a markedly improving delinquency rate. Over the past two years, the industrial delinquency rate began to closely approach the national delinquency curve. Last month, the spread between the two tightened to just 0.66%.

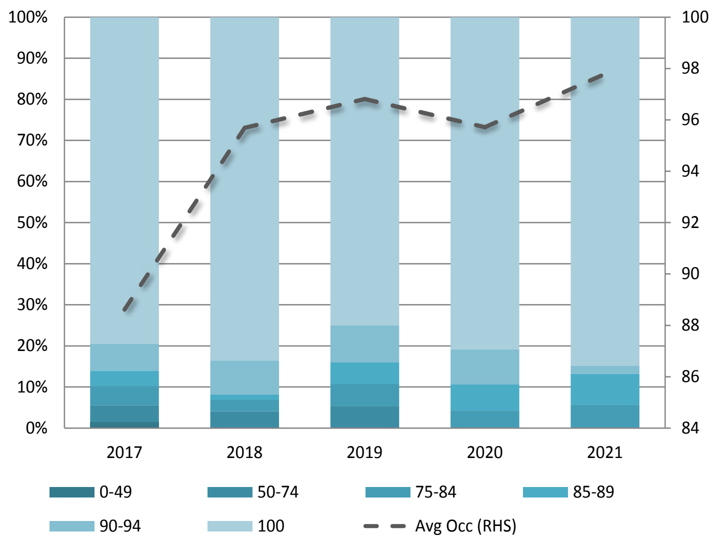
The monthly disposition volume for industrial loans has increased significantly since 2015, coinciding with the start of the wall of maturities. Of the $531.1 million in industrial CMBS liquidated in February, only $12.9 million paid off with losses. Average loss severity was 53.8% last month, pulling the six-period moving average up to 46.1%. The industrial sector has undergone a tremendous improvement in monthly loss disposition. In 2014, 28.1% of the total industrial liquidation volume paid off with losses. The following year, that portion dropped to 13.7%, and fell to just 6.2% for 2016.

Looking Ahead

According to JLL's US Industrial Investment Outlook for Q3 2016, industrial supply increased by 214 million square feet, or 1.8% throughout 2016. To boot, aggregate demand has consistently outpaced supply over the last 12 months. Based on the occupancy trends reflected in our data, demand remains elevated.

E-commerce is a major factor that continues to drive the industrial sector forward; and industrial loans are riding on great momentum into 2017. However, Tony Argiro from CBRE observes "at this time, demand for new buildings is slightly above supply… A flood of new construction could easily disrupt the industrial market and lead to asking rates dropping." Thus, the spike in occupancy rates and property values are tied to the sector's current surplus of demand. Ultimately, future sector performance can either be positively or negatively influenced by the amount of new construction in the pipeline.

Maturing Industrial Loan Occupancy



Source: Trepp

For inquiries about the data analysis conducted in this research, contact info@trepp.com or call 212-754-1010.

About Trepp

Trepp, LLC, founded in 1979, is the leading provider of information, analytics and technology to the CMBS, commercial real estate and banking markets. Trepp provides primary and secondary market participants with the web-based tools and insight they need to increase their operational efficiencies, information transparency and investment performance. From its offices in New York, San Francisco and London, Trepp serves its clients with products and services to support trading, research, risk management, surveillance and portfolio management. Trepp is wholly-owned by DMGI, the information publishing division of the Daily Mail and General Trust (DMGT).