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CRE Research
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Strengthening US Economy and E-Commerce Drive Industrial Real Estate Performance

Multiple Sources of Demand

To the typical consumer, industrial real estate triggers the image of an Amazon fulfillment center, the anchor of the online retailer's business model. In Trepp's research report, S*hifting Retail Landscape Poses Big Questions for CMBS Borrowers and Lenders (March 2015)*, one of the trends in retail real estate that is highlighted is the physical store as a showroom. Rather than use brick and mortar locations as small inventory warehouses, tenants are reducing square footage as they stock less inventory and rely on in-store online purchasing. This reconfiguration, paired with the popularity of straight-to-your-door services, has driven demand for warehouse space.

In addition to retail, spillover effects from expansion in other sectors, such as automobile and housing construction, will lead to further increased industrial demand. Greater demand for industrial space is reflected by higher projected rent rates, growing foreign investment in US industrial properties, rising industrial property construction, and increasingly stable absorption and occupancy rates, according to Colliers International.

After several quarters of positive industrial real estate fundamentals and an optimistic outlook, many experts believe future growth will climb back to pre-recession levels. Due to less expensive energy and more efficient manufacturing techniques, as well as rising M&A activity, the industrial sector has experienced accelerated growth according to PricewaterhouseCoopers' global strategy team.

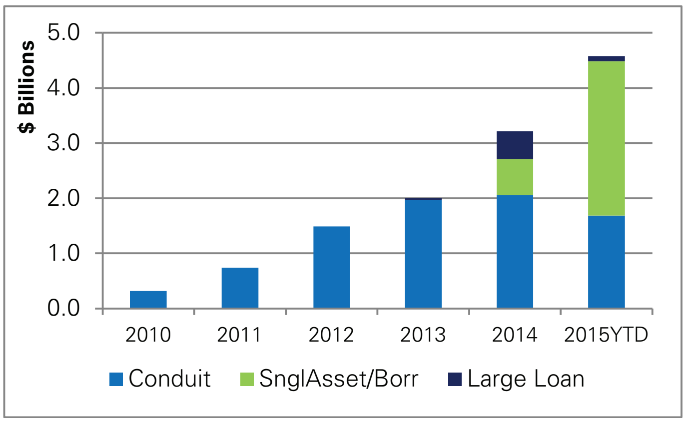
Vacancy rates in US industrial properties have fallen in the past 22 straight quarters and now stand at 6.4% as of Q2 2015, according to Colliers. The primary stimulant of this boom is a rebound in the general state of the economy, as higher GDP, employment, and income levels all spur consumer spending and manufacturing-related demand.

CMBS Originations

The US industrial sector has experienced healthy development in the last two years. In conduit CMBS alone, industrial loan origination has grown from just over $300 million in 2010 to $1.7 billion through August 2015. Combined with large loan and single asset/single borrower CMBS deals, total year-to-date industrial issuance is $4.6 billion, a 42% increase from the 2014 total of $3.2 billion.

New conduit loan origination has risen steadily since 2010, with more than 100% year-over-year increases in deal volume between 2010 and 2012 and a 39.7% annual growth rate from 2010 through August 2015. While industrial origination growth in conduit deals has slowed in the last two years, the former CalWest

Figure 1. Industrial Issuance by Deal Type



Portfolio, for example, was refinanced into three new single asset/single borrower deals totaling $2.8 billion in 2015. That refinancing accounts for 67% of the year-to-date industrial CMBS issuance.

Maturing Loans

Of the major property types, industrial loans make up the smallest portion of maturing volume over the next several years. The percentage of maturing legacy CMBS loans backed by industrial properties will hover around 2% to 5% over the next five years, and is set to peak at 5.49% in 2017. Representing 3.8% of this year's remaining maturing volume, approximately $1.3 billion worth of industrial loans are yet to mature in 2015. This number, however, will rise dramatically over the next two years, as the brunt of the maturing wall comes due. This will bring an expected $13.2 billion of industrial loan maturities between 2016 and 2017.

With the specter of rising interest rates, recent market volatility, and new regulations affecting CMBS issuers and portfolio lenders, the increased volume of maturing loans may cause a jump in maturity defaults and modifications. However, the average occupancy rate is 95% or higher for industrial loans maturing between 2016 and 2020. In addition, less than 5% of those maturing loans have occupancy below 50%. Strong tenancy should mitigate the risk of default for industrial loans.

Delinquencies and Losses

Industrial delinquency rates have exhibited a steady decline following the recession, but have leveled out within the last year and half to around 6%-8%. While industrial delinquencies were relatively modest at sub-5% in 2010, that level breached double digits in 2011 and peaked at 12.74% by mid-2012. Since then, industrial delinquency rates have declined along with

Figure 2. Maturing Industrial Loans

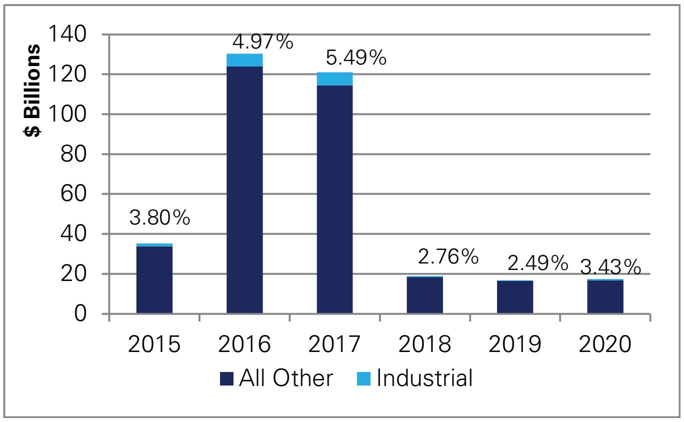


Figure 3. Maturing Industrial Loan Occupancy

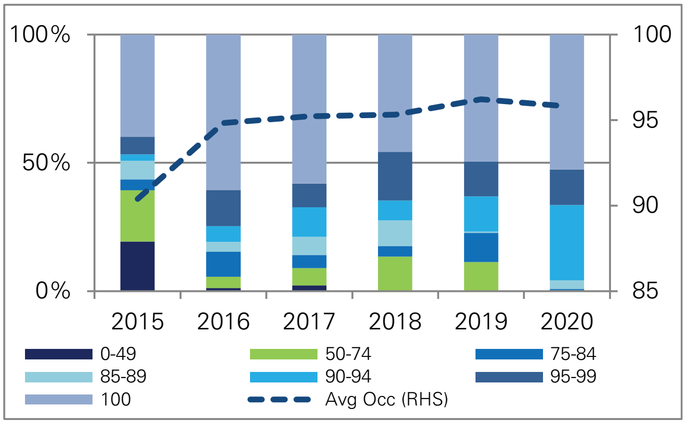
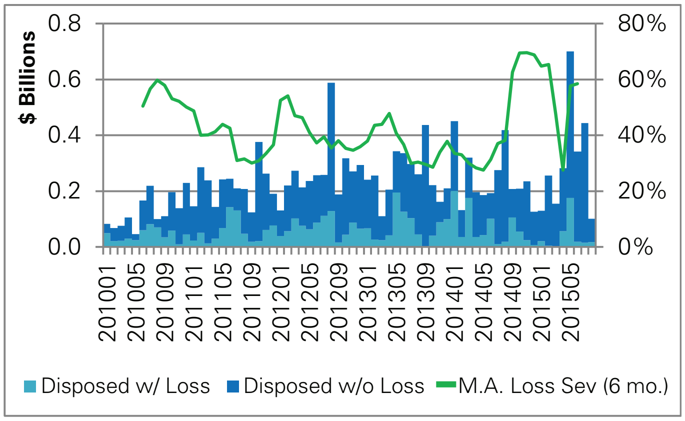


Figure 4. Industrial Delinquencies

Figure 5. Losses on Disposed Industrial Loans



the overall rate, although at 6.18% as of September, the industrial rate is slightly higher than the overall average of 5.28%.

Through the first eight months of 2015, $2.4 billion in industrial loans were disposed. Losses on those dispositions totaled $184.7 million, which resulted in a 7.66% cumulative loss. Looking only at loans disposed with losses, average loss severity through August came in at 59.22%, which compares to 41.56% in 2014 and 37.20% in 2013. With such concentrated tenant exposure, industrial loans that do default tend to take higher losses than other property types with a more diverse tenant base.

Outlook

The expectation of strong future economic performance and market fundamentals provides a solid foundation for further growth in the industrial sector. While increased GDP and job creation spawns consumer confidence and willingness to spend, other major variables, such as cheaper domestic energy prices and the changing e-commerce landscape, will shape US manufacturing and warehouse demand.

Taking into account increasing labor costs abroad and cheaper US energy prices, sourcing manufacturing needs domestically is becoming a more appealing option. Since the industry-wide slump in 2010, 900,000 new manufacturing jobs have been created in the US market, according to *The Boston Globe*. Of those, 40,000 jobs were a result of reshoring attempts made by US firms. The Reshoring Initiative estimates that over 50% of these re-shored jobs originated from China. While the 4% Yuan devaluation in August may temporarily elevate Chinese imports, long-term US manufacturing growth is still expected to remain strong.

The rapidly growing e-commerce business is yet another factor that heavily benefits the industrial sector. As online purchasing becomes more widespread, there will be greater need for warehousing, as well as for manufacturing companies to develop more efficient distribution methods. Consequently, this change has stimulated growing industrial property supply, strong leasing activity, and high absorption rates.

Based on projected economic and retail growth, improving industrial performance could result in the sector becoming a larger part of commercial real estate lending. ■

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