Industrial First Glance 2015

Pre-Release Analysis of First Quarter 2015 Reis Findings in the Industrial Sector

Quarter 1

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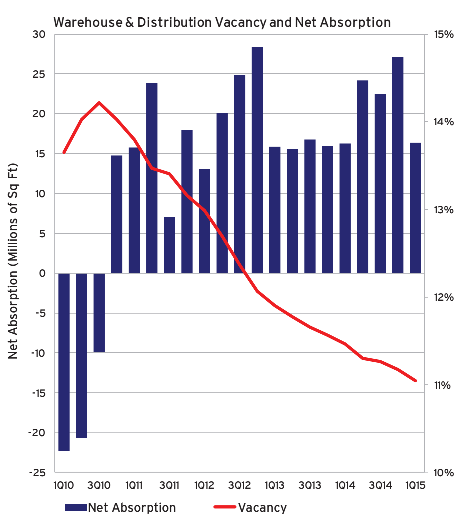
Soft Economic Growth Impacts First Quarter Results

Absorption figures for industrial real estate exhibited a marked pullback, associated with a sharp drop in new construction during the first quarter of 2015. A combination of generally weak economic activity and inclement weather across a large swath of the country halted the steep rise in net absorption and completions evident throughout 2014.

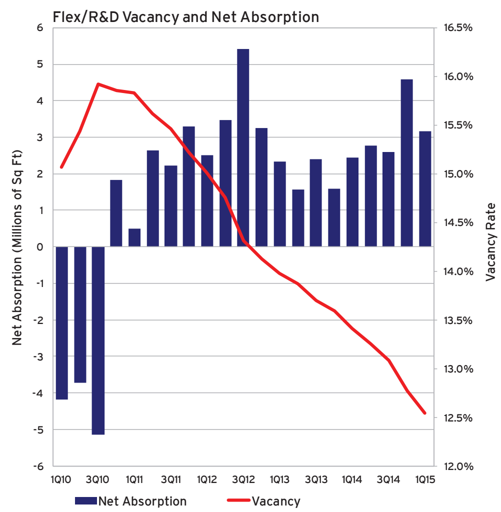
Recent data suggest some softening in the domestic economy. The average increase in monthly payrolls declined from over 324,000 in the final three months of 2014 to 197,000 in the first quarter of 2015. Manufacturing activity, as represented by the ISM Purchasing Managers Index, has been trending downward since August of last year, as have durable goods orders. As a result, consensus forecasts are calling for an annualized GDP growth figure of around 1-1.5% in the first quarter. The U.S. experienced a similar slowdown in early 2014 after a pickup in growth in the second half of 2013. Initial estimates of Q1 2014 GDP showed a minor increase; subsequent revisions indicated growth contracted by over 2.0%. Just as industrial real estate activity slowed in response to weak GDP growth in early 2014, early 2015 results appear to be following a similar path.

Growth in Supply and Demand Slows

Net absorption in the warehouse/distribution subsector totaled 16.3 million SF in the first quarter, a decline of close to 40% from the previous three months. This was on par with net absorption from the first quarter of 2014 when weak economic growth and inclement weather also impacted results. Completions fell even further; first quarter deliveries totaled 9.4 million square feet, a 61.0% drop from the previous period. It is not surprising to see a drop off in construction between the fourth and first quarters as completions tend to increase prior to the end of the year. Yet this decline was particularly pronounced. After rising to a post-recession high in the final three months of 2014, first quarter delivery totals were at the lowest level observed since the second quarter of 2013.



Despite the slump in both leasing and construction activity, there was a silver lining evident in this quarter's results. The trajectory of net absorption has tracked that of new construction closely since the beginning of 2014, so it is not a surprise that the precipitous fall in completions was accompanied by a steep fall in net absorption. However, the gap between the two figures (6.9 million SF) was at its highest since the second quarter of last year. As we have noted previously, demand for large, high-quality product has been especially strong and resulted in tightness at the high end of the market. It is this dynamic that has driven the acceleration in warehouse and distribution construction. Only if demand for existing product also picks up will we start to see larger declines in the vacancy. The fact that demand growth held up better than supply is a positive sign for out of favor portions of the market.

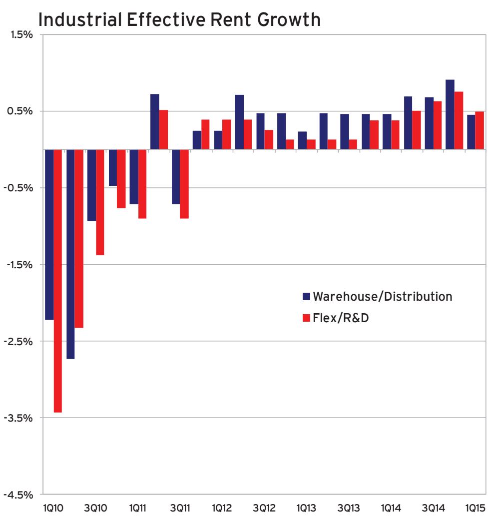


Due to the outsized fall in supply growth, the national vacancy rate declined 20 basis points to 11.0%, the largest quarterly decline since the second quarter of 2014. Over the past twelve months, vacancy is down 50 basis points. Occupancy gains are likely to be halted by a large influx of new supply that will be brought to market in the near future. Nevertheless, vacancy is now 320 basis points below its cyclical high from 2010.

Quarterly rent growth slowed from the previous period. Both asking and effective rents registered increases of 0.4% over the past three months, down from 0.6% and 0.9%, respectively, from the fourth quarter of 2014. This rate of growth was in line with results from the first quarter of 2014 when a backdrop of slow economic growth dampened demand. Acceleration in annual rent growth stalled; asking and effective rents were up 2.3% and 2.8%, respectively, year-over-year, the same as last quarter.

A Similar Slump in Activity for Flex and R&D

The flex/R&D subsector exhibited a similar slump in activity to its warehouse/distribution counterpart during the first quarter. Occupied stock rose by 3.2 million SF in the first three months, which is 31% below the fourth quarter total. However, this is still the second largest quarterly total from 2013 and 2014. Meanwhile, completions plummeted 56% to 462,000 SF, the lowest total since the first quarter of last year. Vacancy fell 30 basis points to 12.5% as a result of the huge decline in new construction. This represents a year-over-year decline of 90 basis points, the fastest annual rate of vacancy compression observed since mid-2013.



Quarterly asking and effective rent growth decelerated to 0.4% and 0.5%, respectively, from 0.6% and 0.8% the previous three months. However, annual growth actually accelerated slightly, reaching 1.9% and 2.4%, both post-recession highs.

Metro Highlights

While the level of activity may have slowed across the country, the recovery in industrial space remains broad-based. Effective rent was up in all 47 primary industrial markets (combined warehouse/distribution and flex/R&D) across the country for the third quarter in a row. Net absorption was positive or flat in 42 markets for the second consecutive quarter. Moreover, the slowdown in supply growth helped support occupancy increases in all but 10 markets.

The largest warehouse/distribution markets have outperformed during the recovery, but some smaller markets were at the forefront this quarter. Only two of the top ten metros ranked by quarterly rent growth, Los Angeles (+0.8%) and Atlanta (+0.6%), would be considered among the largest markets in the country. Meanwhile, metros such as Columbus (+1.3%), Kansas City (+1.0%), San Jose (+0.8%), Orlando (+0.7%) and Jacksonville (+0.6%) outperformed. However, this was largely due to depressed rent growth across most of the nation as opposed to an acceleration in the recovery of smaller industrial markets. Whereas eleven different metros registered quarterly rent growth above 1.0% in the last three months of 2014, only two metros broke that mark in the first quarter of 2015.

California markets were the clear outperformers in the flex/R&D subsector this quarter. Six of the top eight metros ranked by first quarter effective rent growth hailed from the Sunshine state: Oakland-East Bay, Los Angeles, San Diego, Sacramento, San Jose and San Bernardino/Riverside all recorded rent growth of 0.8-0.9%. No metro registered a rent increase of 1.0% or above.

Number of Metros with Improving/Flat or Declining Fundamentals
Combined Distribution-Warehouse and Flex-R&D

	Absorption	Occupancy	Effective Rent
Q1 2015	42 + / 5	37 ↑ / 10	47 ↑ / 0
Q4 2014	42 + / 5	32 ↑ / 15	47 ↑ / 0
Q3 2014	41 + / 6	30 ↑ / 17	47 ↑ / 0
Q2 2014	39 + / 8	31 ↑ / 16	46 ↑ / 1
Q1 2014	35 + / 12	31 ↑ / 16	43 ↑ / 4

Figures are based on 47 metro markets per subsector.

Outlook

Although recent economic growth has been sluggish, we need look no further than one year ago to remind ourselves that the current economic recovery, though strengthening, is not without its fits and starts. We still expect average monthly job increases above 250,000 and decent economic growth for the remainder of the year. Most major risks continue to stem from our trade partners, which would impact those industrial markets situated near ports and reliant on international trade. Nonetheless, we believe domestic demand will remain strong enough to underpin the growing need for industrial space.

Despite somewhat disappointing first quarter results, Reis will not be making any substantive changes to our outlook for industrial properties. Within the warehouse/distribution subsector, the large drop in construction activity during the first quarter just means that more completion dates will be pushed into the final three quarters of the year. Vacancy compression will likely slow over 2015, but demand for new product is sufficiently high to absorb the influx of new supply and support an accelerating rise in rents. Expectations are for rent growth around 3% during 2015. Further occupancy gains are in the offing for flex/R&D as the delivery pipeline has not swelled as quickly as in the warehouse/distribution space. We project rent gains in the upper 2s for 2015.

Note: First quarter trends for warehouse/distribution and Flex/R&D space are now available on a market-by-market basis. Please contact your Account Manager for details on data access and entitlement.