

## Absorption Eases as Companies Temper Growth Strategies; Investors to Target Widening Range of Metros

**Fed takes action to extend economic growth cycle.** Sturdy underlying fundamentals continue to support domestic growth, expanding the economy by 2.1 percent in the second quarter, but headwinds are emerging. Growth has moderated over the past several months and some international forces are weighing on momentum, prompting the Fed to cut the overnight rate by 25 basis points at the end of July, in an effort to extend the economic runway. This modest cut may have fallen short of what was needed to offset the escalating trade war and financial market turbulence as the 10-year/two-year yield curve briefly inverted recently. This commonly perceived signal of an impending recession has the potential to increase uncertainty and work against the positive economic forces such as steady job creation, low inflation, sound wage growth and elevated consumer confidence. In addition, sustained recruiting demand has resulted in a 20 percent surplus of job openings relative to job seekers, enabling many people with weaker skills and education to find work. Reflective of this, organizations are becoming increasingly competitive in their recruiting efforts, opening additional locations to tap new labor pools and boosting compensation packages to attract new staff members and retain existing workers. This has provided a bump to household and disposable income levels nationwide.

**Uncertainty restraining some growth drivers.** Though economic optimism remains elevated, consumption and corporate investment have moderated relative to 2018. Unresolved trade talks, slowing international economies and the hangover from elevated interest rates last year continue to pressure domestic markets, prompting some consumers and businesses to act more cautiously until additional clarity emerges. These factors have restrained leasing activity for some property types in several markets during the first half of this year, but a recovery could be sparked by lower interest rates. Still, the recently inverted yield curve and uncertainty surrounding trade will weigh on the outlook.

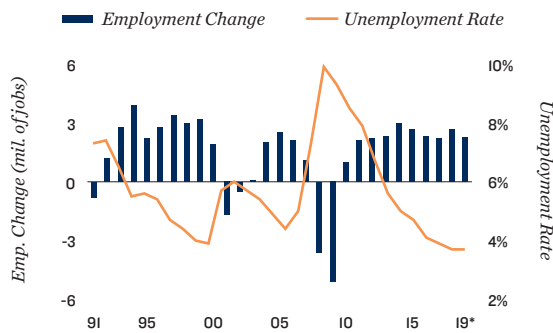
**Digitally driven environment creating new opportunities.** The increasingly connected world is fostering accelerated demand for data storage, making data centers a mainstream property type in the industrial sector. E-commerce and tech companies rely on massive amounts of tracked data, prompting companies like Amazon, Facebook, Google and Microsoft to set up data storage operations. Many states offer data center developers significant tax incentives to build facilities, creating new full-time jobs and potentially generating additional employment through technology-related development. In 2009, only seven states provided incentives, but now 30 states offer inducements for large data center projects. Much of this is due to the high costs of these developments relative to other industrial projects as proximity to fiber optic lines and power grids is essential, putting a premium on required land. The rapid expansion of data centers is piquing the interest of investors, offering them additional investment opportunities and providing them a viable portfolio diversification option amid the maturing cycle.

**Refrigerated space proliferates as consumers evolve.** Demand for cold storage is rising as grocery delivery is embraced by more households. Though online grocery shopping is still in its early stages, its growth potential is high as rapid digitization is shifting consumer shopping patterns. Aging baby boomers have also begun to adopt new digital purchasing habits to support their decreasing mobility. The expanding popularity of prepared meal kits is also driving demand for refrigerated space, keeping these products fresh until they reach consumers. Companies like Blue Apron, Hello Fresh and Sun Basket are spearheading this trend, particularly among younger generations, offering customers personalized meals to cater to varying dietary preferences. Additionally, consumers' growing aversion to food chemical preservatives is spurring the need for more cold storage facilities as many common food items now require refrigeration.

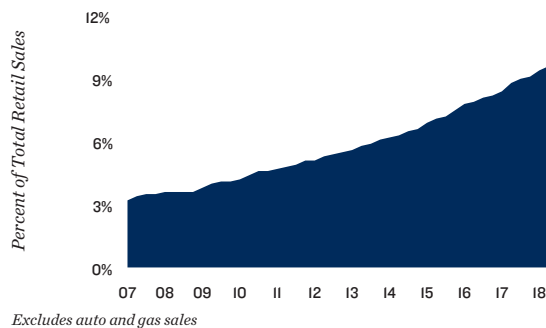
## Executive Summary

- The economy remains on solid footing as job creation and increased discretionary spending are encouraging domestic growth. Solid consumption is benefiting the industrial sector, sustaining tenant demand for distribution centers and warehouses as companies seek to widen their logistics networks to meet the needs of more consumers.
- Trade talks with China are impacting industrial markets nationally, supporting altered supply chains and modified business models to help companies reduce tariff-induced costs. If negotiations extend closer to the holiday season, additional adjustments may be required.
- Space absorption is on track to decrease for the third year in a row as approximately 230 million square feet is leased. Though demand has moderated nationally, many markets are still tremendously tight.
- Amid elevated investor demand, pricing for industrial assets keeps climbing, well outpacing other property types in recent years. This has helped maintain strong bidding climates, keeping the national average flat over the past four quarters.
- Industrial underwriters remain active despite a slowdown in space absorption. Lenders have shown a strong willingness to sponsor well-leased projects, in addition to pinpointing proposals for speculative industrial developments.

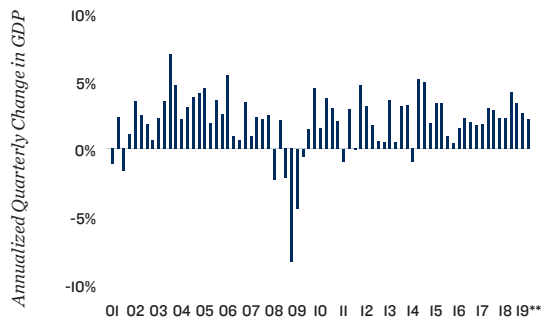
### Employment vs. Unemployment



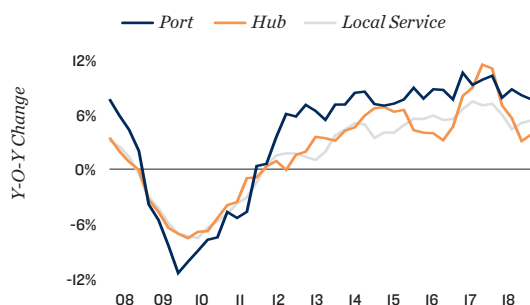
### E-Commerce Sales Growth



### U.S. GDP



### Industrial Rent Growth Healthy Impact of Construction on Hubs Apparent



## Trade Negotiations Bring New Challenges

**Tariffs shake up supply chains.** The ongoing trade war with China continues to weigh on the industrial sector, causing some businesses to adopt a more cautious stance until negotiations are settled. Some companies are rerouting their supply chains to help mitigate tariff-induced costs, while others are compelled to stick with original arrangements for logistical and economic reasons. Though most consumers have yet to feel the impact of tariffs, the effects could surface over the next few months as rising product costs navigate through supply chains, potentially impacting the pricing of common goods. Trade negotiations remain open-ended, putting pressure on suppliers with the holiday season approaching as many Chinese products are needed to meet consumer demands.

## Absorption Trending Down as Headwinds Play Out

**Fulfillment and logistics driving force behind construction.** Developers will bring another wave of new supply this year, adding 210 million square feet as the proliferation of online shopping and expansion of last-mile delivery strategies continue to support elevated levels of construction. Development is concentrated in logistics hubs, led by Dallas/Fort Worth, which will receive 33 million square feet, while Riverside-San Bernardino and Atlanta each receive about two-thirds of that total. Several other Sunbelt and Midwestern markets round out the top 10. Houston remains a top harbor for foreign waterborne freight and Chicago strengthens its status as a distribution hub. In contrast, many coastal metros will see limited construction as sparse land availability restrains traditional development strategies, making it difficult for companies to expand their footprint. To help sidestep this, some builders are beginning to design multi-level industrial spaces in dense areas; however, some configuration challenges still exist. Dense coastal markets may further adopt this trend moving forward as the concept is refined.

**Leasing activity falters amid economic uncertainty.** Absorption in 2019 has substantially softened, registering about the half the pace as previous years in the current cycle. This has generated the first vacancy increase since 2010, moving the national rate up 10 basis points to 4.8 percent in the second quarter as some businesses put expansion plans on hold in response to economic uncertainty. Several Midwestern and West Coast metros support this trend over the past year; however, significant supply shortages still exist in many markets. Nearly a dozen of the nation's major metros boast vacancy rates under 4 percent as developers struggle to keep pace with demand. While the confluence of ongoing trade negotiations and more conservative domestic growth will impact absorption moving forward, vacancy is expected to remain flat through the end of the year.

**Coastal juggernauts keep rents on steep incline.** Rent growth remains strong in 2019, maintaining an average rate in the mid-7 percent range and putting the average asking rent at \$7.29 per square foot at the end of the second quarter. Ultra-tight port markets including Jacksonville, Los Angeles and San Francisco remain primary drivers of nationwide rental gains, posting 10-plus percent boosts over the past year. Though overall space absorption has moderated, demand still remains closely aligned with supply infusions on a national level. Southern California markets will headline rent growth through the remainder of the year as tariffs continue to disrupt supply chains, leaving many warehouses full as companies accelerate imports before additional changes to the geopolitical landscape are made.

\* Employment change trailing 12 months through July; Unemployment rate as of July

\*\* Forecast

Source: CoStar Group, Inc.

## Opportunities Plentiful as Buyers Shape Investment Strategies

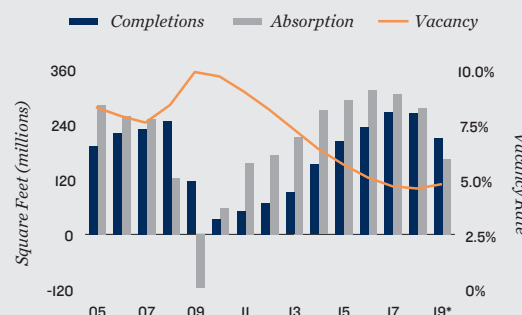
### 2019 Forecast

#### U.S. CONSTRUCTION:

**210 million** square feet completed Y-O-Y

- The building boom continues in 2019 as development eclipses 200 million square feet for the fifth year in a row. The growing e-commerce industry is prompting more fulfillment centers and last-mile distribution hubs.

#### Industrial Supply and Demand



#### U.S. RENT

**5.8%** Y-O-Y increase

- Rent growth will remain strong this year despite another wave of new supply, moving the average price per square foot up to \$7.43. Since 2011, growth has averaged 4.6 percent amid the completion of more than 2 billion square feet.

#### U.S. VACANCY

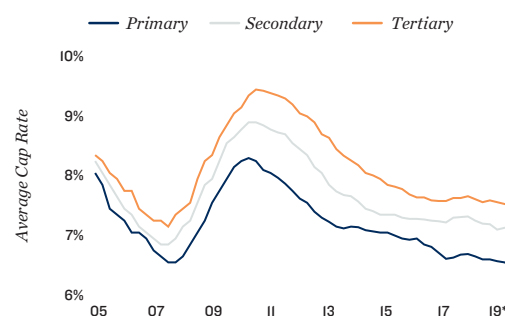
**20** basis point Y-O-Y increase

- Year-end vacancy will increase for the first time since this cycle, moving the national vacancy rate to 4.8 percent. Uncertainty surrounding the economy will continue to weigh on space absorption.

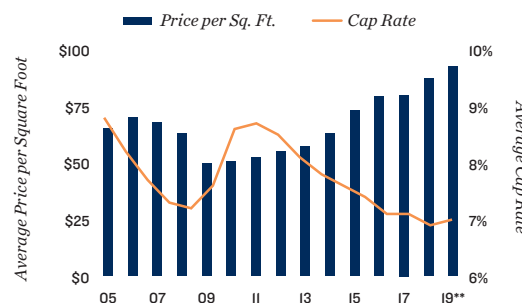
## 2019 INVESTMENT OUTLOOK

- Investors find opportunities across range of assets.** The nation's average cap rate remained flat over the past year at 7 percent as bidding stayed competitive. While yields are largely dependent on asset and location, secondary and tertiary markets continue to offer considerably stronger returns for turnkey options, producing cap rates in the mid-5 percent range — about 100 basis points above primary metros. Yields on older properties with significant value-add potential in primary markets sit in the mid-8 percent realm, while returns in secondary and tertiary metros are in the low-9 percent range.
- Urban infill sits atop the list for many buyers.** With last-mile delivery strategies becoming increasingly essential, investors are zeroing in on urban infill projects, redeveloping existing buildings to accommodate distribution needs in dense areas. These assets are highly prized by investors, generating cap rates in the high-3 to low-4 percent band in markets like San Francisco, Los Angeles and New York.
- Smaller markets drawing more interest.** Industrial price appreciation significantly outpaced other property types, climbing 11 percent year over year to \$92.59 per square foot. Pricing jumps hovering around 20 percent were posted in a number of coastal cities including San Jose, Tampa and Washington, D.C. Several Midwest markets also witnessed solid appreciation as investors focused more heavily on smaller metros. Over the past year, sales volume in tertiary markets rose roughly 22 percent, while sales volume in primary and secondary markets remained relatively stable.

#### Industrial Cap Rate Trends by Market Type



#### Price and Cap Rate Trends



\* Forecast

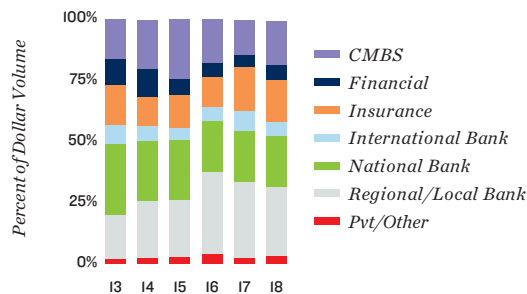
\*\* Trailing 12 months through 2Q

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

### 10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



### Industrial Mortgage Originations By Lender



\* Through Aug. 14  
Include sales \$2.5 million and greater  
Sources: CoStar Group, Inc.; Real Capital Analytics

## Fed Breathes More Life Into Economy; Lenders Recognize Space Shortage

**Fed efforts to extend economic runway facing increased headwinds.** The Federal Reserve's decisive action, including its rate drop in July, will support the economic growth cycle but may be outweighed by the escalating trade war. Uncertainty and caution increased following the Aug. 1 announcement that additional tariffs would be levied, sparking a flight to safety and the recent inversion of the 10-year and two-year Treasuries. Though the Fed's 25-basis-point reduction of the overnight rate and early end to quantitative tightening could pose some inflationary risk, the Fed has communicated a willingness to let the economy "run hot" in an effort to spur growth. Should core inflation rise above 2 percent, it will not be seen as an immediate risk. Falling interest rates, a byproduct of the trade war and the Fed's efforts to boost the economy, will bolster leveraged yields for investors. With the yield on the 10-year Treasury now down 70 basis points from the cycle peak last October and at its lowest level since the record low set in 2016, investment options that may not have penciled even 30 days ago have been reinvigorated. This should help moderate the buyer/seller expectation gap that widened earlier in the year.

**Lenders remain eager as investors bet on shifting consumer preferences.** Underwriters continue to favor industrial space as the rapidly growing e-commerce sector fosters marked space demand. Well-leased projects receive interest from an array of lenders, especially in tight markets, as capital sources remain more than willing to sponsor deals. Conversely, underwriting for speculative space can be slightly more restrained, with lenders focusing on clear-cut investment proposals amid the prolonged cycle. Lending for speculative development appears to be more moderate than the previous cycle as underwriters have maintained their conservative tone coming out of the last recession. Local, regional and national banks and insurance companies remain actively involved, typically offering loan-to-value (LTV) ratios in the 60 to 75 percent range and preferring debt service coverage (DSC) ratios near 1.3, depending on the borrower, asset, location and pre-leasing arrangements. Non-core locations and use cases can call for more nuanced financing such as mezzanine and bridge loans to undertake capital improvements.

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