THE OUTLOOK
INDUSTRIAL

IPA INSTITUTIONAL PROPERTY ADVISORS

MIDYEAR 2021

Tenants Covet Space at Each Stage of Supply Chain; Investor Fervor Signals Long-Term Confidence

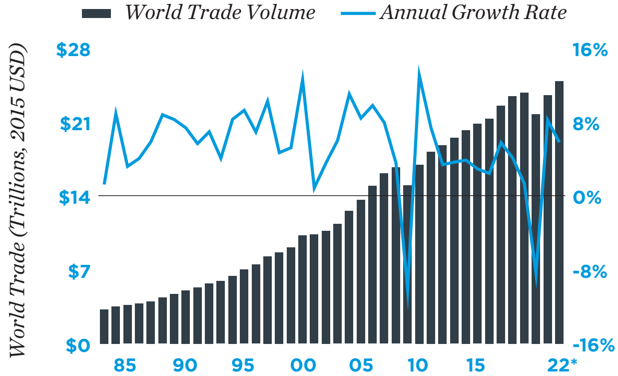
Comprehensive demand drivers strengthen outlook. The industrial sector is emerging from the health crisis well positioned to continue its upward growth trajectory even as the advancement of e-commerce returns to a more sustainable level of expansion. Elevated global trade and supply-chain upgrades during the second half of the year will lift storage requirements for some industrial users in port, hub and emerging markets. Moreover, rising consumer confidence levels and the recently accelerated pace of hiring may prompt more households to deploy built-up cash reserves, testing dual-channel retailers' inventories and distribution networks. Together these factors have the potential to support a historically strong year for industrial absorption and investor demand while simultaneously boosting the overall economy.

Freight handling trends impact port cities. Consumers' return to in-store shopping is extending a stretch of record import activity that began last summer. While vessel turn times have improved, back-to-school shopping and the ramp up to the holiday shopping season are expected to trigger another surge in global trade. The influx of imports will again test terminals' abilities to store containers on site and move 20-foot equivalent units (TEUs) to rail lines and distribution centers. This has the potential to stoke additional demand for long-term and temporary storage near ports and intermodal yards. Elevated cargo volumes will also be recorded at major airports for the foreseeable future, driven by e-commerce firms' need to expedite delivery timelines. The high volume of goods handled at hub airports will require major logistics firms and online retailers to utilize nearby warehouses. In anticipation, developers may expand industrial centers that cater to terminal activity, with airports upgrading their on-site shipping facilities.

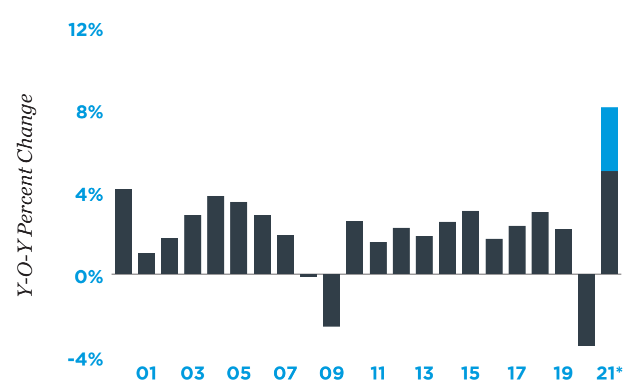
Tech-centric industrial key to dual-channel alignment. Widespread vaccination and the reopening of economies has supported a significant return to in-store shopping across the nation; however, consumers' reliance on e-commerce is not anticipated to fade. Instead, many consumers are expected to maintain their frequency of online shopping for certain purchases while a simultaneous increase in brick-and-mortar patronage occurs. As consumers' shopping habits evolve, retailers that operate both physical locations and online marketplaces will more closely link digital and in-store processes. For most organizations, multichannel improvement will hinge on expediting delivery timelines and more efficiently restocking inventory. Achieving these operational improvements will require companies to lean more heavily on technology, potentially heightening demand for properties that feature high levels of automation.

A focus on emerging markets. Industrial users are upgrading distribution networks in secondary and tertiary cities, confident that the movement of families and individuals to areas of lower housing costs and reduced density is a long-term trend. Fundamentals in metros that ranked as top moving destinations during the health crisis have already benefited from heightened demand for distribution and last-mile space. Austin, Orlando and Salt Lake City each recorded triple-digit-basis-point reductions in vacancy over the past year ended in March. Phoenix ranked as one of the top markets nationally for leasing velocity with 18 million square feet absorbed. The potential for similar conditions remains high moving forward as each metro's employment base is expected to near or exceed its pre-pandemic mark by the end of this year, supporting additional in-migration. As more online retailers, multichannel vendors and logistics firms respond to this growth, local investor pools are likely to deepen.

Global Trade a Major Driver of Growth

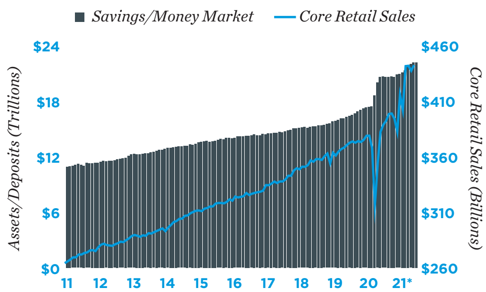


GDP Growth Trends

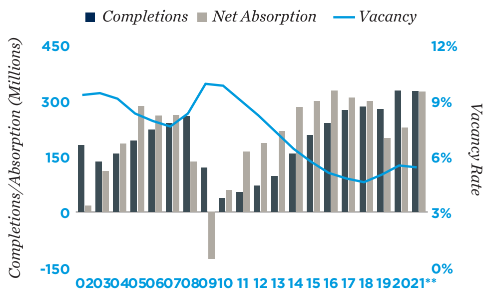


* Forecast; potential growth range for GDP
Sources: BEA; OECD; CoStar Group, Inc.

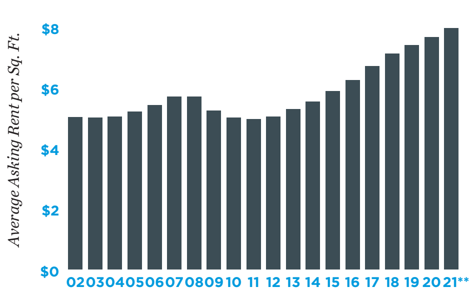
Consumers Cash Reserves Positive for Retail



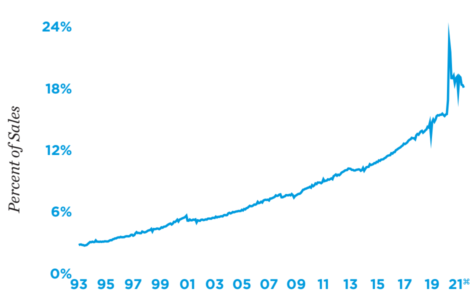
Supply and Demand



Rent Trends



E-Commerce Share of Core Retail Sales



** Through June*
*** Forecast*
⌘ Through May
Sources: CoStar Group, Inc.; Federal Reserve; Office of Financial Research; U.S. Census Bureau

Release of Dry Powder Tests Storage Capacities

Consumers' cash reserves underpin warehouse demand. Driven by large unemployment benefits and federal stimulus, the personal savings rate spiked during the initial months of the health crisis and remained historically high through April 2021. In May, a moderate rate reduction was recorded, coinciding with annual increases of in-person and online spending. As consumers' discretionary expenditures return to pre-pandemic levels, wholesalers, online retailers and brick-and-mortar stores may bolster their stocks of finished goods to keep pace with demand, especially as inventories were historically low entering June. This dynamic is likely to test many tenants' current storage capabilities. Further improvement in consumer spending will also boost factory order volumes and U.S. production, lifting parts and raw materials storage requirements at a time when manufacturing vacancy is extremely tight nationally.

Demand Exceeds Supply Amid Staunch Inventory Growth

Broader project dispersal underscores pipeline refill. Before the health crisis, historically low U.S. vacancy and industrial users' supply-chain upgrades triggered an increase in project starts across distribution hubs and a collection of local service and port markets. The rise in groundbreakings translated to the delivery of 310 million square feet during the past four quarters ended in March 2021, an increase in supply additions over the prior yearlong span. Heightened construction activity was most apparent across the Sunbelt and Midwest, where 10 metros including Dallas-Fort Worth, Houston and Chicago accounted for nearly half the space delivered nationally. The exponential growth of e-commerce during the pandemic and recent migration trends have supported a restocking of the pipeline. As of mid-May, 436 million square feet was underway with an additional 160 million square feet proposed. Development activity appears to be more evenly distributed moving forward as more than 5 million square feet is being built in at least 20 markets. Still, five metros represent one-fourth of ongoing construction, highlighted by pipeline growth in Atlanta and Riverside-San Bernardino. Development activity is also elevated in Phoenix and Philadelphia, markets where absorption outpaced new supply over the past year.

Absorption improvement rooted in large-scale leasing. Widespread demand for warehouse and distribution space enabled nearly all of the nation's major markets to record positive absorption over the 12-month period ended in March. Strong across-the-board leasing activity has allowed U.S. vacancy to hover in the low- to mid-5 percent band since the onset of the health crisis, with the number of lease executions steadily improving. The first three months of 2021 marked the first time in 10 quarters that demand outpaced supply additions as 88 million square feet was absorbed. Preliminary data for the second quarter indicates further improvements in leasing activity are on the horizon, highlighted by growing demand for 100,000- to 200,000-square-foot-plus layouts. The absorption of existing midsize and big-box industrial space teamed with relatively robust pre-leasing of new supply is poised to preserve the nation's low-5 percent vacancy rate over the near term.

Record benchmarks ahead. Successive improvements in absorption following the initial months of the pandemic lengthened a stretch of quarterly asking rent growth that extends back to 2012. These unrelenting gains have enhanced the attractiveness of industrial investment, drawing more eyes to the sector. As dual-channel retailers and e-commerce firms tighten supply chains this year, major local service markets are positioned to be key drivers of asking rate growth.

Investor Enthusiasm Amplifies Across Market Types

2021 Forecast

U.S. EMPLOYMENT

4.6% increase Y-O-Y

- Payroll expansions by online vendors, logistics firms and brick-and-mortar shops will support hiring in the retail trade, transportation and utilities sector this year. These additions will aid overall job creation, enabling the nation to recover nearly 70 percent of the positions lost last year.

U.S. CONSTRUCTION

325 million square feet completed

- Supply additions remain elevated, although the volume of space delivered in 2021 is expected to slightly trail the 327 million square feet finalized last year. Still, the nation's industrial inventory will expand by 1.9 percent, driven by a high volume of 200,000-square-foot-plus completions.

U.S. VACANCY

10 basis point decrease Y-O-Y

- Strong pre-leasing and demand for warehouse space near population centers allows absorption to keep pace with supply additions, lowering vacancy to 5.4 percent. This rate will trail the prior five-year average by 40 basis points.

U.S. RENT

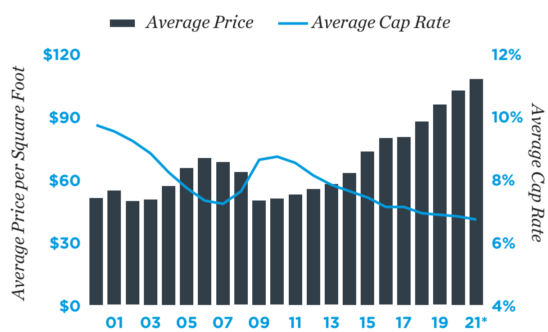
3.9% increase Y-O-Y

- Vacancy compression and operators' ability to lease newly built space will enable the sector's average asking rent to climb at a steady pace, reaching $7.93 per square foot. This level of marketed rate growth will mirror the prior two years, when high-3 percent increases were notched.

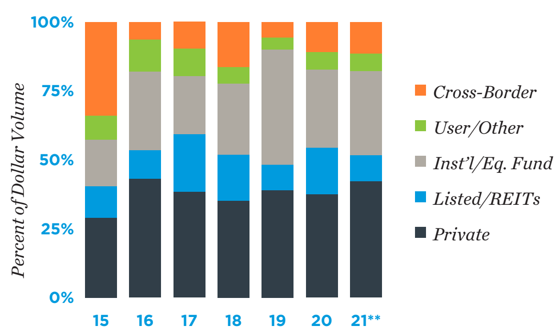
2021 INVESTMENT OUTLOOK

- **Local service markets bolster sales velocity.** The October 2020 through March 2021 stretch was the strongest six-month period on record for deal flow as buyers' risk tolerance shifted back to pre-pandemic levels. Confident in demand for smaller market warehouse space, investors have been active in tertiary destinations including Kansas City, Milwaukee and Salt Lake City. Cap rates for high-quality properties are compressing in these locations, yet 7 percent-plus returns remain available for older assets. These opportunities and nationally below-average pricing may expand buyer pools in tertiary metros as the year progresses.
- **Investors adjust coastal criteria.** Bullish expectations for global trade are fueling buyer confidence in port markets. The lack of developable land in many of these metros' submarkets has also bolstered the long-term outlook for industrial assets in locales that serve as initial sources in the domestic supply chain. Consequently, more investors will accept initial cap rates in the 3 percent to low-4 percent range on both coasts moving forward, fueling a competitive bidding environment.
- **Trading elevates in most populous state.** Vacancies on par or below the national average and proximity to sizable resident bases are drawing buyers to California markets. During the past year ended in March, the state's primary, secondary and tertiary metros combined to record a 7 percent rise in deal flow. Riverside-San Bernardino's standing as a distribution hub will continue to attract a collection of institutions and REITs seeking assets larger than 200,000 square feet. Private buyers may scour the Central Valley and Central Coast for smaller warehouses. Here, pandemic-driven population gains have elevated demand for space, supporting rent growth more than double the national average.

Sales Trends



Buyer Composition Trends



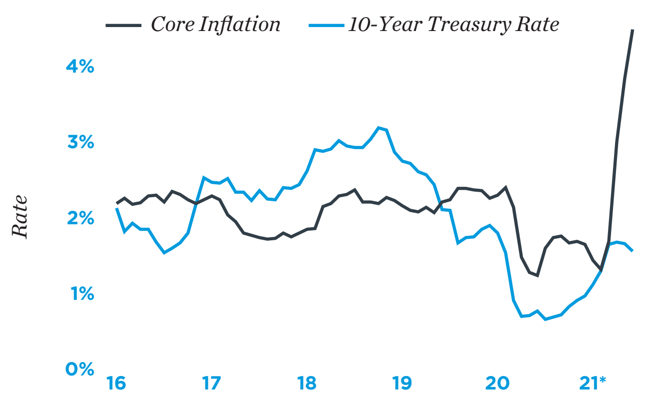
** Through 1Q; ** Trailing 12 months through 1Q*
Buyer composition for sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

Capital Market Operations Largely Resume; Inflation Concerns Becoming More Apparent

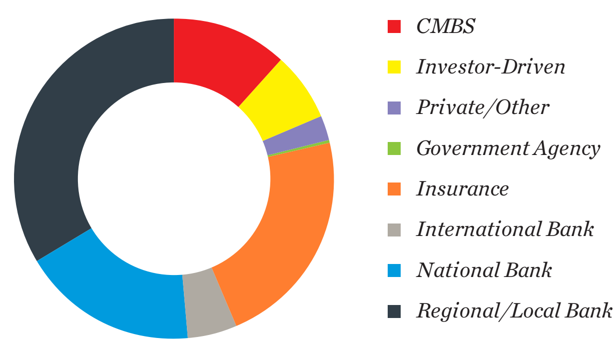
Fed positions for temporary higher-inflation period. Applying lessons learned from the global financial crisis, Congress and the Federal Reserve acted swiftly to preserve market liquidity and support borrowers amid the pandemic last year. As U.S. infections recede and the economy reopens, attention is shifting to the potential longer-term ramifications of these actions. The rapid increase in money supply from multiple stimulus provisions paired with low interest rates and disrupted supply chains has led to higher inflation, with core CPI climbing 4.5 percent annually in June. While above earlier expectations, the Federal Open Market Committee (FOMC) still considers this a transitory concern and intends to allow inflation to stay above the traditional 2 percent growth target for longer than it has in the past. The Fed also expects to keep the overnight lending rate low for the near future, citing still-high unemployment as one reason to hold off. More committee members are now open to the prospect of raising rates in 2023, however. Current quantitative easing practices will also remain in effect for the time being. The FOMC will wait for more substantial economic progress before tapering asset purchases, although some pandemic period programs have already expired.

Lenders, like the economy, are opening back up, with financing available for quality properties. Following significant disruptions last year, the majority of lenders are now active and anticipating larger volume after 2020's slowdown. Sentiment is improving, aided by greater population mobility that will help properties in commercial and travel hubs that were disproportionately affected by lockdowns. Lenders are nevertheless favoring borrowers with whom they have an established and positive relationship. A borrower's credit worthiness and track record bear considerable weight when accessing capital, as does recent property performance, including rent collections. More opportunities are available for assets that demonstrated durability during the pandemic or are now in a strong recovery position. Banks and credit unions are offering competitive lending rates at generally pre-pandemic levels of leverage for a range of high-quality properties. Life insurance companies are modestly more selective by comparison, while CMBS securitizations are now underway. For more challenged assets, bridge financing may be available from debt funds and other sources, at correspondingly higher lending rates. Overall, while lending volume is not anticipated to recover to 2019 levels, the impact of the health crisis on capital availability is expected to be less severe than that of the global financial crisis. The external nature of the health problem and critical efforts taken by Congress and the Federal Reserve have maintained and are improving liquidity in the market.

Inflation and Interest Rate Trends



2020 Industrial Lender Composition



* Through June
Sources: BLS; Federal Reserve; Real Capital Analytics

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Sources: IPA Research Services; Bureau of Economic Analysis; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Organization for Economic Cooperation and Development; Office of Financial Research; Real Capital Analytics; U.S. Census Bureau