The Industrial Recovery

Solid Investor Demand Shifts Investment Activity Toward Class B Assets; A Look at Chicago and Surrounding Areas

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Executive Summary

As recovery continues nationally in the industrial real estate sector, some investors across the country are shifting away from a focus on Class A buildings toward the Class B market as pricing for A properties becomes out of reach of many investors. As a result, B industrial assets—which have in the near term been overlooked by institutional investors—should see increased activity from a wider pool of investors in 2013 as both debt and equity demand continue.

Furthermore, the industrial market is giving the multi-family sector a run for its money as the preferred investment vehicle for institutional investors. This is due to historically steady cash flows, low capital/tenant improvement expenditures, and positive macro-economic occupancy drivers.

This shift in investment activity is being driven by several factors. Since 2007, investors have shown a strong appetite for the Class A industrial market, buying $1.3 billion of inventory in Chicago alone. A shortage of new construction; historically low debt pricing; and expectations of rental increases that would boost investor returns are additional factors creating an enticing environment for investors.

On average nationally from 2003 to 2007, the industrial market had approximately 200 msf of new product under construction annually; today, there is approximately 50 msf of new product under construction annually across the country. A recent report by Prologis projects a 25 percent rent growth in industrial assets from 2013 to 2016 nationally, almost three times the typical annual rent growth percentage.

With only 50 msf of new construction annually across the country and the country's industrial demand drivers causing reduction in vacancies, market conditions are substantiating an uptick in tenant absorption in the Class B industrial properties. This will lead to more incentives for investors to purchase stabilized B assets, allowing institutions, and other investors, to satisfy demands of their real estate equity.

The Recovery

According to CoStar statistics, the overall Chicago industrial market has been trending toward recovery for the past two years. Sales of Class A properties totaled $101.2 million in 2010; $154.2 million in 2011 and $199.8 million in 2012, increases of approximately 53 percent and 29 percent, respectively. Class B sales were $443.5 million in 2010; $451.2 million in 2011; and $742.6 million in 2012, increases of nearly 2 percent and 65 percent, respectively. While the volume is improving, it still is a far cry from the height of the market in 2007, with $607.3 million of activity for Class A and $1.18 billion for Class B.

When evaluated based on square foot volume, Class A sales in Chicago totaled 3.8 million square feet in 2012, exceeding its average for two years, while Class B sales were 14 million square feet. The corresponding sales volume was $199.8 million for Class A and $742.6 million for Class B.

Market Fundamentals

Since 2002, there have been nearly $2 billion in sales in the Class A industrial market in Chicago, as significant inventory changed hands. During 2002 to 2007, there was amply capital in the market looking to be placed. New big box distribution space was built, quickly leased and sold, creating strong investment demand and activity.

Moving beyond that cycle and the recession, the opportunity is shifting into the B market because many A properties have recently traded. Due to changing fundamentals, those A assets that have not changed hands are being held by investors as a cornerstone of their portfolios. Consequently, as the leasing fundamentals for B buildings continue to improve, investor demand, which has not been satiated, will be forced to move into the B asset class.

A review of industrial sales delineated by building age, a factor in determining if an asset is considered “A” or “B,” shows a trend toward investors buying newer buildings. In 2006, for example, sales across A and B classes in Chicago totaled 70.2 million square feet, with an average asset age of 34.6 years. In 2012, the sales were almost as much at the height of the market in 2006, with 66 million square feet of assets trading hands. The average age in 2012 was 28.3 years, however, which shows that the assets were almost 10 years newer, an almost 25 percent increase.

All Chicago Industrial Sales by Age/Square Footage

Year	Average Age	Total Sq. Footage
2012	28.3	65,967,337
2006	34.56	70,152,834
2005	38.41	66,309,310
2002	37.1	35,692,221

Recent Chicago B Investment Sales

Property	Buyer	Seller	Price	Sq. Ft.	Price PSF	Type of Building	Occupancy	Date
7 Bldgs., Wood Dale, IL	Sitex Group	American Realty Advisors	$12.05 M	280,947 SF	**$42.89**	Industrial	**100%**	**7/10/2012**
Wirtz Building, Elk Grove Village, IL	Panattoni	Wirtz Group	$5.425 M	215,000	**$25.23**	Industrial	**100%**	**7/8/2011**
Tri Center Elmhurst, IL	Zilber Property Group	Welsh Investments	$3.97 M	140,837	**$28.19**	Industrial	**66%**	**12/28/2010**
Unisource, Des Plaines, IL	DCT Industrial Trust	Albion Partners	$4.3 M	84,730	**$50.75**	Industrial	**100%**	**11/17/2010**
Prospect Industrial Center, Mt. Prospect, IL	Brennan Investments	Principal Investors	$3.53 M	224,643	**$15.71**	Industrial	**59%**	**9/30/10**

Recent Regional Investment Sales

Property	Buyer	Seller	Price	Sq. Ft.	Price PSF	Type of Building	Date
5. Bldgs in Memphis, TN	Exeter Property Group	DCT Industrial Trust	$69.5 M	2.12 MSF	$32.86	Industrial	12/21/2012
12 Bldgs in Memphis, TN	Industrial Income Trust	IDI	$180 M	3.6 MSF	$49.30	Industrial	12/05/2012
6 Bldgs in Memphis, TN	DCT Industrial Trust	Boubyan Bank of Kuwait	$78.2 M	2.6 MSF	$36.91	Industrial	11/15/2012
11 Blds in Minn, MN	Artis Real Estate Investment Trust	Prologis	$96.6 M	2.0 MSF	$48.55	Industrial	10/26/2012
4211 Pilot Dr., Memphis, TN	Hillwood	Stockbridge Capital Group	$7.5 M	600K SF	$ 12.50	Industrial	6/1/2012

Industrial Investor Profile

In step with the changing market fundamentals and building characteristics, we expect that the typical investor profile also will be shifting. While investors in Class B industrial assets historically have been regional and local investors, this segment of the market is catching the eyes of institutions for the reasons cited above.

While there is a wide spectrum of properties in the Class B category, activity will continue to focus on higher quality assets in top tier markets, such as Chicago, New Jersey, Miami, and Los Angeles. Another shift will occur, however, as other notable industrial markets within the interior of the country such as Indianapolis, Columbus, and Memphis begin to garner the attention of buyers. The main targets for investors are properties that are fully stabilized—with 90 percent occupancy or higher—and those with strong value-add potential that include positive leasing momentum and approximately 75 percent occupancy.

While institutional buyers are willing to dip into the waters in the B industrial market, most will limit their exposure to approximately $30 to $40 million per purchase. This size investment is enough to build some momentum while avoiding too much exposure in the B market. In rare instances, some buyers who are looking to aggregate portfolios in certain markets will easily exceed these levels. Therefore, these assets will typically be sold in smaller, more regional portfolios as B buildings are more difficult to assess, have more underwriting variables, and are less "commodity" like in nature as compared to their A counterparts.

Fully stabilized B buildings that can demonstrate characteristics of A buildings, such as excellent locations, strong credit tenancy, long lease terms and quality construction, will catch the eye of investors looking for stable returns. Value-add buyers will be attracted to B industrial opportunities given the improving leasing conditions and the ability to make improvements and increase the value of the asset.

Investors are looking for B buildings with key characteristics—ceiling heights above 24-feet and deep and efficient truck courts, among others— that can meet the logistics needs of today's tenants. An estimated 60 to 70 percent of Class B properties have these features. Investors who are optimistic about their ability to grow rents and occupancy are correspondingly confident in investing capital into these types of assets, as the path to profitability may be clearly outlined. Buyers see these opportunities as having a lower risk profile than typical value-add properties.

Sitex Group Expands Investment Activity

One investor group that is focused on the value-add category is The Sitex Group, which spent $60 million buying industrial properties in Q4 of 2012 and recently announced plans to significantly boost its investment in this category in the next two years. Sitex has secured financing from a major pension fund and plans to spend another $300 million acquiring Class B industrial space in Chicago and other markets, according to Globest.com.

Activity in Other Select Cities

As recovery takes hold in the Chicago region, other nearby markets also are seeing positive momentum. This movement was first evident in positive leasing and absorption of space and is now extending to the investment market. Recovery is occurring first in markets that offer strong fundamentals—proximity to key geographic areas, strong demographics, and convenient access to major transportation arteries to link distribution facilities to end users.

Markets such as Memphis, Indianapolis, and Columbus, among others, are sought after because of their excellent distribution networks and linkages to major means of transportation, including highway systems, rail systems, airports and waterways. Those markets also offer business friendly environments that can help facilitate investment activity.

Investment Activity 2010-2012

	2012		2011		2010	
	Dollar Volume	Total SF	Dollar Volume	Total SF	Dollar Volume	Total SF
Memphis	$19,099,400	1,503,346	$27,997,402	2,406,331	$39,405,408	2,197,490
Columbus	$19,357,600	2,254,659	$18,380,500	928,732	$7,932,306	329,023
Indianapolis	$28,643,600	1,552,486	$44,774,281	1,892,337	$9,542,000	334,269

Memphis

Overview:

Net absorption totaling 2.9 million square feet helped push the vacancy rate down to 12.5 percent at the end of Q4 of 2012, according to CoStar.

Tax abatement and municipal incentives can hinder true rental growth over the long term, thus providing an artificial cap for building pricing. As with Columbus, there are instances when modern bulk distribution buildings in Memphis can trade at 20% to 40% discount to their replacement costs.

Market dynamics:

- Access to more than 70% of the US population within 2 days truck drive
- Significant rail/intermodal facilities
- Located along southern automotive corridor

Indianapolis

Overview:

Indianapolis saw vacancies rise and rental rates increase from 6.3% in Q3 to 6.7% in Q4. A total of 625,537 square feet of new space delivered at the end of 2012 and 2.13 million square feet of space was under construction, according to CoStar.

Nicknamed the "Circle City" for its downtown roundabout, Indianapolis certainly has been running circles around other North Central US industrial markets with its significant speculative construction activity in addition to its industrial investment sales. Well over 1.5M square feet of speculative industrial product has been developed by Prologis, IDI and others. Recent purchases by Industrial Income Trust, Clarion and other institutional investors continue to underscore the importance of this fantastic logistics market.

Market dynamics:

- Access to more than 80% of the US population within 2 days truck drive
- Significant rail/intermodal facilities

Columbus

Overview:

The Columbus industrial market ended 2012 with positive net absorption of 221,479 square feet, down significantly from the positive 2.6 million square feet in the previous quarter. New construction activity was positive, with 407,000 square feet of industrial space under construction at the end of 2012 and two new buildings totaling 540,000 square feet, delivered in Q3, that are now 100 percent leased, according to CoStar.

Tax abatement and municipal incentives, especially in Columbus, may hinder true rental growth over the long term, thus providing an artificial cap for building pricing. In some instances, modern bulk distribution buildings in Columbus can trade at 20% to 40% discount to their replacement costs.

Market dynamics:

- Access to more than 40% of the US population and 43% or U.S. manufacturing capacity within 1 day truck drive
- Significant rail/intermodal facilities

Recent Class A and B Sales

Property	Buyer	Seller	Price	Sq. Ft.	Price per Sq. Ft.	Type of Building(s)	Occupancy	Date
4211 Pilot Dr., Memphis, TN	Hillwood	Stockbridge Capital Group	$7.5 M	600K SF	$ 12.50	Class B Warehouse	0%	6/1/2012
INDI, Cinc, Columbus, Chicago	Welsh	KTR	$99.5 M	2.7 M SF	$ 36.85	Class A/B Industrial warehouse	96%	2/1/2013
INDI, Phili	Industrial Income Trust, Inc.	Prologis	$137.3 M Total for A and B portions	3.5 M SF 1.98 M Class B	$ 39.29	11-building portfolio	93%	4/1/2012

Conclusion

As the industrial market continues to recover, market dynamics are creating a shift in equilibrium. Many Class A properties have traded in recent years. A shortage of new construction and continued investor appetite for stable returns is opening the door to a wider pool of assets in the Class B market. As this momentum plays out, we'll likely see the following in 2013 and into 2014:

- Upward pressure on rents and, ultimately, sales prices as investors pay more attention to Class B assets.
- A narrowing in the spread between pricing for Class A and Class B assets.
- The creation of a more clear distinction among Class B product, a "top tier" that is considered more appealing to larger investors.
- A greater focus on capital improvements by investors owning lower tier Class B properties, as they look to maintain their pricing and remain competitive from a leasing standpoint.

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As a national industrial capital markets specialist, Erik and his team focus on providing asset advisory, disposition and sale-leaseback services to industrial property owners in Chicago and across the country. He has more almost 20 years or experience in real estate investment sales. Erik has a strong track record of investment sales success and relationships with the leading institutional and regional commercial real estate owners across the country, such as AEW, CBREI, Clarion, Cobalt Capital Partners, DCT, First Industrial, Heitman, IIT, IndCor, Inland, JP Morgan, Liberty Property Trust, Manulife, Prologis, RREEF, and TA.

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