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Foreign Investment in U.S. Industrial Real Estate Markets

Executive Summary

As foreign investment continues to flow into the U.S. real estate market, the industrial sector is seeing its largest surge in sales activity since 2007, according to Avison Young's industrial capital markets group. Industrial sales to foreign investors totaled $2.64 billion year-to-date mid-November 2013, eclipsing the peak of $2.33 billion reached at the end of 2007 and far surpassing the recent low point of $326 million in 2010, when the effects of the recession took hold.

The total volume of investment activity in the industrial sector has increased during each of the past three years, up from $2.13 billion in 2012 and $1.16 billion in 2011, according to Real Capital Analytics statistics analyzed in mid-November. These figures show a 23.9% increase from 2012 to 2013; an 83.6% increase from 2011 to 2012; and a 127.6% increase from 2011 to 2013.

The most active investors are from Canada, where each year from 2011 to November 2013 the total amount disbursed was greater than the dollar volume from all other countries combined.

The makeup of industrial real estate has changed dramatically during the past 20 years, as the U.S. continued its shift away from its heavy manufacturing base to high-cube regional distribution centers and more sophisticated light-manufacturing spaces. The assets being sold today represent a wide range of facilities that all contribute to the country's national supply and distribution network, from 100,000-square-foot (sf) data centers or parts supply warehouses to 1-million-square-foot (msf) or larger distribution centers for companies such as Whirlpool Corporation, Dart/Solo Cup and Amazon.com.

The stability of the U.S. investment market, along with improving macroeconomics in the real estate industry, are prompting investors to spend money that has been waiting on the sidelines. The industrial sector is gaining favor among institutional investors because it offers steady cash flow, low capital/tenant improvement expenditures, and lower volatility than many other asset classes.

Investors from such diverse countries as Canada, Australia, Germany, South Korea and the United Kingdom are buying industrial assets in major markets throughout the U.S. In many cases, investors are seeking stable cash flow and the opportunity to increase cash flow and long-term value through the potential for higher rental rates in the near term.

Rental Rate Increases Likely

As the industrial market continues to stabilize following the recession, the fundamentals point toward rental-rate growth. As vacancy rates move below 10% in many core markets — and new construction is limited — tight supply and strong demand are likely to drive rents upward into 2014. The following chart shows how rental rates in most markets, excluding Dallas/Fort Worth, are below their peak, which occurred in 2007-2008.

U.S. National Industrial Rental Rates Through Q3 2013 (in price per square foot)

Market	2007	2008	2009	2010	2011	2012	Q3 2013
Chicago	$5.16	$5.20	$5.07	$4.89	$4.88	$4.90	$5.11
Philadelphia	$5.07	$5.00	$4.75	$4.57	$4.51	$4.48	$4.52
Los Angeles	$8.61	$8.59	$7.49	$6.97	$6.91	$6.98	$7.52
North New Jersey	$6.43	$6.47	$5.89	$5.69	$5.62	$5.72	$5.81
Dallas/Fort Worth	$4.76	$4.53	$4.46	$4.46	$4.34	$4.66	$4.96
Atlanta	$4.36	$4.39	$4.13	$3.93	$3.90	$3.87	$3.88
Detroit	$5.20	$5.06	$4.77	$4.52	$4.37	$4.39	$4.49
Houston	$5.83	$6.27	$5.65	$5.31	$5.34	$5.49	$5.70
Inland Empire (California)	$6.39	$6.12	$5.12	$4.75	$4.87	$4.93	$5.20
Boston	$6.78	$7.01	$6.39	$6.26	$6.18	$6.12	$6.17

Source: Avison Young, Costar Group Inc.

Market Fundamentals

The industrial market has witnessed six quarters of positive absorption and a decline in vacancy in most markets. While select markets, such as Phoenix, Chicago and Indianapolis, are seeing speculative construction, the pipeline remains far below levels from five years ago. These factors are all strong indicators for investors looking for stability and the potential for long-term rental growth.

Foreign Investment Growth

By mid-November 2013, foreign investors had purchased 189 industrial properties in key markets across the country, an increase from 180 in 2012 and 102 in 2011. According to Real Capital Analytics, the top five countries for origin of investment in U.S. industrial assets are:

Country	Investment 2013*	Properties Purchased
Canada	$1.4 billion	101
South Korea	$514 million	23
Germany	$310 million	19
Kuwait	$145 million	24
Mexico	$65 million	3

Country	Investment 2011-2013*	Total Properties Purchased
Canada	$3.23 billion	265
South Korea	$558.2 million	26
Kuwait	$463.5 million	63
Germany	$414.8 million	24
Switzerland	$262.8 million (no activity in 2013)	11

** Through mid-November 2013*

Who's Buying?

Canada is, by far, the leading country of origin in today's foreign investment market for industrial properties — with $1.4 billion spent on 101 properties this year. While the 2013 figure is largely due to one transaction — Brookfield Properties' purchase of Industrial Developments International (IDI) and its 75-building portfolio for $1.1 billion — there is more to the story.

Canadian investment in U.S. industrial real estate has been ongoing for several years and increased to $1.41 billion to-date in 2013 from $1.13 billion in 2012 and $690 million in 2011 for a three-year total of $3.23 billion.

One example of an active Canadian buyer is Dalfen America Corp. (DAC), a private-equity firm that recently purchased approximately 300,000 sf of class A industrial assets in Minneapolis, Phoenix and Plainfield, IN near Indianapolis. The firm also announced plans to spend another $110 million on warehouse and distribution properties in major U.S. markets during the next 12 to 18 months.

Why Canada?

This influx of Canadian investors is due to many of the same macroeconomic and supply-and-demand factors that drive others to the U.S. industrial market. Investors from South Korea, Germany, Kuwait and Mexico are drawn to the stability of the U.S. real estate market and the steady cash flow that industrial assets provide. Foreign investors also like the lower volatility found with industrial assets when compared with other asset classes, such as office and retail.

However, there are several additional reasons why Canadians find the U.S. market so attractive. The U.S. is closely linked to Canada in terms of culture and the way their respective real estate markets operate. The lease structure, product type, tenancy and language are the same, making U.S. investing a smoother — and more easily understood — process for Canadians.

All major Canadian banks operate in the U.S. as well, making the currency transfer and lending environment relatively seamless. Some investors, such as DAC, also are looking for opportunistic investments with a strong upside. They want high-quality assets in core or emerging secondary markets that can be recapitalized and positioned for stronger leasing and long-term value.

In addition to the sales listed at the bottom of this page, other notable acquisitions in 2013 include:

- Canadian investment advisor Bentall Kennedy purchased a new 1.1-msf distribution center in Haslet, TX occupied by Amazon.com. The e-commerce giant plans to use the building as a regional fulfillment center. The price was not disclosed.
- South Korean investment group Heitman JV National Pension Service's $543-million acquisition of 22 properties (noted in chart above) included a 1.68-msf property in Perris, CA (selling price: $134 million) that houses Whirlpool Corporation's regional distribution operation, along with a 900,000-sf Whirlpool warehouse near Seattle ($81.4 million).

Top Markets for Foreign Investment

According to Real Capital Analytics statistics compiled through to mid-November 2013, foreign investors looked to a diversified mix of markets for their investments. First, they went to primary markets, such as the Inland Empire. While other major cities like Los Angeles and Chicago ranked high in activity, secondary markets Cincinnati and Seattle were two of the top five markets in which foreign investment activity took place.

Top Markets 2013	Total Spent
Inland Empire	$304 million
Cincinnati	$130 million
Seattle	$124 million
Los Angeles	$112.5 million
Chicago	$112.4 million

Top Markets 2011-20113	Total Spent
Los Angeles	$370 million
Inland Empire	$349 million
Atlanta	$339 million
Minneapolis	$306 million
Chicago	$289 million

Top-tier cities, such as Los Angeles, Atlanta and Chicago, will continue to draw investor attention because of their prime locations and superior access to national and regional distribution networks. At the same time, a lack of inventory and limited new construction will continue to push sales prices upward, forcing some investors into secondary markets. Furthermore, with so much money still on the sidelines, investors are shifting their focus in order to find suitable assets to buy.

Representative Foreign Investment Sales by Country of Origin

Property	Buyer	Seller	Price	SF	Type of Building	Date
75-Building Portfolio Multiple cities	(Canada) Brookfield Property Partners	IDI	$1.1 billion	27 million	Distribution	Sept. 2013
22-Building Portfolio SoCal and Seattle	(South Korea) Heitman JV National Pension Service	DEXUS Property Group	$543 million	5.97 million	Warehouse/ Distribution	Feb. 2013
(St. Louis area) Gateway Commerce Center Edwardsville, IL	(Canada) WPT Industrial REIT	Welsh Property Trust/Prologis	$53 million	1.26 million	Warehouse/ Distribution	July 2013
(Inland Empire) Centergate Distr. Park San Bernadino, CA	(Canada) Bentall Kennedy	KTR Capital Partners	$68.5 million	1.03 million	Warehouse/ Distribution	March 2013
TechRidge Five Austin, TX	(Mexico) Grupo Haddad	Metzler North America	$24 million	226,076	Warehouse	April 2013

A look at the past three years shows that investors are shifting some of their focus to secondary markets. In some top-tier cities, many assets have traded in recent years, leaving investors with fewer options and, thus, higher pricing.

Other markets have witnessed bursts of activity in some years as investors moved in and acquired assets that met particular investment criteria. Minneapolis, for example, had a total of $306 million in foreign investment in 2011 and 2012, due to some large portfolio purchases, but none in 2013. Similarly, Cincinnati saw $129 million in foreign investment in 2013, but none in the previous seven years.

Among the key markets to watch in 2014 are:

Indianapolis, IN

Indianapolis is a strong logistics market that has seen several years of positive sales activity and new construction starts. At the end of the third quarter of 2013, there was 2.1 msf of industrial space under construction. Two buildings, totaling 162,527 sf, were delivered in the quarter, according to CoStar.

Recent purchases by DAC, speculative construction by IDI, and strong activity by other institutional investors continue to underscore the importance of this centrally-located logistics market. Indianapolis ended the third quarter of 2013 with a 7.1% vacancy rate and net absorption totaling 603,030 sf.

Market dynamics:

- Access to more than 80% of the U.S. population within a two-day truck trip
- Significant rail/intermodal facilities

Columbus, OH

The region has a strong transportation and warehousing sector that is projected to grow at a steady rate through 2016. There are more than 4,400 logistics and distribution operations in the area, all served by multimodal infrastructure, including four intermodal facilities.

The industrial sector ended the third quarter of 2013 with a vacancy rate of 8.5% and net absorption totaling 3.08 msf, a jump from 1.42 msf in the second quarter. Seven buildings were delivered in the third quarter totaling 2.03 msf with 125,141 sf under construction, according to CoStar.

Market dynamics:

- Access to 46% of the U.S. population and more than 33% of the Canadian population within a 10-hour drive.
- Rickenbacker International Airport is the nation's largest cargo-dedicated airport and handles more than 300,000 flights per year.

Charlotte, NC

Charlotte is a growing region with a strong history as a hub for aerospace-related manufacturing and distribution and is known for its advanced manufacturing capabilities. A new intermodal facility is expected to draw additional logistics facilities to the region and position Charlotte for continued growth.

According to CoStar, the vacancy rate in Charlotte was 10.9% at the end of the third quarter of 2013. Net absorption was 409,201 sf, down from 1.85 msf in the second quarter. Two new buildings totaling 100,527 sf were added to the inventory, with 109,554 sf under construction.

Market dynamics:

- Home to eight Fortune 500 and more than 900 international companies
- Home to 130 aerospace companies that manufacture and supply components to major aviation and defense companies

Memphis, TN

Memphis is one of the top logistics and distribution centers in the country, offering a central location and easy access to air, ground, rail and water transportation. Foreign investment in Memphis nearly doubled in 2013 to $70 million from $37 million.

Memphis has approximately 176 msf of industrial space and lease rates that are among the lowest in the country, averaging $3.38 per square foot in the third quarter of 2013.

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

Market dynamics:

- Access to more than 70% of the U.S. population within a two-day truck drive
- Significant rail/intermodal facilities
- Located along southern automotive corridor

The Future of Foreign Investment

The industrial market is poised for continued growth into 2014 as improving economic conditions and a greater sense of confidence from Corporate America continue to strengthen the manufacturing and warehouse/distribution sectors. Many companies are increasing their revenue and profitability, enabling them to increase capital expenditures and invest in supply-chain improvements. This activity translates into greater demand for industrial real estate.

Looking ahead to the close of 2013 and early 2014, Avison Young's Industrial Capital Markets Group expects to see the following:

- **Rental growth:** The prospects for continued rental-rate growth will continue to be a factor in investors' decisions to buy industrial assets. As vacancies fall in recovering industrial markets and existing leases expire, rents generally grow. Today's rent levels are 10% to 20% below peak and are below replacement cost levels in recovery markets. Many investors will continue to be drawn by that type of growing income stream. A report by Prologis earlier this year projects a 25% rent growth in industrial assets from 2013 to 2016 nationally, almost three times the typical annual rent growth percentage.
- **Investment growth:** The U.S. commercial real estate market will continue to see foreign investors acquire industrial assets, likely in double-digit increases, but probably not at the level of growth that has occurred during the past two years.
- **Supply constraints:** Improving absorption and limited new construction also will continue to make the industrial market an appealing place for investors who want stability and the prospects for long-term growth.
- **Continued movement to secondary markets:** As pricing increases in core markets, due to a lack of supply and shortage of new construction, investors will continue to explore secondary markets for investment opportunities. ■

About The Author

As a national industrial capital markets specialist, ***Erik Foster*** *and his team focus on providing asset advisory, disposition and sale-leaseback services to industrial property owners in Chicago and across the country. Foster has nearly 20 years of experience in real estate investment sales. He has a strong track record of investment sales success and relationships with leading institutional and regional commercial real estate owners across the country, such as AEW, CBREI, Clarion, Cobalt Capital Partners, DCT Industrial Trust, First Industrial, Heitman, Industrial Income Trust, IndCor, Inland, JP Morgan Chase, Liberty Property Trust, Manulife, Prologis, RREEF Asset Management, and TA Associates Realty. He can be reached at* ***erik.foster@avisonyoung.com***

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