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industrial market analysis

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The outlook for the Portland industrial sector is more appealing today than it was prior to the pandemic. Coronavirus has primarily acted as an accelerant for the short- and long-term demand fundamentals that were driving the industrial sector before the close of Q1 2020. These fundamentals include the well documented growth in e-commerce that scored a staggering $6.7B jump in revenue during the government mandated shutdown. This was supplemented by the increased demand for space from distributors who are strategically repositioning their inventory levels and supply chain sources to minimize exposure to potential supply chain disruption. And as the industrial sector thrives in these unique times, other CRE classes face long-term uncertainty and are scrambling to reposition themselves to capture rapidly shifting consumer patterns.

These risk and opportunity dynamics across commercial real estate have played out in the capital markets, with investors diverting newly available funds towards industrial's favorable forecast and low-risk profile. Foreign money drawn to the low interest and high liquidity traits of the United States' "deep and diverse capital markets" are choosing industrial when placing their money. National players are also looking to deploy capital that was unlocked by the recent stimulus packages into low-risk assets. Adding to the competitive climate is the shift from tenant to landlord. Given the low interest rates, well-capitalized National companies are preferring to take on debt than take out a lease, eyeing potentially significant capital appreciation courtesy of continued cap rate compression. Strikingly, cap rates of 2 to 3% for industrial properties are being reported in regions across the United States.

Craig Meyer, JLL's President of Industrial Services recently described industrial's growth potential at NAIOP's Fall conference, "the fact that e-commerce still has a long runway for growth makes industrial real estate the darling of the commercial real estate industry". This runway can be described numerically; E-Commerce represented 16% of total retail sales in 2019 but could grow to 30% or more. Giving an indication of the scope of potential demand, ProLogis has stated that for every $1Bn of E-commerce sales, 1.2MSF of new warehouse space is required to be built. This adds up to over 400 billion square feet of new space. Meyer added that for JLL, "currently, as much as 50% of our leasing activity can be attributed to e-commerce related operations".

Faced with a series of disruptions caused by Covid, wildfires and the China trade war, companies that failed to preemptively implement "supply chain risk management and business continuity strategies" prior to the pandemic have lost market share and revenue. Locally, firms such as Columbia Sportswear were significantly impacted. The outbreak caused factory closures in China as well as a protracted return to work, and as a result disrupted the ability of Columbia's manufacturer to acquire the specific raw materials necessary for production. The company stated that "it expects its supply chain issues to affect its ability to fulfill orders and meet consumer demand in a timely manner, and the potential order fulfillment delays would impact future seasons.". Efforts to offset these risks are intensifying demand for industrial space nationally. Companies are abandoning old strategies centered around minimized stock levels that cater to fluctuating supply and demand dynamics, rather opting to significantly increase their safety stock. Additional strategies include diversifying supply chain sources geographically and vertical integration of the manufacturing process when access to raw materials is available.

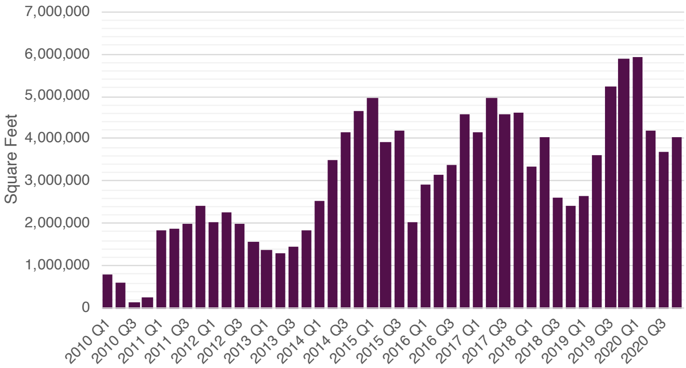
Amongst all of this positivity around Industrial, there are challenges to growth according to industry participants. With the Urban Growth Boundary acting as an artificial supply constraint, the small inventory of parcels that remain are typified by lower quality and prevailing issues. One such issue is the lack of infrastructure - power, sewer, water, transportation – and the State's inability or unwillingness to invest. Prohibitively expensive topographical and environmental issues also deter development. As a result, a lack of developable land along the Columbia Corridor or I5 as well as congestion along Highway 26, is enticing projects north of Vancouver to areas such as Ridgefield, and south of Portland to areas such as Woodburn. This lack of expansion potential has acted as a deterrent to some investors, and limited certain existing companies' local expansion. Those who wish to tackle the challenges of remaining parcels need to be "patient and creative" according to Gabriela Frask, land use planner at Mackenzie, accepting that breaking ground might be at least 2 years post acquisition. Another emerging challenge is skilled labor availability. Despite widespread unemployment, as fulfilment centers increase their technological makeup with automation and robotics, the skill level required by workers is being elevated. These new requirements combine with fulfilment centers being employment intensive, making skilled labor availability and retention issues as being a priority for bigger companies moving into 2021.

Before going into a more detailed analysis of Portland's Q3 industrial performance, a snapshot of the market can be described as; structural vacancy levels with increasing availability rates, market rents are typically inelastic and remaining stable but are destined for a short-term contraction in rental rate growth forecasted until Q2, 2021. Absorption remained positive but will be tested as a large amount of new space gets delivered over the subsequent quarters, including a high percentage of speculative development. Growth remains strongest around transportation nodes along I5 and along the Columbia and Willamette Rivers. From discussions with brokers, forbearance, and concessions are largely unheard of, rather many tenants are seeking to expand if space is available. Success across the industrial sector is fragmented by product type, with big box warehouse spaces proximate to urban centers quickly transacting whereas demand for smaller industrial space, flex, and certain types of manufacturing are softening.

SUPPLY

At the start of 2020, Portland had more industrial square footage under construction than it had since the start of the real estate cycle (Table 1). These builds have continued to come online slowly in Q3 with approximately 571,361 square feet of space delivered. Including an additional 267,425 square feet of warehouse and distribution space delivered in North/Northeast Submarket, and 169,864 of space delivered in the Westside Submarket. Subaru invested $19M to expand their 40-acre Gresham Vista Business Park by 236,225S square feet. New deliveries reduce that record number of construction (5.8MSF in Q1 2020) to 3.8MSF in Q3 2020. Per Colliers Q3 Brokerage Report , little new construction was undertaken in Q3, with the exception of Rivergate Commerce Center which commenced a 40,890 square foot construction.

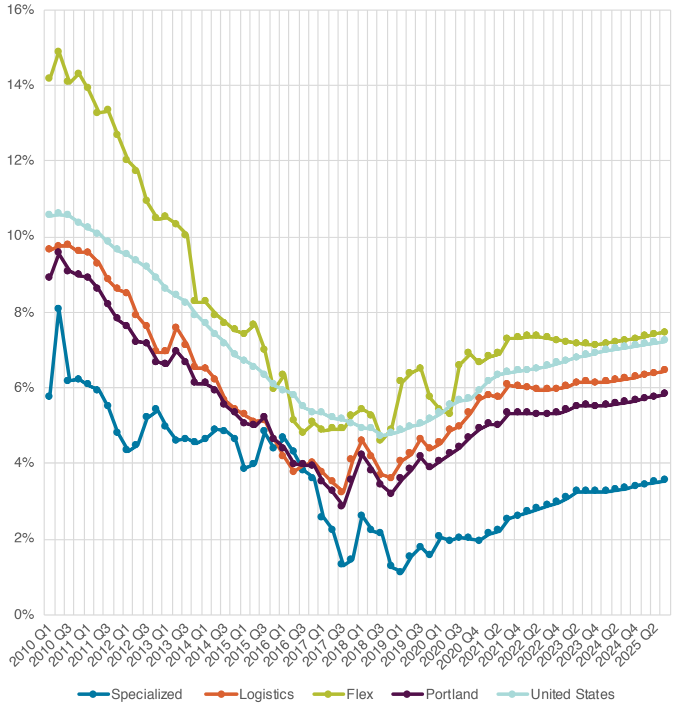
TABLE ONE
PORTLAND MSA INDUSTRIAL UNDER CONSTRUCTION



Source data from CoStar

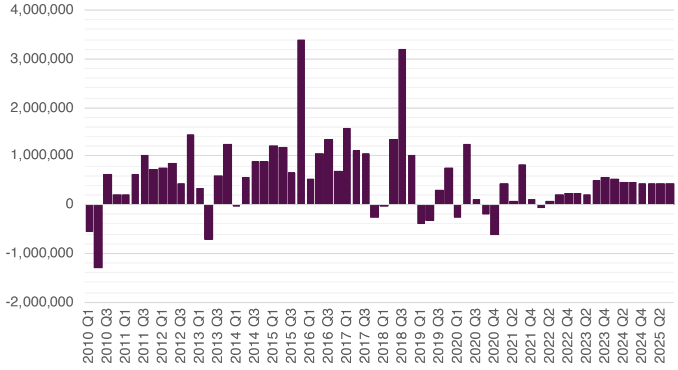
According to CoStar, Q4 will see 1.7MSF of new deliveries brought online, impacting absorption, and vacancy metrics in Q4 2020 and Q1, Q2 of 2021. 75% of that 1.7MSF to be delivered is not pre-leased, so developers may choose delay delivery to ensure assets are allowed favorable market conditions. Submarkets that have low pre-leasing and large deliveries in the pipeline include: Airport Way, East Columbia Corridor, Sherwood, CBD/West Vancouver, St Johns/Central Vancouver, and Rivergate. Pre-leasing has been strongest in Sunset/Hillsboro and outlying areas of Southeast Portland. Notable builds coming online in Q4 2020 include Columbia Distributing, Bldg B/A - 755 NE Columbia, and 15250 NE Airport Way. As discussed, the UGB is broadly constricting the supply of new developable land. Developers will likely start to turn their focus to renovating older assets, and perhaps converting obsolete office and retail to meet demand.

TABLE TWO
PORTLAND MSA INDUSTRIAL VACANCY RATE



Source data from CoStar

TABLE THREE
PORTLAND MSA INDUSTRIAL NET ABSORPTION



Source data from CoStar

DEMAND

Vacancy rates for distribution/warehouse space continues to tighten in the Portland Metro courtesy of E-commerce's expansion, with a 20bps reduction in vacancies across Q3 settling at 4.5%. There was a minor market-wide increase in vacancy rate of 20bps during Q3, reaching 4.5%, however this is largely attributable to softening demand for Flex space that scored 120bps increase from 5.4% to 6.6%. These market dynamics play out against the backdrop of vacancy rate compression that has been occurring at a steady clip in the Portland metro since Q2 2010 (Table 2).

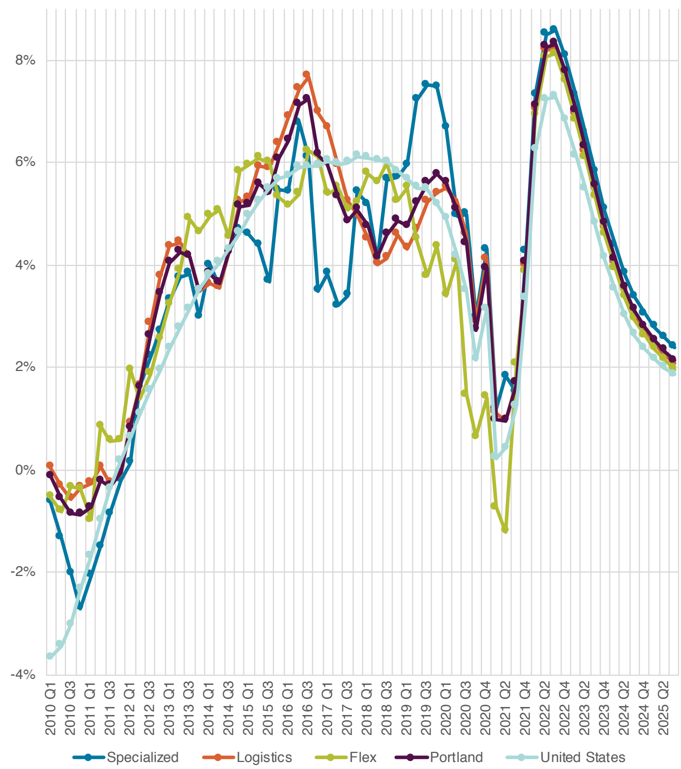
Surveying the trends across submarkets between Q2 and Q3 , Clark County saw a 30bps increase in vacancy levels reaching 2%, and the Westside submarket saw a 70bps increase to 3.7%. Noticeably, the vacancy rate for Flex Space in the Westside submarket jumped 130bps to 5.9%. In the highly coveted Southeast submarket, Distribution/ Warehouse's Q3 vacancy rate dropped 160bps from 4.1% to 2.5%. This contraction is occurring while availability rates have reached their highest point since Q1 2015, hitting 7.1% in Q3 2020. Perhaps suggesting that whilst space is getting newly leased, an increased number of tenants are stuck in leases looking to sublet, or that tenants are contracting their size requirements. Looking forward, market-wide vacancy rates are expected to rise over the next two years before plateauing at just under 6%. A large cause of this increase in vacancy rates is an absorption delay between Q4 2020 to Q2 2021, when over a million square feet of new space is brought online.

Portland Metro's net absorption in Q3 was more subdued, with Q3 registering 335,870 square feet compared Q2 2020 with 1.2MSF (Table 3). The positive absorption was driven by leasing of warehouse and distribution spaces with 665,368SF of net absorption, whereas both flex and manufacturing experienced negative absorption. Noticeable trends were in the Westside submarket, where there was negative absorption of 335,947 square feet, and in Clark

County which went from posting a million plus sq ft of positive absorption in Q2 to negative absorption metrics in Q3. The SE Submarket's proximity to supply sources and target demand continues to drive strong demand, seeing almost 350,000 square feet of positive absorption.

To detail some of this demand, highly financed, nationally based companies are preferring new Class A warehouses that feature a larger number of longer loading docks, and 36-42 foot clear heights to accommodate mezzanine levels. Class B & C landlords are attempting to achieve market rents similar to Class A with mixed results due to demand being limited by the financial scope of local and regional companies. There is a rapid growth in grocery good delivery, spiking interest in cold storage facilities. As a broad flow-on effect, businesses that support e-commerce's functioning such as 3PL, box manufacturers, plastic bag manufacturers are also actively leasing and purchasing. Also of note, the reduced demand for office space that is impacting the composition of flex space with tenants substituting office space for increased distribution capacity. This may impact flex market rent metrics given office commands a higher price than shell rates.

TABLE FOUR
PORTLAND MSA INDUSTRIAL MARKET RENT GROWTH

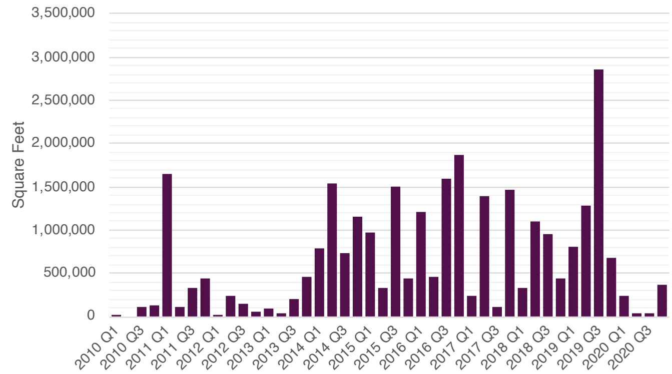


Source data from CoStar

RATES / COSTS

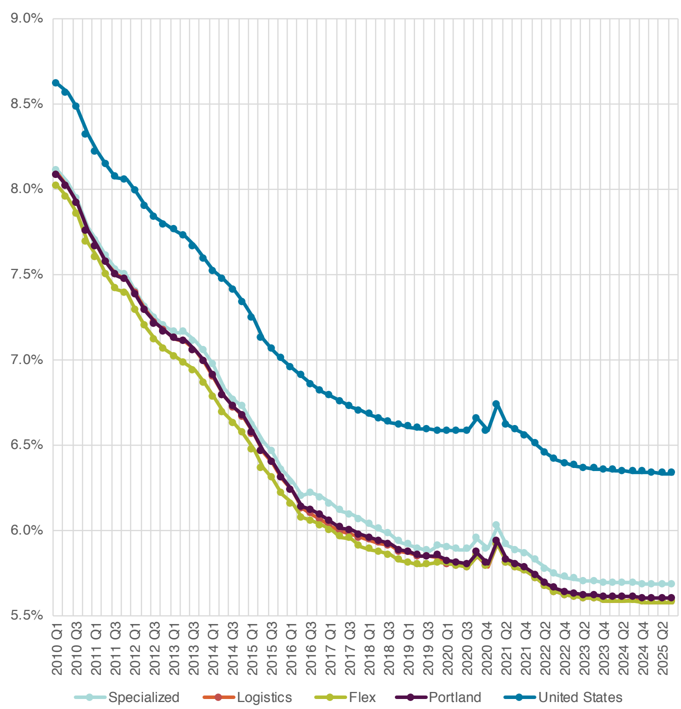
Industrial rents are inelastic, with a lower correlation to market pressures than other product types such as multifamily and office. Consequently, it is not surprising that we have seen rental rate stability despite the overall economic duress being experienced by the broader economy. Yet according to CoStar estimates, Q3 2020 represents a significant turning point, with rent growth expected to drop sharply from above 4% in Q3 2020, to negative 2% in Q2 2021 as seen in Table Four. Perhaps contributing to this inversion is the influx of speculative developments and the resultant loss in landlord leverage. The 1.7MSF of space expected to be delivered in Q4 2020 will put upward pressure on availability and vacancy rates. Amongst this movement, flex and specialized industrial are expected to experience the most pricing volatility. (CoStar)

TABLE FIVE
PORTLAND MSA INDUSTRIAL CONSTRUCTION STARTS



Source data from CoStar

TABLE SIX
PORTLAND MSA INDUSTRIAL MARKET CAP RATES



Source data from CoStar

Rent gains have been strongest for submarkets along the Columbia and Willamette river including Hayden Island / Swan island, East Columbia Corridor, and Rivergate. Poorer performing submarkets have a lower amount of industrial land and are geographically dislocated from Portland's key logistics hubs around the Columbia river. Per Cushman and Wakefield's Q3 brokerage report , rental rates have remained stable with Warehouse/Distribution seeing a 3% increase in rental rate growth from Q2. Flex, and manufacturing saw small drops in average net prices. Newly delivered construction is achieving the highest shell rates, whereas older products are experiencing greater pricing variation subject to location. Northwest Portland submarket saw substantial gains in the average rental rate.

In terms of construction costs, compared to Q3 2019, Q3 2020 costs have inflated 2.4%. As seen in table five. fewer construction starts have had a depressive impact on suppliers and contractor rates yet supply chain disruption is pushing up material costs. HVAC and plumbing costs have increased 2.4% and 1.9% respectively since Q2 2020.

SALES / LEASING ACTIVITY

Portland industrial market sales volume continues to outperform office and retail in Q3, drawing significant attention from capital markets. However, Q3 2020 sales volume remains significantly below pre-Coronavirus levels, when 2019 boasted all-time record sales (Table 6). Factoring into this dynamic; uncertainty in investor sentiment due to Coronavirus, the Presidential election, potential pockets of oversupply impacting negotiations and underwriting assumptions, and expansion limitations due to lack of developable land. Q2 saw prices eclipse $140PSF for the first time in this current cycle, whilst Q3 saw these prices start a downward trend that is expected to last until Q1 2021 before starting an exponential recovery that is expected to last through until Q2 2022. Again, likely to reflect when the Portland market finally absorbs any short-term oversupply. Transaction sales prices which had previously trended below market prices for the majority of the cycle, have jumped above market rates in Q3, reaching $180 per square foot.

Perhaps this is hinting at the competitive sales climate where core orientated buyers are willing to pay a premium for preleased assets with national credit tenants offering stable returns. Transaction cap rates dipped below 5% in Q3, whilst Market Cap rates continued their stable trajectory having gravitated around the 6% mark since 2017. This underscores that debt and equity is still largely available for eligible developments, further supported by favorable financing terms.

PDX Logistics Center Phase III. Source: CoStar

The Cubes at Troutdale. Source: Real CRG

Private Equity and institutional investors were active buyers in Q3. REITs who were highly active Q1 took a backseat in Q2, and Q3. Notable sales in Q3 included Capstone Partners LLC and their joint venture partner PCCP LLC divesting their leasehold interest in of one of Port of Portland's Airport Way properties; the 257,000 square foot two building PDX Logistics center Phase III (pictured) which sold for $43.5 million, at a 5.48% cap rate. The building was fully leased at the time of sale. This continues Clarion Partners acquisition of the center having already purchased Phase I and Phase II. The Cubes at Troutdale in the East Columbia Submarket (pictured) also sold in Q3 for $61 million, with CRG selling the Class A 349,000 square foot space to KKR. Hawthorne Hydroponics signed a large new lease in the East Columbia submarket, taking on 378,000 square feet of space in the Blue Lake Corporate Park. Cascades Tissue Group also signed a new lease in Rivergate, with 225,000 square feet of space at the 6308-6310 N Marine Dr. property.

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