CAP RATE OUTLOOK

Why Cap Rates for Single Tenant Net Lease Industrial Properties with Long Term Leases and Credit Tenants Will Move Lower Over the Next Year

Introduction

There are powerful forces at play that will push cap rates down and values up over the next year for single tenant industrial properties with long term leases and credit tenants. The following discussion highlights these forces.

Financing Rates & Terms

In recent serious recessions, like the early 90s and 2008-2009, real estate financing locked up and become hard to obtain. Transaction volumes and values were severely impacted by the lack of financing. Fortunately, history is not repeating itself during this Covid recession. Life companies and banks are active.

Real estate financing interest rates are at historical lows. Financing experts expect LIBOR and 10-year Treasuries to stay low over the next two years. To underscore this, Tim Mattingly at American Mortgage & Realty notes that, “even at today’s historical low rates, life companies prefer to make more 10-year loans than 5-year loans because they are concerned that interest rates are going to decline further.”

Some financing terms are now more borrower friendly than they were in recent years. Banks and life companies will consider 30-year amortization schedules for properties with 15-year lease terms and borrowers with moderately low loan requests (i.e. 50% LTV).

These trends generate more cash flow for buyers at 2019 and today's record low caps.

Life company interest rates may trend even lower as the high spreads of corporate bond yields over Treasuries tighten.

The Current Supply of STNL Industrial Properties for Sale is Limited and Dwindling

There are not many quality single tenant long termed leased properties with credit tenants available for sale. Despite a withdrawal of some investors from the market as will be touched on below. Cap rates are at 2019's record low levels and are about to start inching down as more investors reenter the market.

Prologis has stated that there will be less new product constructed nationally in 2020 than in 2019 and there will be less built in 2021 than in 2020.

A Capital Tsunami is Coming for Industrial on the Demand Side - There Is No #2

1. Approximately 40% of the industrial institutional investors are in the market to buy properties. 30% of this 40% think they should be getting higher returns just because that has happened in past recessions. That is not happening. They have not grasped the underlying dynamics of the current market. These investors will not get any quality business and their empty pipelines will force them to reconsider their pricing strategies.

2. The 60% of institutional investors that are not in the market will gradually reenter the market.

3. Industrial has always been a desirable property type for institutions, some funds and REITs, and some sophisticated private investors. Retail, office and hotels attracted various types of investors until the pandemic hit us. Except for essential retailers, bricks and mortar retail is obviously a disaster. The pandemic is hastening its settling point as ecommerce accelerates towards its maturity. Office is office – a constant struggle with TI's, leasing commissions and downtime. Zoom and Microsoft Teams will soften the pressure for full time office presence of all employees. Hotel's, while a nightmare in the short run, will be a hunting ground for hospitality experts when businesspeople and consumers feel comfortable enough to start traveling again. Apartments have been popular, but their income streams will be soft until the unemployed service workers are rehired. Even multitenant industrial properties will have rent collection and turnover issues with small companies, which will impact property cash flows, market rents, turnover costs and downtime.

Here are the total U.S. sales volumes for each major property type in 2019 for transactions over $10 million.

All Industrial	$116,364,134,700
Warehouse (a)	93,469,562,800
Single Tenant (a)	32,550,645,500
All Apartments	189,350,229,400
All Retail	87,197,130,900
All Office	141,709,406,800
All Hotels	38,351,505,150
All Properties	$575,967,406,900
All Non-Industrial Properties	$456,603,272,200
Single Tenant Industrial as a % of all Non-Industrial	Only 7.13%

(a) Subcategories included in All Industrial
Source: Real Capital Analytics

Over the next two years, single tenant industrial buildings with long term leases and credit tenants will be the No. 1 preferred property type and **there will be no close No.2!** Conservative investors that opted for other property types, will start to converge on single tenant industrial. New investors unfamiliar with industrial properties will gravitate to properties with credit tenants to mitigate their lack of knowledge. We have been witnessing this defensive move for the last two years as a result of ecommerce. It will accelerate. This new capital will pour more fuel on the demand fire.

Even a minor redirection of investor targets from multifamily, office, retail and hospitality to single tenant industrial would have a big impact on industrial values.

Robust Leasing Activity

Positive leasing activity in the next few years will make the industrial properties even more appealing.

Ecommerce

While the demand for warehouse and last mile space by ecommerce retailers and shipping companies has been growing at a healthy rate for the past two decades, the pandemic and the resulting shelter-in-place restrictions have ignited the surge in demand for warehouse space by ecommerce companies over and above the “normal” growth rate.

Ecommerce retailers and shipping companies are reporting 25% to 33% increases in demand. Many are not committing to delivery dates.

FedEx salespeople are no longer calling customers to get more business. They are calling to give them quotas of how much FedEx can ship for them!

Before the pandemic hit the U.S., ecommerce demand accounted for approximately 25% of all new warehouse leasing. Now, the ecommerce demand during the pandemic is running at 40% of positive absorption.

Prologis believes that the surge demand for warehouse space by ecommerce companies could lead to an extra absorption of 140-185 million sq. ft. in 2020!

Shelter-in-place forced many reluctant to consumers to change their behavior patterns and to go online to have foods and other goods delivered. Now that they have experienced the convenience, they are embracing it. This has led to a vertical step of up of the ecommerce growth curve.

Margin of Safety

Prologis, the largest owner of quality distribution space in the world and arguably the most knowledgeable, has set forth the following outlook. It says that large corporations have spent the last 20 years trying to make their supply changes as efficient as possible so that they can reduce their inventories as low as possible and minimize their inventory carrying costs. These super-efficient supply chains have failed to deliver during the pandemic which has cost the companies sales opportunities.

The following graph shows the historical relationship between inventories and sales for retail companies. You can see the gradual shrinkage of inventories over the past 28 years.

Source: Federal Reserve Board of St. Louis; https://fred.stlouisfed.org/series/RETAILIRSA

Prologis believes that large companies will begin to carry more inventory to accommodate unexpected surges in demand. Prologis thinks this process of adding a “margin of safety” will begin following the availability of a vaccine and will last for two to three years. This new inventory strategy will lead to an overall increase in demand for warehouse space in the U.S. of 5% to 10%. That is an immense amount of demand in a short period on top of a market that entered the pandemic with a high occupancy level.

Prologis believes that the 5%-10% increase in demand will translate to a need for 285-570 million sq. ft. more of warehouse space over a two to three-year period in the U.S.

The ecommerce and margin of safety demand boosts will be evident in leasing activity data and make industrial properties even more appealing to experienced and new industrial property investors.

Wrap Up

Prologis executives stated on two calls with stock analysts in April that they believe cap rates to be lower in 2021 than they are right now.

Douglas M. Longyear, SIOR
Executive Director
Capital Markets, Net Lease Group
CA License 00829911

Current: +1 925 284 4832
Cell: +1 415 705 9655
doug.longyear@cushwake.com