Industrial Redefined -
Investments for a Flexible Future

Commercial real estate investment in the industrial sector continues to grow as e-commerce, supply chain management and technology transform economic models and consumer behavior.

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INTRODUCTION

Commercial real estate is typically divided into four main sectors — office, retail, residential and industrial. The first three attract everyone's attention. Who wouldn't want to own a shiny office building, a contemporary lifestyle center or luxury apartment complex? Industrial assets, however, are often overlooked or misunderstood and have been defined by how they look instead of their broad functionality and economic benefit.

Contrary to this popular misconception, industrial assets are supporting the growth of a new economic model based on e-commerce and a demanding consumer base, which is redefining the general category of industrial to include distribution, logistics and technology. Additionally, industrial assets are often crucial to the efficient functioning of a city, region or even country than any other asset class. In fact, industrial is so important that many managers and investors place it in the infrastructure assets class, which includes the interrelated systems and assets that supply the goods and services necessary for a company or country to grow and flourish.

While properties such as office buildings, malls and apartment complexes are often built with a singular (and therefore limiting) purpose in mind, industrial space can be used for almost anything. Most of the time, its highest and best use is for storage, distribution or manufacturing, but sometimes the best use of the space is for offices, or housing, or biotech laboratories, or retail shops, or nearly anything that fits in a large open space. This flexibility and optionality gives industrial property the ability to become whatever is needed in an economy that is changing and becoming ever more global and connected.

Versatile, essential and ubiquitous, warehouse, manufacturing or laboratory space can also be an integral part of a well thought-out property portfolio.

WHERE REAL ESTATE FITS

Adding commercial real estate to a multi-asset portfolio has long been known to produce better risk-adjusted returns than what can be achieved through a portfolio composed only of stocks and bonds. Real estate has a low or inverse correlation with securities and fixed-income investments, and thus is able to provide a diversification benefit that smooths total portfolio volatility, while at the same time providing higher returns than fixed-income investments, with less risk than securities.

In addition, real estate's risk/return profile is very attractive to investors. Falling firmly between fixed-income and stocks, commercial real estate can provide both income and capital appreciation. Well-located core assets with long-term leases can provide bond-like income returns with the possibility of an appreciation bump when the asset is sold. Taking on a bit more risk by investing in a well-located asset in need of a new tenant, repositioning or cosmetic refurbishment can increase the returns significantly — if the management team knows how to execute and effectively add value.

Including commercial real estate in a portfolio in the form of direct investment or through a fund structure also offers private investors a partial hedge against inflation, as commercial real estate total returns have historically equaled or exceeded the inflation rate.

Add the often-significant tax advantages of owning real estate, and investors are finding industrial assets to be an extremely attractive and lucrative asset class to hold.

WHY INDUSTRIAL

Once an investor has decided to add real estate to his or her portfolio, the decision must be made as to what kind of real estate. All real estate is not created equal, and investors need to know the differences and determine the best fit for their own goals.

Most investors are familiar with office buildings, retail centers and rental housing, so it is no surprise that these sectors have been the overwhelming assets-of-choice as investors have moved into real estate. Investors have often used such buildings themselves, and feel they understand and are comfortable with the types of tenants who would occupy the premises. These properties are often nearby, and real estate is certainly a local business. But by only focusing on these familiar properties, private investors are missing out on the very tangible benefits of investing in warehouse, manufacturing, laboratory and flex office space.

Ask investors about warehouse or industrial, and they are likely to be wary as they picture old, unattractive buildings. Although this can describe some industrial space, it is a very small percentage of a property type known for its functionality and flexibility rather than its aesthetics. Industrial assets are being refurbished to accommodate modern distribution and logistics needs created by e-commerce and just-in-time production, as well as finding new ways to boost returns. It's not uncommon, for instance, for warehouses to rent their expansive roofs to solar energy firms that fill the space with solar panels. The power generated is often used to offset energy costs for the industrial space, with excess being sold to the local electric company — all to the benefit of the bottom line and the investor's portfolio. It is this flexibility that makes industrial assets the perfect investment for a changing future.

BENEFITS/RISKS OF THE INDUSTRIAL SECTOR

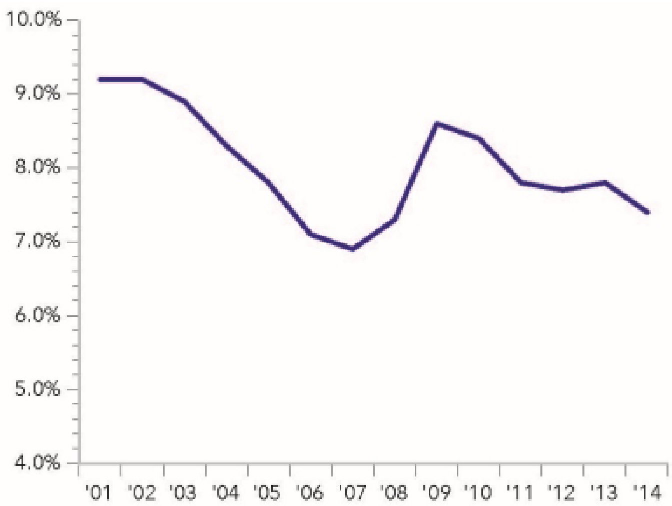
The traditional definition of Industrial properties include manufacturing facilities, warehouses, distribution centers and research & development space. These are typically subdivided into four major categories:

- Light to heavy manufacturing facilities.
- Warehouse and distribution facilities.
- Laboratory and research facilities.
- Hybrid properties that tend to offer flexible space options or serve multiple needs, as in the case of all-encompassing facilities such as office, distribution, and manufacturing facilities.

Investors are finding opportunities in all four categories, and a trend toward flex space and biotech space has made these industrial assets particularly attractive.

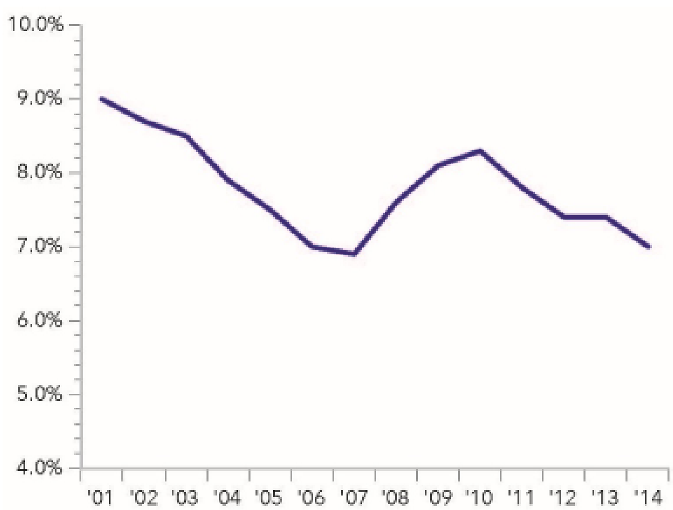
While, high-quality, well-located industrial properties provide a number of benefits to savvy investors, it is also important to understand the risks.

Industrial Flex Sector Cap Rates



Source: Real Capital Analytics

Industrial Warehouse Sector Cap Rates



Source: Real Capital Analytics

Relatively steady cap rates/returns. Although industrial performance is closely tied to the economic swings — and therefore often considered a volatile investment — its long-term leases help keep returns in a rather narrow range. While the Industrial class doesn't typically have high highs, it rarely has low lows either. Volatility can be mitigated by working with a knowledgeable investment team and by viewing the investment as a long-term hold.

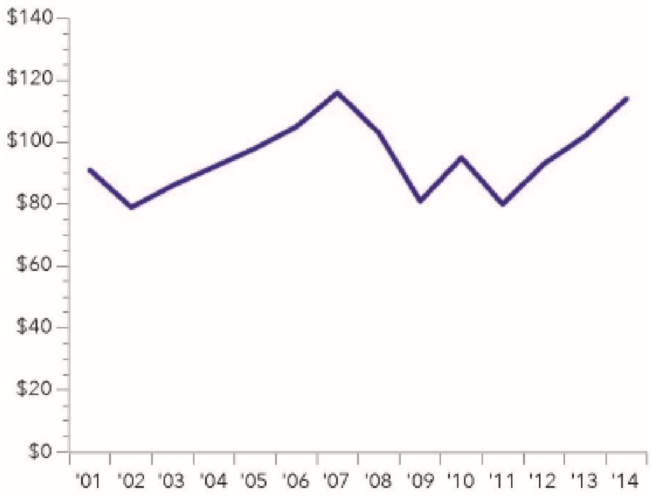
According to the NCREIF property index (NPI), the industrial sector's total returns of 9.2 percent during the past 15 years were higher than the apartment, retail and office sectors in absolute terms and trailed only retail on a risk-adjusted basis. This timeframe includes an equal number of economic up-cycle and down-cycle periods, and so is a credible indicator of long-term performance.

Flexibility. As noted previously, industrial properties are essentially large shells covering versatile open space. This space can be configured for any number of uses to fit tenants' needs from basic warehouses to sophisticated manufacturing and laboratory functions. This optionality provides additional liquidity at exit from a wide range of potential buyers, users or developers. Other real estate sectors, such as multifamily, simply don't have the luxury of reinventing themselves if sector fundamentals or tenant trends change.

Stable, long-term leases. Industrial leases are typically signed for a period of five to ten years, with ten to fifteen year leases not uncommon. When you compare the leases of industrial real estate to other types of commercial real estate, such as office, retail and multifamily, there is significantly less turnover. Many industrial tenants make significant capital investment in their space, which makes it difficult to move. Having a stable tenant base means lower vacancy rates and future capital costs, and increased profits for investors.

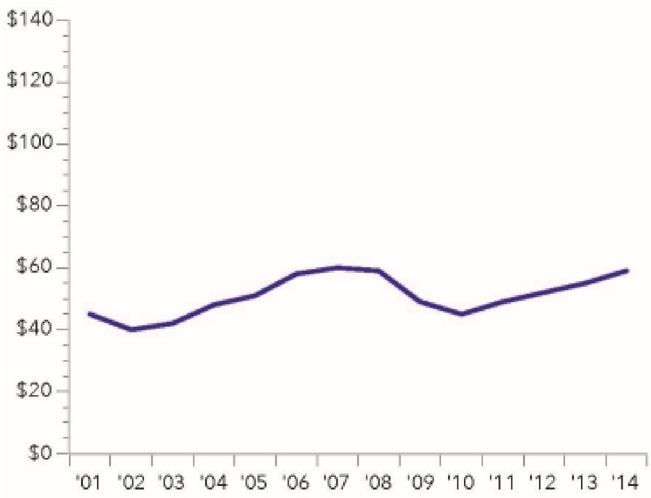
Low-cost property management. Industrial real estate is one of the least management-intensive assets in the market. It is often triple-net leased, meaning the tenant is responsible for all taxes, insurance and upkeep, in addition to monthly or annual rent payments. For properties leased on standard rental agreements, amenities and landscaping are typically minimal, resulting in low upkeep costs for the owner. As noted before, many tenants make substantial investments in their space, such as machinery and technology, for manufacturing and logistics facilities.

Industrial Flex Sector $ PSF



Source: Real Capital Analytics

Industrial Warehouse Sector $ PSF



Source: Real Capital Analytics

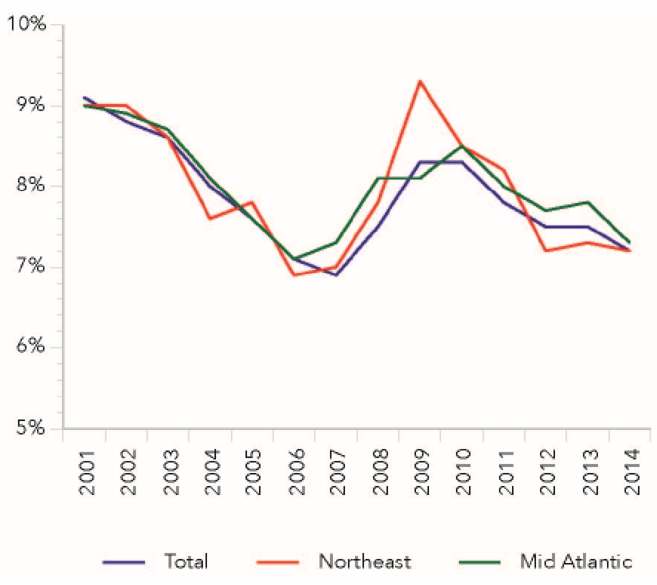
Shrinking supply with growing demand. Due to the trend of the Millennial market moving to the city, housing is at a premium. As a result, the flexibility of warehouse space is coming into play with older industrial buildings finding new life as apartments and retail centers. While this is good for the owners of those buildings, it is not good for the users of industrial space. Due to high land costs in the northeast, very little new industrial development is occurring in the urban and suburban areas to replace the space being taken out of industrial use. From an investor's supply/demand perspective, this means that infill industrial locations will likely become more valuable in these areas as suppliers and manufacturers need aim to be closer to the cities they serve.

Volatility. The industrial sector is correlated to manufacturing, consumer demand and the broader economy. A slowdown in manufacturing or the exchange of goods can affect the industrial sector. On the plus side, however, a growing and evolving economy provides significant upside and stability. Industrial investment, therefore, is a cyclical play, rather than a timing play. Those looking for a long-term investment that will add diversity to their portfolio can easily weather the industrial markets ups and downs.

Environmental risks. In some situations, older industrial buildings can present environmental risks that need to be analyzed and mitigated. These risks can come from the types of products originally stored or manufactured, or from dilapidated and outdated water and refuse systems. In any case, the risk would need to be rectified before the building could be leased. In general, this is a risk specific to opportunistic investment opportunities of older properties, but nonetheless something an investor should be aware of with any building located in a traditional industrial area. For an experienced buyer this can create pricing advantages resulting in a very low basis and there can also be beneficial government programs and tax advantages to repurposing older properties.

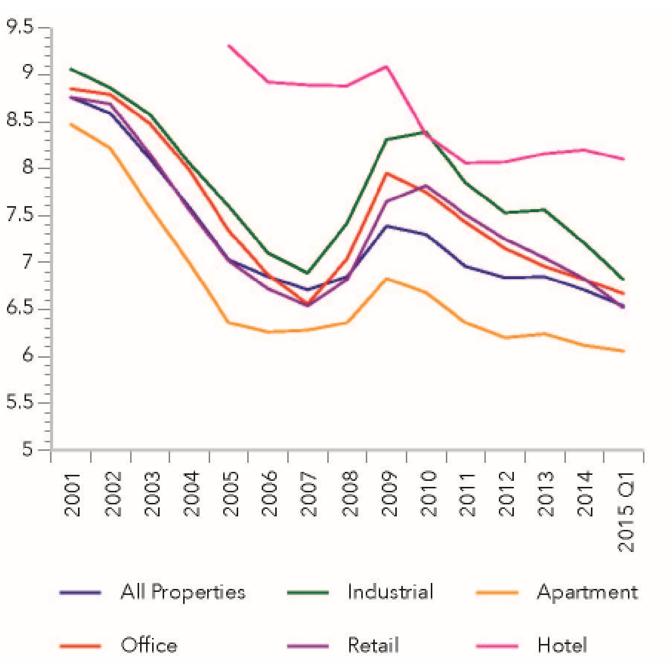
Tenant risk. As with any real estate investment, the tenant can make or break an investment. Tenant risk can be mitigated through long-term leases, as well as thorough tenant credit checks — including researching the viability of the business sector they are involved in. It is imperative for real estate managers to create close relationships with their tenants and to keep open lines of communication to understand their business needs and challenges.

Average Cap Rate Comparison by Region



Source: Real Capital Analytics

Annual Cap Rate Comparison by Sector



Source: Real Capital Analytics

Obsolescence. The needs of manufacturers and shippers are changing at an exponential pace, requiring the flexibility for their warehouse space to also change and be reconfigured for operational efficiencies. Ceilings that were formerly "more than adequate" might no longer be high enough. Locations that used to be in the main interstate shipping corridors are now too far away from customers wanting same-day delivery. Investors need to be aware of changes in the industry and to look ahead to what those changes can mean for their properties. With professional management, most buildings can be refurbished and updated to meet the needs of a changing industry before the changes impact the investment.

As with all generalities, there are exceptions to the rules, and benefits and risks must be weighed appropriately. Real estate is complicated, and that is especially true of industrial real estate. Working with an experienced, local investment team can mitigate the risks while increasing returns.

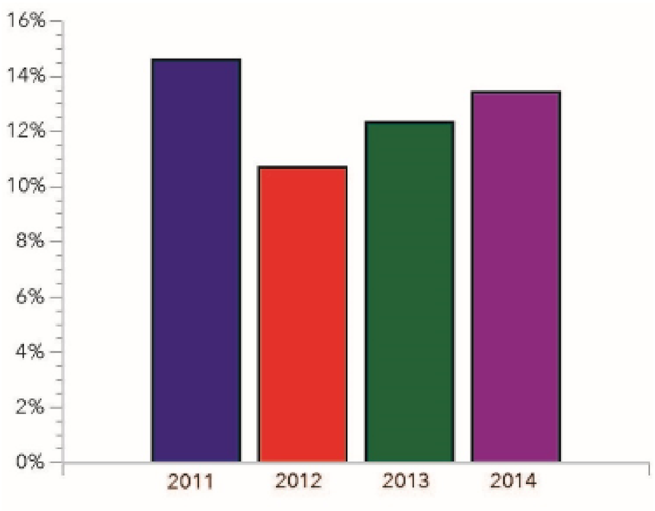
WHAT HAVE YOU DONE FOR ME LATELY?

Historically, industrial/distribution properties have been considered a cyclical investment because they are so closely tied to the manufacturing sector. Today, however, these buildings are seen as flexible open spaces suitable for a variety of purposes. For example, the NCREIF industrial portfolio consists of more than 2,100 industrial properties and more than 1,700 warehouse properties. In addition to those categories, it includes roughly 300 flex properties, 54 R&D properties and another 60 unspecified industrial facilities. Any one of these buildings would be considered an industrial investment, yet the fundamentals are entirely different when considering a manufacturing plant in a old line harbor versus a flex office building in a new office park.

This flexibility, along with a dearth of supply and an increase in demand, is positioning industrial for several years of solid returns. In fact, 2014 saw the NPI Industrial Index lead all other sectors with a 13.42% annual total return. Other 2014 metrics also point to a strong industrial investment climate:

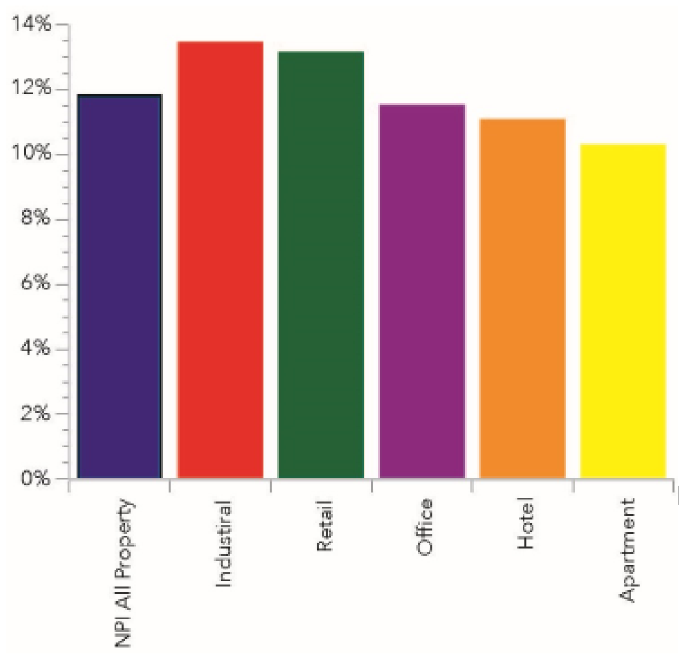
- Total investment volume in U.S. industrial properties totaled $54 billion, a 13% increase over the prior year and the highest increase since its peak in 2007.
- The national industrial availability rate fell to 10.3% in Q4 2014, down 0.9 point over the prior year.
- Development activity has risen in recent years and reached 117 million SF (1% of total industrial base)

NPI Industrial Index Unlevered Returns



Source: NCREIF

NCREIF NPI Total Returns by Sector - 2014



Source: CBRE Research

According to CBRE Research, an upswing in construction is expected to halt the decline of the national industrial availability rate in 2015. However, favorable market conditions will continue to drive demand and the market should still see rental increases averaging about 5%.

If industrial investment continues to increase at the pace set in 2014, as is expected, the 2015 volume will reach the prior peak of $61 billion, set in 2007.

Investors certainly think that this pace will continue. The Pension Real Estate Association (PREA) surveyed a subset of its members in February 2015 and found that industrial is the consensus favorite to lead the pack in 2015. Those taking part in the survey predicted a 10.3% return in 2015, followed by office and retail at 9.8% each, and apartment at 9.3%. Although forecasts into 2016 and 2017 saw the predicted return easing off, industrial is still expected to be the best of the four sectors. Just two years ago, the consensus opinion placed industrial returns a shade below 8%, but the outstanding performance during the past two years has made the industry much more enthusiastic about warehouse, distribution and manufacturing space.

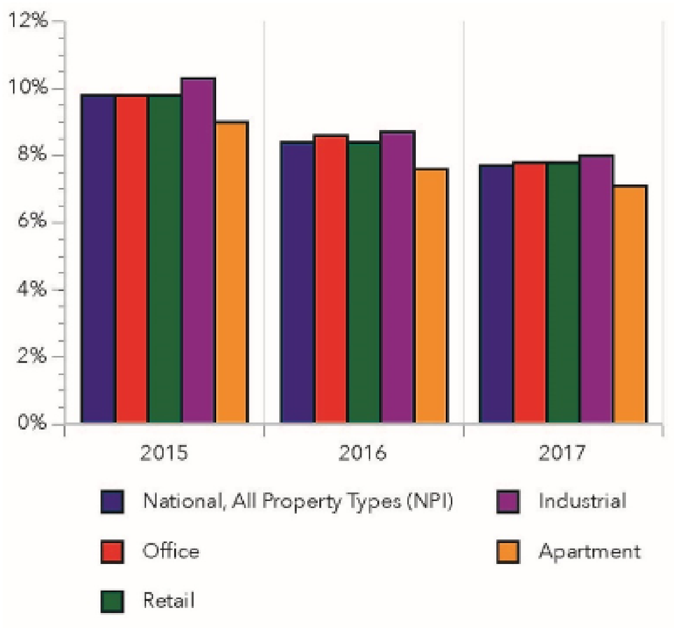
The reason most investors are expecting good things out of the industrial sector is because its performance drivers have been strong and e-commerce continues to change our economy and consumer behavior.

According to CoStar, the 2015 consensus GDP growth forecast is coming in around 3.5% as more people find work and wages begin to rise. GDP is considered a primary driver of demand for industrial space because its components —- online and brick-and-mortar consumer spending, business spending, homebuilding, and import/export — all generate activity in the warehouse and logistics market.

The increased demand for industrial space has encouraged development, as CBRE Research noted, but the consensus among most analysts is that supply remains in line with demand across much of the country, even in the high-growth markets.

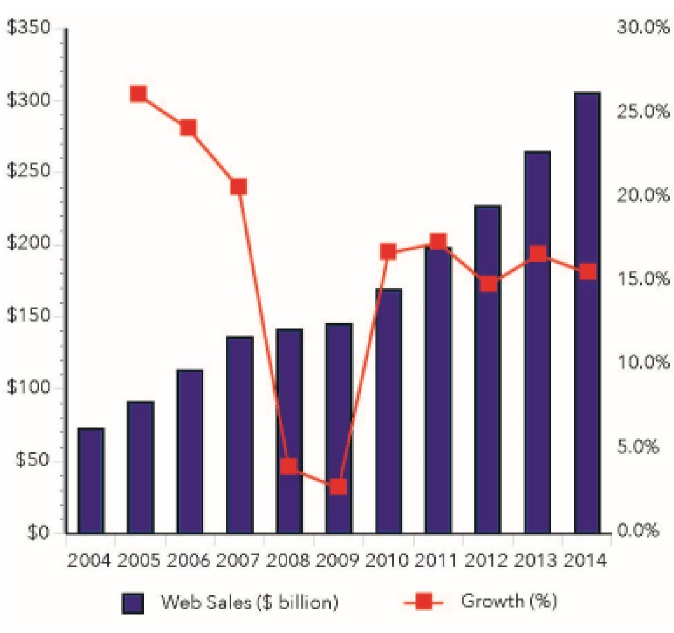
The average asking rental rate ended 2014 up by 3.8%. Of the 45 markets tracked in a CoStar survey, eight posted double-digit rent gains in 2014, including Boston.

PREA Consensus Total Return Forecast



Source: Pension Real Estate Association

Growth in E-Commerce



Source: U.S. Commerce Department

E-COMMERCE DRIVING FUTURE DEMAND

The industrial sector is performing well in today's economy, but it is also well positioned to take advantage of future drivers, such as a consumer sea change to e-commerce. Research done by Avison Young found that there is correlation between the growth and expansion of e-commerce and the creation of positive momentum in the industrial and logistics real estate market (i.e. the demand for industrial space increases with the importance of e-commerce distribution). This is particularly true in, and near, high-density metropolitan areas and markets that serve as regional distribution hubs. When looking for the best regions to invest in, investors can't get much more high-density than the population centers of the northeast and mid-Atlantic regions.

E-commerce has grown steadily in the past 10 years. Although growth slowed during the recession, it still remained positive. 2014 was the fourth consecutive year of 15% or more growth, and 2015 is slated to be the fifth. According to the U.S. Census Bureau, the first quarter 2015 U.S. e-commerce retail sales totaled an estimated $74.9 billion, an increase of 14.3% over first quarter 2014. E-commerce sales in the first quarter of 2015 accounted for 7.0% of total retail sales.

The need for online retailers to provide same-day deliveries is now driving a movement to occupy space in, or near, urban centers. Consumers love the convenience of online shopping, but they don't want to wait days to receive their goods. Those retailers that are able to solve the same-day fulfillment problem will obtain a distinct competitive advantage. Amazon, Walmart, Home Depot, and several grocery chains, are all in various stages of testing same-day delivery and are making decisions about their distribution facilities based on those forward-thinking concepts.

Population growth also is a driving factor in the increase in e-commerce and the correlating need for distribution space, according to Avison Young. Population in the United States is growing by an average of 2.5 million people annually. According to Dr. Glenn Mueller of the University of Denver's Daniels School of Business, each person consumes goods that require approximately 50 square feet of warehouse space. This equates to new demand for 125 million square feet of space annually. The compounding effect of an uptick in population growth, and the rise in demand for e-commerce could be a significant demand driver for industrial real estate, according to Avison Young's report.

TOO GOOD?

All the good news surrounding the industrial sector has made some investors nervous. They are afraid that past results do not always correlate to future results. The future drivers of the sector, however, point to an investment class that should continue to grow, having demonstrated the ability to adapt to changing economic and user trends.

Industrial assets can be found throughout the country, but the prime population centers along the east coast, particularly in the northeast and mid-Atlantic, show high demand and strong supporting demographics. These are the areas that support manufacturing and distribution. These population centers are also the home of e-commerce, which is driving a resurgence in distribution space near major cities. The industrial asset class has proven itself resilient and adaptable - all qualities that should serve owners, occupants and investors well in the future.

Calare is a private real estate investment manager and operator focused on acquiring commercial real estate for the economic benefit of our investors. Since 2003, Calare has led the acquisition of over 15 million square feet representing $650 million of real estate transactions though funds, direct deals and a multi-asset portfolio. We leverage our experience and knowledge of specific industries and property types such as warehouse, manufacturing, research, lab and flex/office to purchase assets within our target markets. These assets, traditionally known as industrial, have evolved and are supporting the growth of a new economic model based on e-commerce, demanding consumer bases and global markets, which is expanding the asset class to include distribution, logistics, industrial and technology.

For more information on Calare Properties and our investment process, please contact Charles Nolfi at 978-627-1078 or via email at cnolfi@calare.com.