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COMMERCIAL MARKET

Industrial Market Analysis

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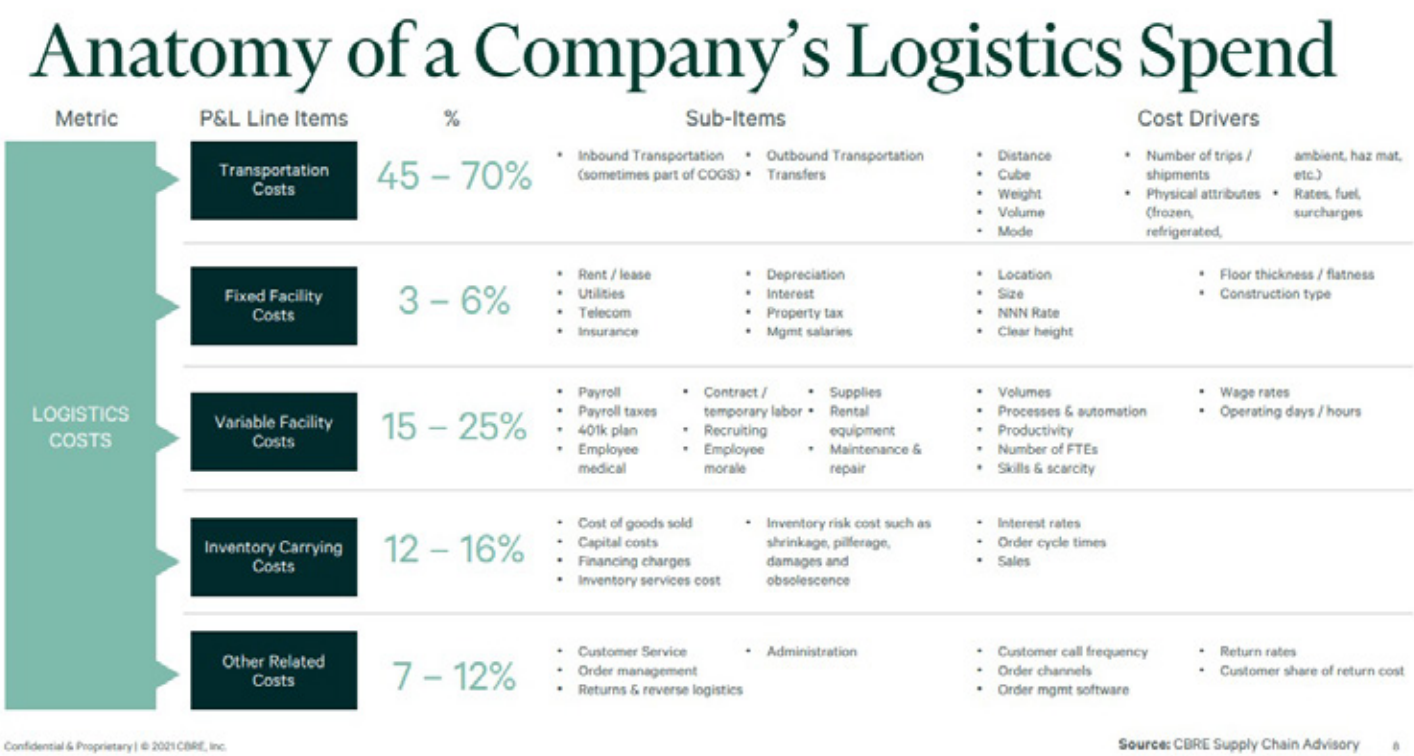
INDUSTRIAL SECTOR

The industrial sector continues to be the star of the real estate industry with total returns in double-digit territory over the past cycle, according to the National Council of Real Estate Investment Fiduciaries (NCREIF). With ever-increasing tenant demand for more space, the industrial sector shows no signs of slowing as companies continually battle for space and proximity to their customer base. As a result, supply/demand imbalances continue to fuel pricing and returns to record-breaking heights. The size of buildings are growing as companies expand and seek to maximize square footage and building efficiency. E-commerce growth has been one of the most notable contributors to recent demand. With continued strong tenant demand and pricing pressure, the industrial sector appears poised for continuing growth.

LOGISTICAL DEMANDS

Companies are currently competing to secure industrial space near their customer base. CBRE's Anatomy of a Company's Logistics Spend shows why.

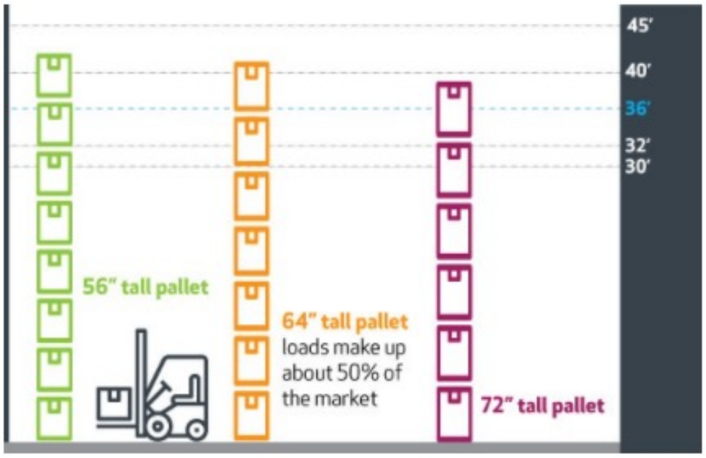


Transportation costs make up a whopping 45% to 70% of all logistic costs, with many cost drivers that are unpredictable and pose a risk to the company's bottom line. In contrast, fixed facility costs account for only 3% to 6% of total logistics costs, with cost drivers that have a relatively lower risk. Companies are identifying ways to control and reduce transportation costs. The best way is to be as close to your customer base as possible to mitigate major transportation cost drivers. It becomes more cost-effective to increase fixed facility costs by paying a rent premium for the correct location.

Furthermore, companies are expected to begin to focus more on reshoring. A May 2020 survey by McKinsey and Company found that 93% of logistics executives plan to increase resilience in their supply chains. Nearshoring and reshoring could play significant roles in those efforts. The NAIOP article All Eyes on Supply Chain also highlights how labor costs factor in reshoring. According to a 2019 report from IVEMSA, a Mexican manufacturing back-office services provider and shelter company, labor costs in Mexico are about $4 per hour compared to roughly $4.95 in China. Naturally, it is significantly cheaper to transport goods from Mexico than China.

Portland's industrial sector continues along the same vein as the national industrial sector, with supply chain woes leading companies to get closer to their customers. They are increasing their logistical reliance on warehousing as consumers expect fast delivery. According to Capacity Commercial Group's Industrial Market Outlook for Portland Q4 2021:

> "…supply chain constraints will continue through 2022. With major ports such as Los Angeles and Long Beach experiencing ongoing congestion, smaller to mid-sized ports such as Portland have benefited from some of these supply chain issues, leading to increased demand for warehouse space from retailers and logistics service providers. The Port of Portland has seen a large increase in TEU processing as the Port added weekly container services with MSG and SM Lines. The increased port activity places Portland at 15th in the country for top Port of containerized cargo."



In a building with a 36-foot clear height, a user will be able to rack one pallet position higher. Fifty-six inch pallets require 37 feet clear before they can gain another pallet position.

BUILDING GROWTH

Industrial buildings in Portland, and in general, are getting larger and taller. The article Go Big or Go Home by Mark Childs discusses the evolution of building square footage by analyzing the current construction pipeline. Childs states:

"We are showing around 5M SF under construction, and close to 6M SF planned beyond that. Just a few years ago, building a speculative 200k SF building was rare. If you had enough land, you built a few buildings larger or smaller than 100k SF each. Now, most sites are covered by one building, with some sites having two or three buildings only because the site configuration won't allow one large building. The average building size currently under construction is close to 250k SF, and while the data is still a little sketchy, the average size for the buildings planned will probably be a little larger."

Tenant absorption rates are increasing due to forecasted long-term demand. Tenants are stockpiling inventory to ensure sufficient supply as demand continues to rise and there is no clear-cut path to end the supply chain woes. Thus, there is a demand for larger spaces. Portland has also seen its clear heights rise. In interviews, multiple local industrial brokers have said that clear heights have consistently gotten taller to accommodate tenant demands. They stated that 10 years ago, the typical clear heights were 24 to 26 feet. Today the standard clear height ranges from 30 to 36 feet in the Portland metro area. An article by Method Architecture explains how clear heights add to a building's efficiency. The article states, "the efficiencies in utilizing more cubic space rather than a larger footprint" maximizes the volume of the cube.

E-COMMERCE

According to CBRE's U.S Industrial & Logistics Market National Update, companies are leasing space at record levels to handle the significant increase in e-commerce sales. There was a record estimated 432.1 million square feet absorbed in 2021. Also, the increased demand from e-commerce and the need for safety stock to counter supply chain disruptions will further push up asking rents and keep vacancy rates at record lows. This is despite a large amount of new development in 2022.
A typical rule of thumb in the industry is that a $1 billion increase in sales requires 1 million square feet of

industrial space. CBRE projects that e-commerce sales will reach 33% of all retail sales by 2032. In light of these projections, there remains significant new demand potential.

In his article, Mark Childs explains the effects of e-commerce on the Pacific Northwest and Portland:

> "Why the shift? The Amazon effect. As I've shared before, the basic concept is that the largest 100 retailers have to compete with home delivery, so they are expanding their one or two national warehouses to the six to eight range, with at least one landing in the Pacific Northwest. And when they land, it is usually in the 100k to 500k square foot range. One would expect them to land in the Seattle area, the larger market, but that has happened so much that they are basically out of land. New, large developments have been pushed down to the Centralia/Chehalis area, and while this locale has the land, they don't have any employees to staff them. Plus, the Kent Valley has become very expensive. A 20k SF lease in the Portland area that would be in the $0.70 shell and $0.25 NNN range is a $1.10 shell and $1.00 NNN range in the Kent Valley."

Like the rest of the nation, Portland's industrial assets have benefitted from the rise in consumer demand and lack of available warehouse supply.

CONCLUSION

There is no clear end in sight for industrial rent growth. Compared to transportation spending, the logistic spending companies are incentivized to pay rent premiums for locations closer to their customer base. As tenant demands shift, buildings are growing larger and larger as warehousing is becoming more popular due to inefficiencies in the supply chain and other factors. E-commerce sales are projected to rise steadily over the next 10 years and make up 33% of retail sales by 2032. There is considerable upside for Portland's industrial rent growth. According to CBRE's 2021 U.S Industrial & Logistics Market report, national annual asking rents rose to a record $9.10 per square foot, 11.0% higher than a year ago. Rent growth is expected to remain at double-digits for the foreseeable future.

The Kidder Matthews Fourth Quarter 2021 Portland Industrial Market report shows leasing activity climbed 15.6% year over year from 9.9 million square feet in 2020 to 11.4 million square feet in 2021. The most active submarket clusters for the year were the Southeast and I-5 Corridor, with 35.8 million square feet and 29.4 million square feet. Rent growth in Portland's industrial market shows no sign of slowing down.