VIEWPOINT
U.S. INDUSTRIAL

CBRE

Pandemic May Bring Lasting Shifts in Industrial Sector

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EXECUTIVE SUMMARY:

- The COVID-19 pandemic continues to suppress activity on the macroeconomy, and CBRE Econometric Advisors (EA) expects that this will translate into some near-term weakness in the industrial sector.
- The shift toward social distancing has encouraged e-commerce spending, which should provide some protection for the industrial sector over the next few quarters.
- Over the long term, EA expects that e-commerce will largely maintain its gain in retail share and businesses across the economy will look to carry larger amounts of inventories, boosting industrial demand.
- The industrial sector is likely to experience a brief downturn throughout 2020 but is expected to quickly recover and has an improved outlook in outer years.

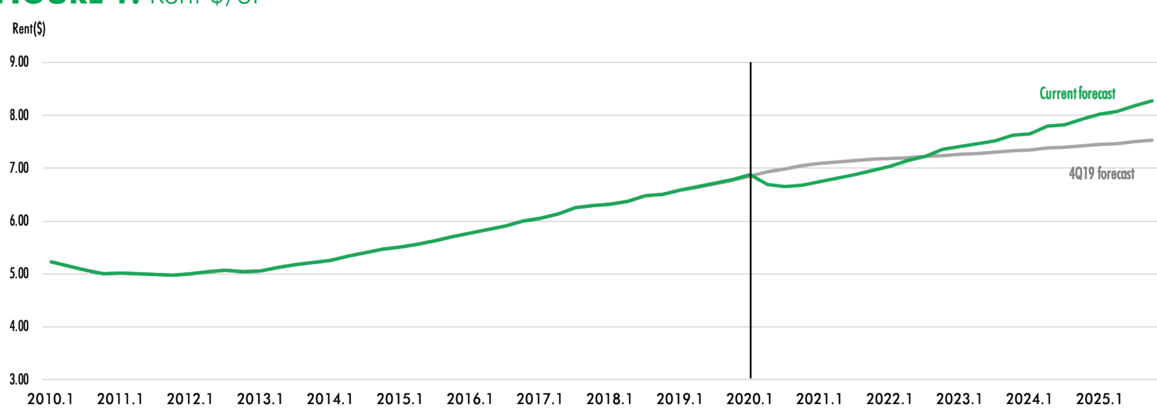
SHORT-TERM DIFFICULTIES WILL DERAIL THE INDUSTRIAL SECTOR'S MOMENTUM

The spread of the COVID-19 pandemic and the ensuing wave of state-level restrictions on business and consumer activity dealt a significant blow to the U.S. economy in the first half of 2020, ending the nation's longest period of consecutive growth. The economy is expected to contract by an annualized pace of over 30% in the second quarter, which would mark it the largest single drop in our nation's recorded history. Early signs from the manufacturing and retail sector show that activity plummeted in the immediate aftermath of the pandemic, with industrial production and retail sales both experiencing historic declines in March and April before partially rebounding in May.

As a result, the industrial sector is likely to be negatively affected over the next few quarters, both on the demand and the supply side. Absorption trends are likely to turn negative in Q2 and remain negative throughout the rest of the year. Part of this is driven by weakness in the manufacturing and retail sectors, which reduce the demand for manufacturing and warehousing space. In addition, the uncertainty surrounding the pandemic has put some otherwise sound transactions on hold. On the supply side, local restrictions on construction activity have disrupted planned completions in Q2.

EA expects the net effect of this disruption to absorption and construction will be a modest rise in availability rates over the next few quarters, peaking at 9.7% in Q1 2021 before improving steadily throughout the rest of 2021 and 2022. This rise in availability will put downward pressure on rates in the short term, sapping all the momentum that the industrial sector possessed headed into the year. Rents are projected to decline by 1.5% year-over-year by the end of 2020 before improving in 2021 and 2022.

FIGURE 1: Rent $/SF

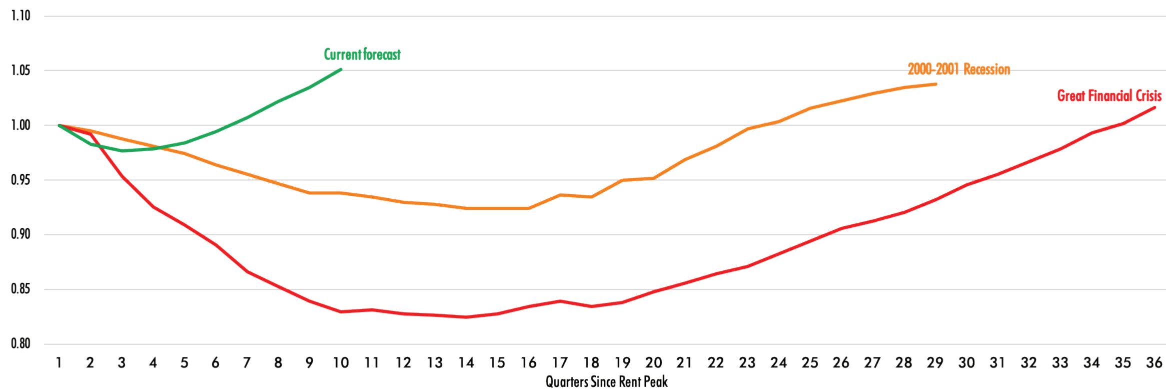


Source: CBRE EA, Q1 2020.

E-COMMERCE TRENDS WILL PROVIDE SOME HELP TO THE SECTOR

Compared to previous recessions, the impact on the industrial sector in our Baseline forecast is noticeably milder. Nominal rents took nearly six years to recover from the 2000-2001 recession and almost nine years to fully recover from the Great Financial Crisis (GFC). By contrast, our Baseline forecasts call for nominal rents to return to Q1 2020 levels by Q3 2021.

FIGURE 2: Rent Recovery | Index Value (1 Previous Peak)



Source: CBRE EA, Q1 2020.

Some of this projected quick recovery in industrial is driven by expectations about the macroeconomy. Unlike the 2000-2001 recession and GFC, the current economic downturn was not caused by any significant imbalances in sectors of the economy. Instead, the pandemic spread at a time when the economy was slowing, but still generally healthy. As a result, there is greater capability for economic activity to rebound quickly once there is some resolution to the COVID-19 crisis, particularly in sectors that are relevant for industrial. The expected V-shaped recovery in GDP and employment should allow for a faster recovery time in industrial.

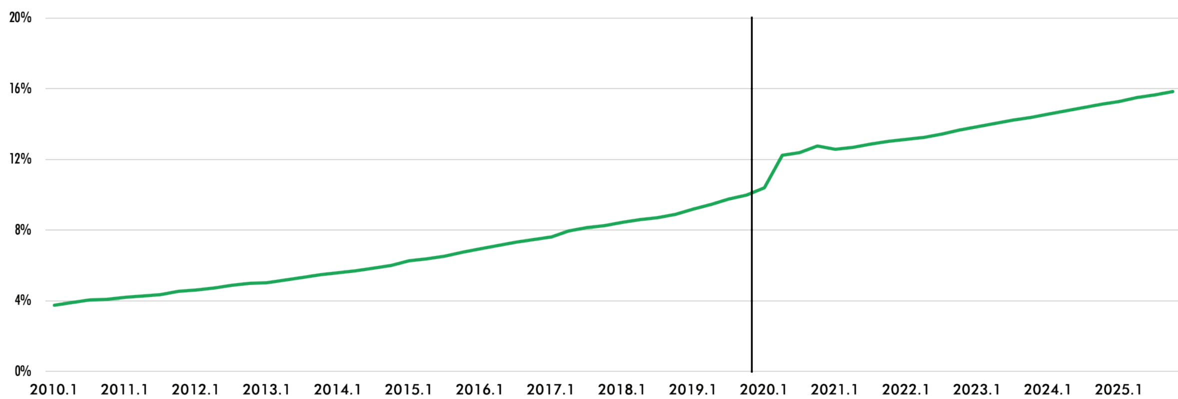
In addition, the pandemic has forced social distancing measures into everyday life, as government officials and households try to limit the spread of the virus. As a result, consumers have increasingly turned to e-commerce channels to substitute for traditional retail spending in recent weeks, accelerating a trend that has dominated the retail landscape for more than a decade. Overall retail sales in the U.S. have collapsed over the past couple of months, but online spending has remained a consistent bright spot during the first half of the year.

E-commerce supply chains typically require more warehousing space than traditional retail outlets, and the shift during the pandemic has stimulated some warehouse demand in the short term. This has helped to offset some of the sector's weaknesses elsewhere and should lead to a milder downturn than previous downturns over the next couple of quarters.

PANDEMIC SHIFTS WILL HELP INDUSTRIAL FUNDAMENTALS IN THE LONG RUN

The shift to e-commerce also caries some positive implications for industrial demand once the pandemic has subsided. Beginning with the Q1 2020 forecasts, EA is now modeling and incorporating e-commerce trends into our outlook for the industrial sector. EA expects that much of the gain that e-commerce makes in the retail sector will be maintained once the pandemic has passed, as households increasingly adjust to purchasing different types of goods online. Current forecasts call for a noticeable shift upward in e-commerce's share of total retail sales in Q2 and Q3 before resuming the general slow upward share gain trend in outer years.

Figure 3: E-Commerce Retail Sales | % of Total Retail & Food Services



Source: US Census Bureau/CBRE EA.

Industrial demand will also likely benefit from an increased shift by manufacturers and retailers toward carrying additional inventories relative to the amount of sales. The past two years have been marked by several supply chain disruptions, beginning with the trade war with China in 2018 and 2019 and amplified by the COVID-19 pandemic this year. Many businesses that rely on lean inventories have been left exposed, causing shortages and production delays. Going forward, EA expects that manufacturers and retailers will adjust by holding additional inventory relative to their sales. This would reverse the post-GFC trend toward leaner inventories, particularly in retail, and would stimulate demand for industrial space further over the long term.

As a result, there is a significant change to the long-term outlook in the Q1 2020 industrial forecast compared to previous forecasts. The strength of e-commerce is expected to lead to healthy absorption trends in outer years as retailers seek to meet consumers' demands. As a result, absorption is expected to decline well below our previous expectations, remaining below 9.0% through the end of 2025. The tight availability should stimulate healthy rent growth over the next few years, averaging 4.4% from 2022-2025.

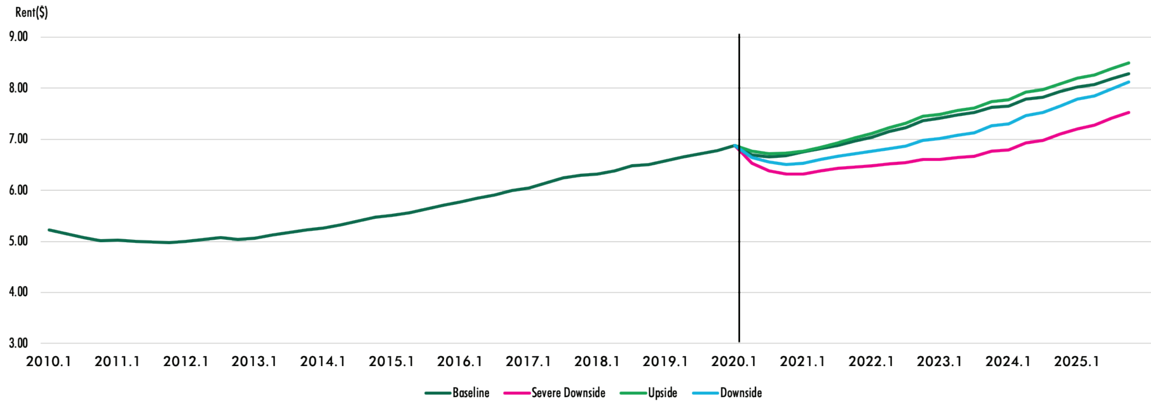
THE SPEED OF RECOVERY IN THE INDUSTRIAL SECTOR HINGES ON THE MACROECONOMY

Real-time data suggests that the contraction in the U.S. economy may be finding a bottom after an historic collapse in the second quarter, but the speed of the recovery remains an open question. Baseline forecasts assume that government stimulus will keep businesses afloat while the economy reopens, and improved consumer sentiment will drive a rapid recovery beginning in Q3 2020. Because of the short-term nature of the economic downturn, the policy moves designed to assist businesses, and the nature of industrial leases which typically have longer terms, there is unlikely to be a major downturn in the industrial sector. Landlords and tenants are likely to pursue mitigation strategies such as altering lease terms rather than terminating existing agreements.

This phenomenon likely changes significantly in a more prolonged economy recovery, where policy may not be able to fully compensate for persistently weak economic activity. EA's current Downside and Severe Downside scenarios all assume similar declines in GDP as our Baseline forecasts but differ greatly in the speed of recovery in upcoming quarters. However, the prolonged nature of a downside macroeconomic scenario is expected to cause more severe declines in rent and larger increases in availability in the industrial sector. The sector would take longer to recover in a Downside scenario, regaining its Q1 2020 rent peak in Q3 2022 in a Downside scenario and Q2 2024 in a Severe Downside environment.

The long-term strength in the industrial sector is still likely to emerge even in weaker economic scenarios, however. The shift toward e-commerce and increased desire to carry more inventory relative to sales will still exist even if the macroeconomy takes years to recover. The timing of recovery will vary, but these secular changes in the economy will drive increased activity in the industrial sector in outer years and keep the sector vibrant once the economy returns to normal.

FIGURE 4: Alternative Scenarios | Rent



Source: CBRE EA, Q1 2020.

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