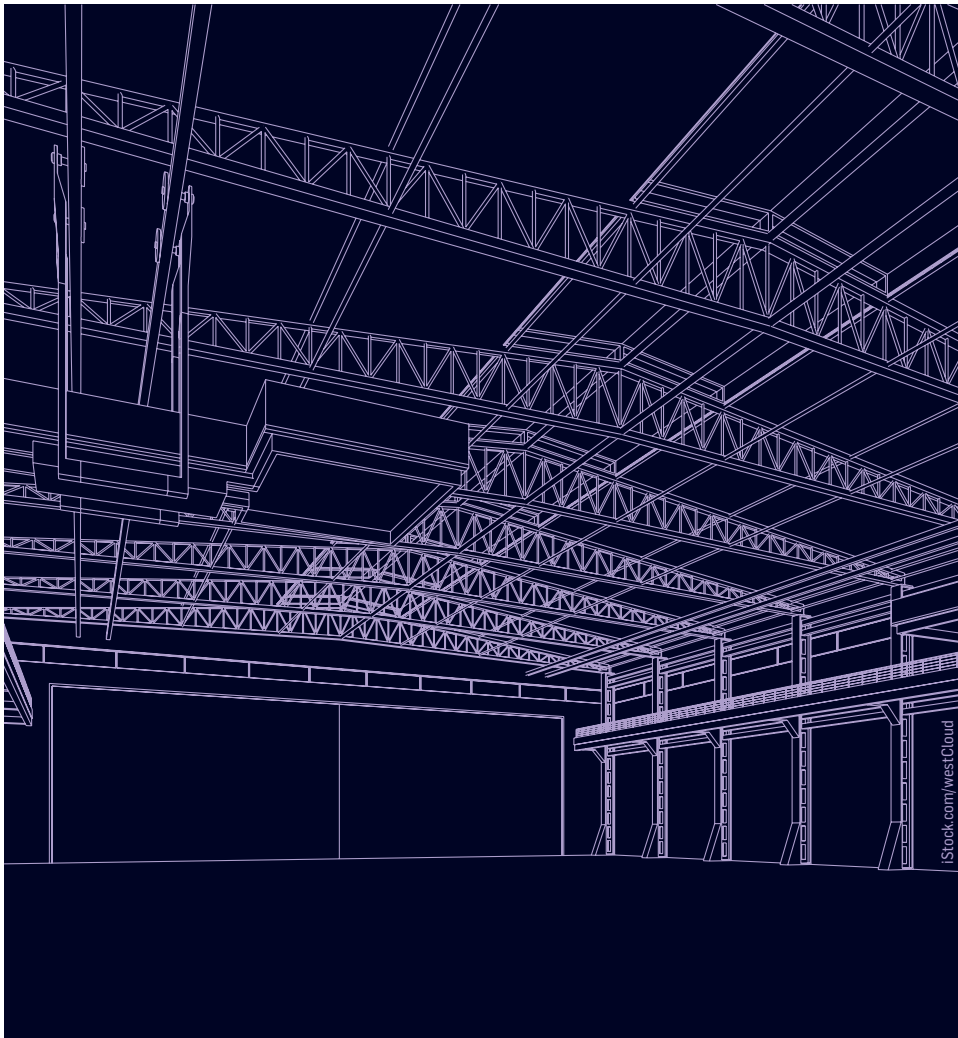


Q&A

INDUSTRIAL IN A recession



Recent market turbulence has left investors with questions about what this moment means for the industrial sector. Its dramatic evolution over the past few cycles — largely the result of rapid e-commerce growth — offers several lessons and opportunities that can insulate the sector from total disruption. **David Egan of Stockbridge** dives into how the sector performs in a recession and future opportunities.

How does industrial typically fare in a recession?

Industrial, as an asset class, tends to track closely with the economic cycle. As the economy slows, demand will typically follow, often lagging a quarter or two. Looking back at data over the past few decades, we can see a tight correlation between GDP and demand (see Exhibit 1).

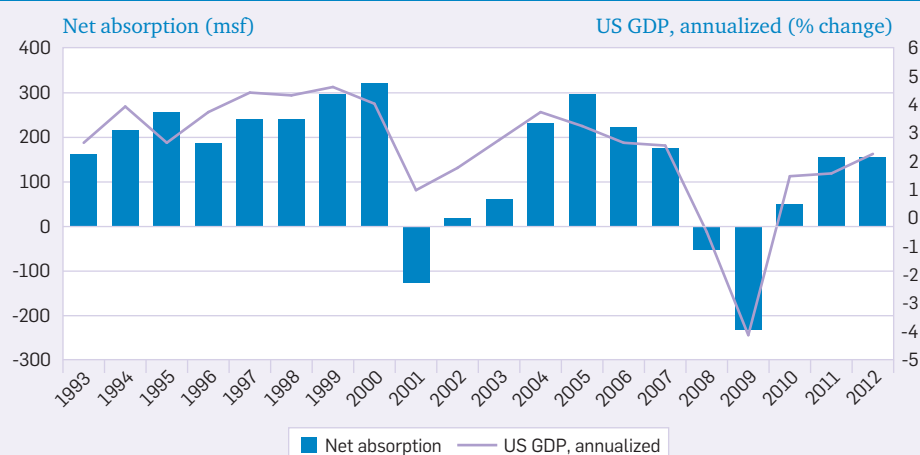
This cyclical trend has typically been most evident within warehouse, especially big box. Demand in this space is largely tied to consumer consumption.

A shift happened in 2012 when e-commerce erupted and really took hold. Faced with delayed shipments to consumers around the holidays, Amazon made the leap to take their entire delivery process in-house and, with that, changed the very nature of its business from price-oriented to become inherently service-oriented. This move is what ultimately drove broad e-commerce adoption.

According to CBRE Research, the e-commerce share of total retail sales roughly tripled from 3.8% in 2009 to 11.3% at the end of 2019. The pandemic also caused a dramatic change in consumer behavior, which drove e-commerce to comprise 16.1% of total retail sales in 2020. With the onset of Covid-19, the on-demand economy broke; it became crucial for suppliers to store excess inventory within warehouses and big-box spaces for 'just-in-case' situations like ports shutting down and ongoing delays.

Due to e-commerce and changing consumer expectations for speed of service, the amount of real estate needed to fulfill this rapid movement of goods has greatly exceeded what economic trends suggest. CBRE data shows that since 2013, users have

Exhibit 1: Industrial net absorption correlates with US GDP growth



Source: CBRE EA, World Bank, US Bureau of Economic Analysis.

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absorbed an annual average of 115 million square feet more than GDP has predicted. However, as the growth of e-commerce has not yet plateaued, we expect user demand will outpace the typical demand generated by economic output, largely due to e-commerce growth and inventory needs.

What we have experienced historically tells us we are likely to see a slowdown in the sector, though it will be less directly related to economic turmoil. Eventually, e-commerce supply chains will be largely developed, so the need for massive and rapid growth will decrease, resulting in demand drivers returning to more typical

factors, such as GDP, employment and production.

What can we learn from previous cycles?

People often think of industrial in a holistic sense, but viewing the sector this way can be counterproductive and often dangerous. The sector is a collection of different types of properties, with different uses, in a wide variety of markets. Factors that affect one property type or market may have little or even the opposite effect on another. Understanding what those differences are is critical in times of disruption.

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To conduct a thorough analysis of the sector, it is important to examine the market fundamentals first and foremost since the key fundamentals — vacancy, rental growth and new supply — will always lead the way and offer insights as to what may be coming. Viewing the market and product type in a much more granular way results in far more potential opportunities.

Following the Global Financial Crisis (GFC) in 2009, industrial was largely viewed on a grand scale. Many shared the belief that the entire sector was struggling, and, as a result, missed out on opportune investments. Low vacancy markets like Southern California, the Bay Area and New Jersey, were either only slightly affected by the downturn or bounced back significantly quicker than others. While other markets collapsed, demand in these markets remained stable and infill locations outperformed. While big-box new development was a cause for concern, the low vacancy rate coupled with rebounding demand, made the recovery in these markets swift. Any investment thesis that ignored the general panic and negative headlines around the GFC would have performed exceptionally well — this is certainly an important consideration today.

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demand. In any downturn or recession, supply indicates how much the cycle really fluctuates. It is crucial to track supply rather than demand and to understand what the components of supply really are.

Why track supply over demand?

Supply is the biggest indicator of the overall health of the sector. Historically, the addition of new supply causes problems in a downturn. This time around, we could see this again.

Based on previous cycles, we will likely see a few quarters of negative absorption, but demand should stabilize quickly. Looking back over the past 40 years, less than 10% of quarterly net absorption totals were negative, so even in an economic downcycle, we will see net absorption turn positive quickly.

However, in the current slowdown, new projects under construction total roughly 600 million square feet of warehouse space and will deliver regardless of economic conditions. Depending on the level of construction, this could ultimately lead to elevated vacancies and slumping rents, even as broader economic conditions improve.

This new supply can have a much more significant and adverse impact on

certain markets and property types than others. This is especially the case for large format warehouses in markets that do not have natural barriers to expansion. In an effort to drum up demand, developers tend to expand beyond areas of robust demand like established submarkets or corridors. This can take place in any market, but it is especially risky in locations where land expansion is easy.

The Inland Empire is an interesting example of a market with natural barriers to expansion. Developers are trying to push out, but the surrounding mountains result in significantly fewer projects further out from the core. According to CBRE, the Inland Empire leads the nation with 60% year-over-year rent growth for big-box facilities, due to a vacancy rate of 1% and robust demand. The region has more than 25 million square feet of big-box development underway. Of this total, 39 projects average 18 miles from the core, compared with 34 projects averaging 13 miles away in 2017. Because the mountains prevent expansion, there is little to no development beyond 25 miles of the core. This is the type of market dynamic that provides insulation against recession. While the Inland Empire may be the most extreme example of this, there are others across

¹ Peter Grant, Amazon Slowdown Sends Shivers Through Red-Hot Warehouse Sector, *Wall Street Journal*, May 31, 2022.

“ What we will likely see in a recession is that the more niche or specialized properties, such as outdoor storage and cold storage, are going to be much more resilient to market turmoil. However, the ability to replace that infill or highly specialized facility space is much lower due to how supply constrained the sector is. ”

the country that are similar — Seattle, New Jersey, Long Island and Boston for example.

Developers have focused on big-box spaces over the past cycle because they are bolstered by manufacturing, e-commerce and distribution sectors, and demand for this type has been steady. However, in recent years, user demand has expanded and spread to lower coverage, supply-chain-oriented industrial along with smaller infill locations aimed at the last mile.

As e-commerce growth has continued, industrial outdoor storage (IOS) properties have served as a central step in the flow of goods and services in the modern supply chain. IOS and other similar, smaller format industrial properties have several characteristics that discourage overbuilding and, in turn, oversupply, contributing to their attractiveness as investments despite market volatility.

Which industrial properties are likely to do well in a recession?

What we will likely see in a recession is that the more niche or specialized properties, such as outdoor storage and cold storage, are going to be much more resilient to market turmoil. However, the ability to replace that infill or highly specialized facility

space is much lower due to how supply-constrained the sector is. The availability of new product and the need for these niche property types is not going away any time soon.

Demand has typically been driven by local economic activity and population growth, which attract tenants focused on distribution activities, equipment leasing and storage. Another component of this demand is driven by the path of goods movement, because of IOS's exposure to trucking and transportation activities. Given e-commerce growth prior to the pandemic, and rapid acceleration since, the demand for industrial space in general, and infill IOS properties specifically, has drastically increased. Infill product tends to be much closer to the consumer. If you give that up, you are putting your relationship with your customer on the line and ultimately risking your chance to get that last-mile location back in the future.

This mindset is slightly different from what is often talked about on the business side of things. Understanding user motivation is an entirely different angle. It is easy to focus on markets and vacancy rates, but focusing on why the users are there in the first place is the key to identifying opportunities.

What should managers look out for and what opportunities are there to be exploited in a tough market?

Surrounding any recession is a general sense of fear and uncertainty, but understanding the user and market fundamentals is of first and foremost importance.

A current example is the noise surrounding the Amazon pullback headlines.¹ To the extent this happens, there will likely be a slight disruption in microlocations, but a minimal impact on the markets overall. In my opinion, the reaction has been wildly disproportionate. The fundamentals in many markets tell us that, even with a large user like Amazon slowing down and construction continuing, the amount of new or vacant supply will not meet demand and will still drive rent growth. The trends may be slower for rent growth, but there will still be growth, nonetheless.

Understanding why users are where they are and why they are making the decisions they are making to meet their end user is critical. Investing where the user is more durable will result in long-term vitality. ♦

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