SECTOR RESEARCH

Research and Analysis for Each Sub-Sector of the REIT Industry

INDUSTRIAL SECTOR

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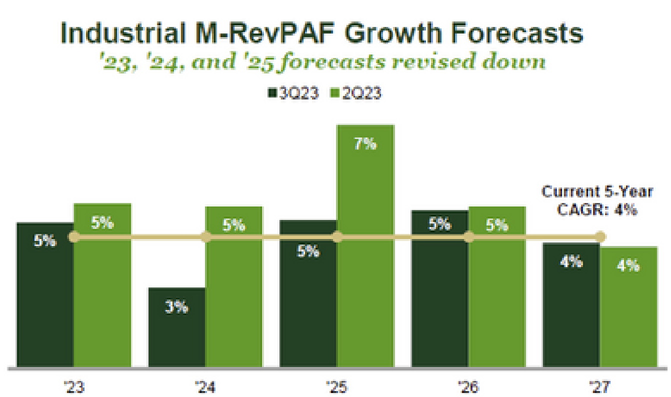
Performance

The sector has been described as the "defending champion" for revenue growth and continues to outperform due to strong rent growth and declining availability rates, primarily as a result of accelerated e-commerce penetration during the COVID-19 pandemic and the resulting surge in demand for last-mile delivery centers, plus an increased need for resilient logistics and distribution networks. Industrial in-place rents averaged $7.60 per SF in December 2023, up 7.7% year-over-year. (5)

Demand for industrial real estate is expected to cool in the near term, however. The Congressional Budget Office (CBO) projects 1.5% US gross domestic product (GDP) growth in 2024, amid “soft landing” expectations. (6) It has begun to exhibit signs of deceleration starting in the latter half of 2023, evidenced by declines in REIT same-store NOI growth. Despite solid long-term fundamentals for the sector, concerns of higher near-term supply, weaker consumer demand, labor shortages and a potential slowdown in leasing activity from major players like Amazon dampen the mood. Highlighting this, M-RevPAF growth forecasts have been adjusted downward by 50 bps for 2023, 200 bps for 2024 and 250 bps for 2025.(1)



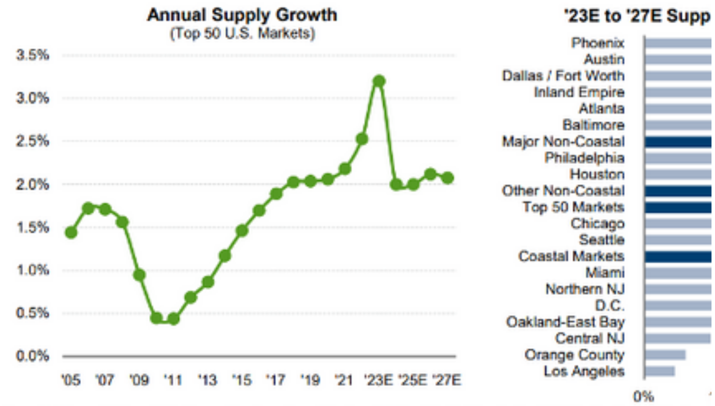
Source: Company filings, Compstak, INTEX, NCREIF, RealPage, and Green Street.

Industrial sector vacancy reached 5.0% in December 2023, ticking up 60 bps to reach the highest rate since Q3 2020. This reversal is driven by record supply and a right-sizing of occupier demand, despite steady leasing velocity.(9) It is expected to surpass 5% as new speculative supply continues to come online. (10) Despite the increase, this rate is still very healthy and well below the 15-year average of 6.4%.(9)

Source: CBRE, Prologis Research

This increase in vacancy is expected to be temporary, however. Construction pipelines are anticipated to shrink to pre-pandemic levels in the near term, partly due to higher cost of capital and tightening development margins.(1) Eventually, some markets may become supply-constrained once again and we could see a reacceleration of rent growth. Overall, new supply should exceed demand by ˜250 million SF in 2023 (+1.4% vacancy).(1)

Industrial net asset values (NAV) have remained flat and are in line with equity market value.(1) Cap rate expansion (driven by slower lease mark- to-market) has been offset by consistent NOI growth.(1) Having said that, the industrial sector has experienced muted cap rate movement compared to other asset classes, rising only ˜140 bps on average since the market peak in Q1 2022.(1) This translates to a ˜16% decline in unlevered asset values.(1)



Coastal Markets = Baltimore/D.C., Boston, Bay Area, Central/Northern NJ, Honolulu, NY, Seattle, South Florida, Southern California
Major Non-Coastal Markets = Atlanta, Chicago, Dallas, Houston, Philadelphia/Eastern PA, Phoenix
Other Non-Coastal Markets = The remaining markets within Green Street's Top 50 U.S. markets
Source: CBRE-EA, Green Street

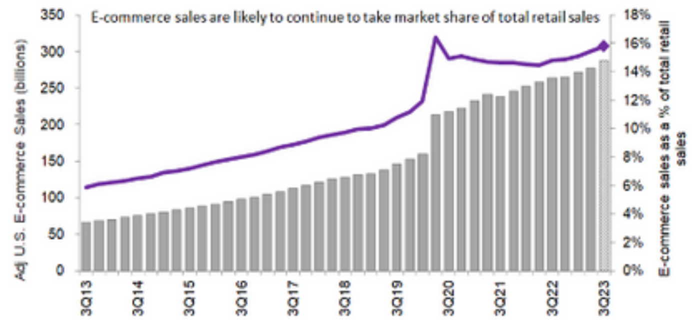
The weighting of the industrial sector on the FTSE Nareit All Equity REITs Index has grown from 8% in 2018 to 14% in 2023, and is now the second largest after residential. Industrial REITs have achieved the second-highest compound annual return of 13.33% over the past 5 years, only 0.09% off the top returning sector. 10-year returns have been similarly impressive, with compound returns of 14.59%, also enough for second highest among REIT sectors.(11)

Company	Prem/(Disc.)
STAG	-2%
EastGroup Properties	11%
Prologis	1%
LXP Industrial Trust	-23%
Terreno	-3%
First Industrial	-24%
Rexford Industrial	-14%
Industrial Wtd. Average	-2%

Demand Drivers

An underappreciated driver of industrial demand is the marginal effect of rents on total supply chain costs. Leasing pricier space closer to the end consumer compares favorably to increased transportation and labor costs, which continue to make up a lion's share of total logistics costs. As an illustration, every 1% saved on transportation or labor equates to approximately 15-20% of rent savings.(4)

Moreover, the COVID-19 pandemic, geopolitical tensions and increasingly frequent and severe weather events have intensified disruption risk,(7) which has crystallized the needfor supply chain resilience. The resulting trend of nearshoring, onshoring and regionalization seeks to addressthis, with approximately 40% of firms reviewing their supplier bases.(7) This broad shift is expected to generate regionalized medium to long-term tailwinds for the sector.(8)

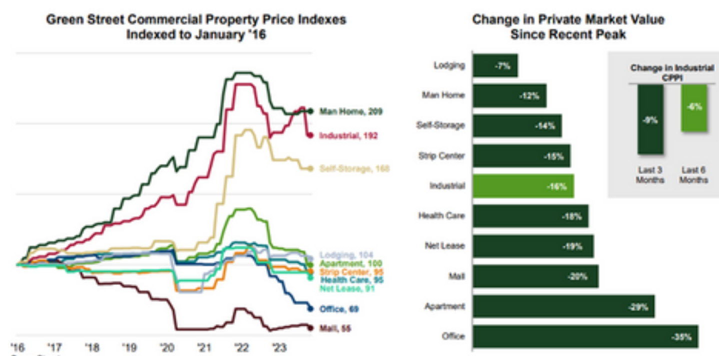


Source: U.S. Census Bureau, VettaFi. 3Q23 data are VettaFi estimates

Continued e-commerce penetration is a major driver of the positive long-term outlook for industrial space demand. Morgan Stanley predicted that the online channel could account for 31% of total domestic sales, up from 14.7% currently.(2)

E-commerce supply chain operations require more warehouse and logistics space, typically three times more than a traditional brick-and-mortar supply chain. A study by CBRE Research found that for each incremental $1 billion in growth in e-commerce sales, there needs to be an additional 1.25 million SF of distribution space.(3)

Other long-term trends of supply chain reconfiguration, and inventory expansion are expected to also support robust demand for industrial space.



Conclusions

For portfolio allocation, we advise directing investments toward companies whose business strategies and property portfolios are well-equipped to combat potential challenges such as high-interest rates, oversupply, and reduced demand from major clients like Amazon and Home Depot. Decrease our involvement in multi-market or gateway distribution facilities ranging from 500,000 to 1,000,000 square feet. Instead, we suggest focusing on last mile distribution facilities. Our sector analysis indicates that this will be the most robust niche within the industrial market in the coming years.