TENET HOLDINGS UPDATE: STATE OF THE INDUSTRIAL MARKET Q2 2023

TENET HOLDINGS

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U.S. Industrial Market Q2 2023[1]
4.1% Vacancy Rate (Increased 30bps from prior quarter)
44.9MM SF Net Absorption (23% decline from prior quarter)
$10.06 SF Asking Rent
16.6% Rent Growth Year-over-Year

Economic Indicators Q2 2023
43MM Industrial Employment
155.9MM Total Nonfarm Employment
3.6% U.S. Unemployment Rate

OUTLOOK

In a reversal from the ballooning logistics capacities required during the pandemic, demand for space continued its retrenchment towards pre-Covid levels across North America in Q2. After rebuilding inventories from the fall of 2021 through Q3 last year, many retailers and wholesalers have paused on adding further capacity out of caution over the economic outlook, resulting in a second-quarter net absorption reduction of 58% year-over-year in the United States.

U.S. imports have fallen from the record highs achieved in November, 2022, the effect of which has been most pronounced at the Port of Los Angeles, where cargo traffic was significantly impacted by China's Covid wave in late 2022 and early 2023. Furthermore and, until the recent labor agreement that was tentatively reached by the West Coast dockworkers and the Port of LA, the risk of a strike was enough for many importers to divert cargoes to alternative ports, such as Newark, Savannah, Norfolk, Charleston and Houston.

Also contributing to the weak absorption figures were troubled retailers such as Neiman Marcus, Bed Bath & Beyond and Stitch Fix, which shuttered a number of distribution centers larger than 500,000 SF. Additionally, Amazon recently put its 508,000-SF distribution center outside Baltimore on the market, along with a facility of similar size in Broward County, Florida.

While the resumption of student loan payments and a possible recession could result in a pullback in consumer spending, the onshoring of high-tech manufacturing is likely to be a driver of U.S. absorption through 2026. The CHIPS and Science Act and Inflation Reduction Act approved more than $400 billion in incentives for new U.S.-based high-tech manufacturing. More than 30 battery plants are in the planning stages, many of which are targeting 2024-25 to start production. A significant number of these plants are planned in Georgia, Arizona and Texas.

[1] Cushman and Wakefield US Market Beat Industrial Q2 2023.

From a supply perspective, total stock of U.S. industrial properties is set to grow by nearly 4% this year, the fastest pace in more than three decades. Barring a severe economic shock, however, the amount of space under construction will likely produce only a moderate increase in vacancy, as construction starts have plummeted since last fall. Developers have grown increasingly concerned that higher interest rates are causing values of newly delivered projects to dip below replacement costs.[2]

SUPPLY AND DEMAND

Following two years of record-setting demand and cumulative rent growth of at least 30%, the industrial sector appears to be reverting to its pre-Covid baseline. In the second quarter, net absorption registered 44.9 million square feet (msf), down sequentially from 71.4 msf over Q1 and from 126 msf year-over-year.

To be clear, demand for industrial space remains healthy, historically speaking. Absorption levels in the first half of 2023 were roughly on par with what was observed in the years leading up to the pandemic, which were relatively strong years for absorption versus the prior long-term moving average. Regionally, the South accounted for 61% of the second-quarter absorption total, led by the Savannah, Dallas and Houston markets—each of which achieved more than 3 msf of net absorption. In aggregate, 21 markets posted at least one million square feet of net growth, a definitive sign of a healthy, albeit cooling, industrial market.

Leasing activity is also showing signs of moderating, which is unsurprising given the economic headwinds. In the second quarter, gross new leasing volume registered 141.1 msf, which was down 8.9% sequentially from the first quarter. Although trending lower from the post-pandemic boom in 2021 and 2022, leasing activity observed in the second quarter was on par with the quarterly average of 137.8 msf observed between 2015-2019, consistent with the trend in net absorption.

Despite the national slowdown, there were notable surges in new deal activity within the Columbus, Baltimore, Charlotte and Denver markets, each of which more than doubled their respective first quarter totals. Meanwhile, 16 out of the 83 markets tracked by Cushman & Wakefield posted leasing totals of more than 3 msf during the quarter. This included Dallas/Fort Worth, which posted 11.5 msf, and was the only market to surpass 10 msf. Though moderating from the first quarter, year-to-date (YTD) new leasing volume came in at 295.9 msf, firmly setting the market on pace to eclipse 500 msf for the eighth consecutive year.

[2] Lee & Associates Q2 2023 Industrial Overview.

DEAL FLOW

The influx of vacant sublease space in some markets helped temper the absorption totals. Vacant subleases rose by 38% quarter-over-quarter (QoQ) to 66.8 msf, up from 48.4 msf in the first quarter. Even though this is a large percentage increase, the sublease rate is still only 0.4%—up from 0.3% in the first quarter and an increase of 20 bps vs. the comparable prior period. The current sublease rate is marginally higher than its long-term average of 0.3% and still trending below the range where sublease rates typically peak during periods of economic softness—usually between 0.4% and 0.7%. A meaningful percentage of tenants who have placed space on the market for sublease are seeking short-term subleases, hoping to reoccupy the space once there is more clarity on economic conditions. Markets with notable increases in sublease space in the second quarter included the Inland Empire, Dallas/Fort Worth, Atlanta and New Jersey.[3]

Industrial real estate sales volumes came in at $27 billion through the end of July 2023, down substantially from the $98.5 billion recorded over the comparable period in 2022 and even more so versus the $128.2 billion in transactions through July 2021. As rent growth remained positive, property owners were content to hold assets, while buyers were reluctant to purchase properties, given the relatively low cap rates and the impact of higher interest rates on acquisition financing costs. Industrial cap rates rose to 6.1% (from 4.9% in 2022), as the Ten-year treasury surged to 3.81%. Industrial asset pricing continued its national ascent to $135/sf (from $132/sf in 2022) and, while industrial real estate has shown a dip in the RCA commercial properties pricing indices, this sector continues to post greater gains than any other asset class.

LARGEST INDUSTRIAL MARKETS IN THE US	
Chicago	1,307,295,856 SF
Norther/Central Pennsylvania	814,733,703
New Jersey	783,508,666
Los Angeles	778,434,621
Dallas/Fort Worth	757,494,459
Atlanta	647,754,520
Inland Empire	599,799,552
Detroit	540,726,942
Houston	507,461,378
Cleveland	379,123,617
Phoenix	328,788,232

[3] Cushman and Wakefield Market Beat U.S. National Industrial Q2 2023
[4] Avison Young US Industrial Market Report Q2 2023