US Industrial Real Estate Outlook

- **Helped by increasing demand from e-Commerce, industrial real estate sector outperformed.**
- **Despite the more recent moderation in activity, outlook for the sector remains strong...**
- **…thanks to structural drivers ranging from demanding consumers to climate change...**
- **…and supportive cyclical influences of falling interest rates and reviving manufacturing.**

Why at all? – Structural drivers (A to F)

- **A demanding consumer:** Expectations of consumers have risen sharply when it comes to the services offered by online retailers; one of the key expectations of the consumer is a reduction in the time taken in the delivery of their packages at lower costs. This requires more warehousing facilities closer to consumers.
- **B2B:** The increasingly demanding consumer has resulted in the need for operational efficiencies not only in the B2C segment, but also in the B2B segment with businesses asking their suppliers to deliver closer to the customer. This means even more manufacturing and warehousing facilities on an industrial scale.
- **Climate change:** Distributing closer to the consumer through more facilities helps businesses reduce their carbon footprint. For the context, nearly one-third of all greenhouse gas emissions are transportation related. By avoiding these, companies can move closer to meeting their climate goals.
- **Deglobalisation:** A deglobalizing world means more diversified supply chains but also near-shoring/friend-shoring adopted by western economies. Extending these trends, onshoring/re-shoring is also being seen as an alternative. This could effectively mean simplified value chains with more focus on closer-to-consumer operations. For detailed discussion on deglobalisation, see our note A deglobalising world and our 'Yellow brick road'.
- **e-commerce:** The rise of e-commerce is a structural theme and has been in place even before the COVID-19 pandemic. As consumers prefer digital channels to purchase goods, last-mile warehousing garners importance. Given the still low penetration of e-commerce in the US, the scope for demand increases is higher and structural (exhibit 1).
- **Freight rates:** The rise in shipping costs (both freight rates and insurance costs) is likely to continue in a deglobalizing world. This means that businesses will need to build more facilities closer to consumers. All this creates investment opportunities in the industrial real estate space.

Why now? – Cyclical influences

- As interest rates come down (we expect the Fed to cut rates twice in 2024), one of the primary headwinds for the sector is likely to fade.
- We are seeing signs of a recovery in the US industrial activity with the manufacturing sector bottoming out after being weak for close to two years (exhibit 2). This along with the resilient consumption should help the industrial real estate sector in the US.
- Industrial real estate sector benefitted from the pandemic fuelled surge in e-commerce. Also, the lower interest rate regime helped. However more recently, rising interest rates and moderation in consumer demand for goods, played a key role in pricing and deal volumes for the sector. Yet the sector overall has outperformed the broader universe (exhibit 3). Recent correction, which we anticipated (see page 11 of our note Q3 2022 Outlook: Delayed, not derailed), in the industrials sector offers a better entry point now.
- Supply of new industrial real estate has slowed significantly in recent quarters, preventing rents and property values from falling further. According to Cushman & Wakefield, new industrial construction starts are down 50% y-o-y in Q1'24. In our view, new supply is unlikely to rise materially till industrial rents rise or interest rates start to drop.
- While the vacancy rates of the sector have ticked up, they remain well below pre-pandemic levels. Quarterly industrial leasing has fallen from pandemic-era high but remains above pre-pandemic levels. Despite this, warehouse rents continued to climb (exhibit 4).

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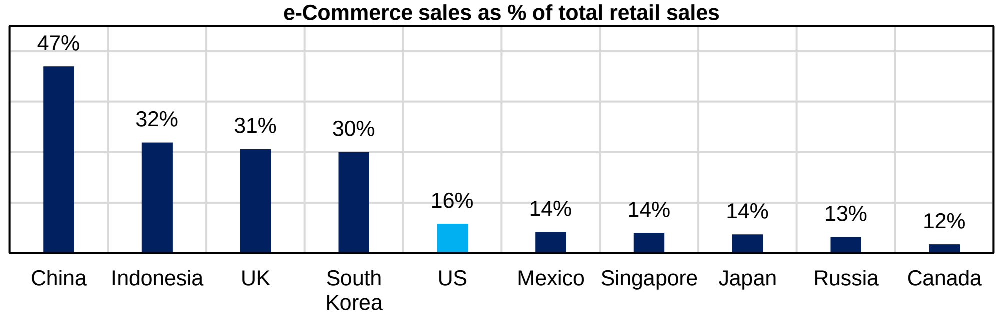
- Rental growth might have reached a new steady state after the pandemic related distortions have unwound themselves. For instance, Moody's Analytics CRE forecasts that annual rent growth for warehouse and distribution properties will consistently track at approximately 5% to 6% per annum over the next ten years.

Risks to our constructive view on US industrial real estate:

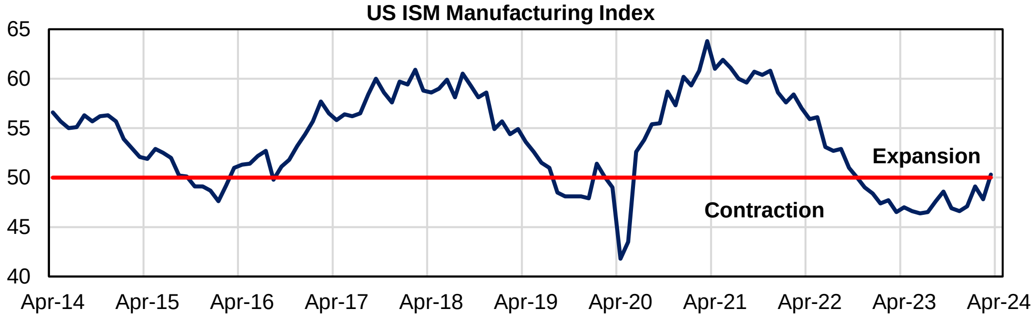
- The US Fed increasing interest rates further to counter the comeback of inflation.
- A recession/hard landing of the US economy driven by consumer-related weakness.
- A sharp rise in delinquencies of other real estate segments (e.g. office) having a spill over effects.
- Idiosyncratic issues with locations – policy changes during the year of US presidential elections.

Exhibit 1: US has significant potential to increase its e-Commerce penetration



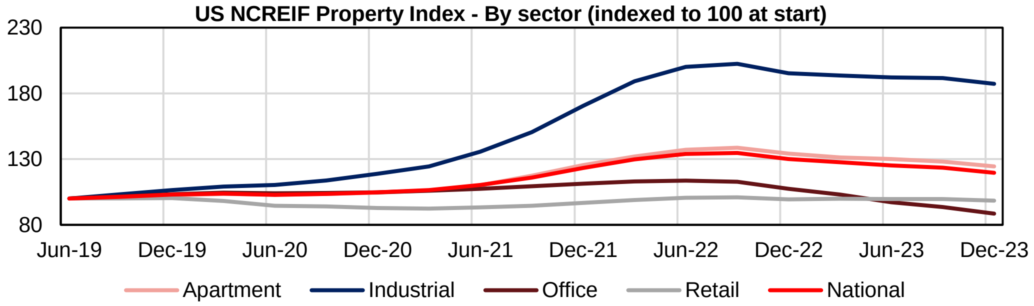
Source: Statista, and ADCB Asset Management

Exhibit 2: Manufacturing sector in the US is set to expand after experiencing contraction for several months



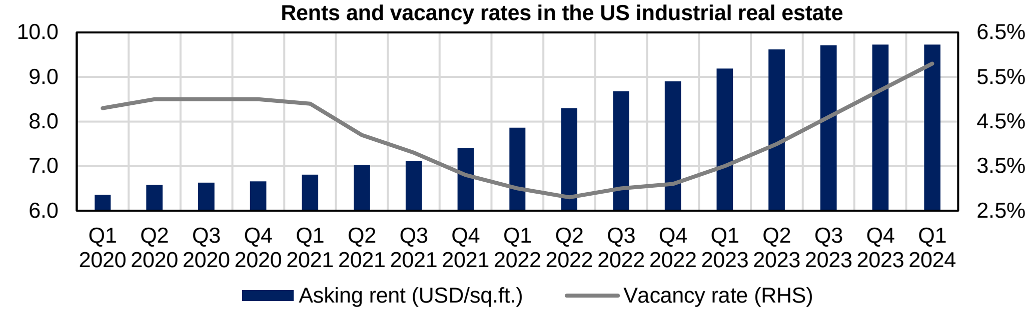
Source: ISM, LSEG Workspace, and ADCB Asset Management

Exhibit 3: Industrial real estate sector has outperformed the broader private equity real estate



Source: NCREIF, LSEG Workspace, and ADCB Asset Management

Exhibit 4: Despite the uptick in vacancy rates, asking rent has grown over the past several quarters



Source: Cushman & Wakefield Research, and ADCB Asset Management

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