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KEYNOTE INTERVIEW

US logistics adapts to changing market

The industrial asset class has felt the full force of volatility over the past year, but it is not doom and gloom for investors, says Jim Martell

US industrial real estate has been one of the big beneficiaries through the pandemic as e-commerce boomed and supply chain disruption heightened warehouse demand.

But, in early 2023, not everything is quite as rosy. Interest rates are on the rise, inflation is significantly above the Fed target, recession is a real possibility and geopolitical volatility is still broiling.

The key question is how long these headwinds will last and how much will they affect logistics this year and into next. Jim Martell, CEO at Logistics Property Company, expands on these themes and lays out how the changing economic backdrop is creating a new raft of opportunities for investors.

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Q How has the logistics market changed since March 2022?

There are a lot of factors, so let's start with capital markets. The capital markets are currently digesting the impact of higher interest rates, which is really the negative leverage component due to cap rates retreating but not as quickly as interest rates are rising.

Borrowing today will likely put your project in a negative leverage position, obviously reducing returns, as your yield on the debt is greater than the yield you are getting from your investment. Cap rates have increased anywhere from 75 to 150 basis points from their lows in 2021 and early 2022. Due to a lack of capital market transactions, it is tough to discover where pricing is.

It is difficult to figure out where capital is willing to go based on the lack of activity. Where are investors willing to strike a price? And how does negative leverage fit into that equation? Where will interest rates peak? The Fed seems to be firm in getting inflation under control with the only viable tool they have - raising rates takes liquidity out of the market, thus increasing the cost of capital.

Debt markets are in the same position as equity markets – there is a pull

back by lenders with available debt at a premium. Major lenders are not going very long as borrowers are not going long as well.

Q How has demand and rent growth been shaped in the last year?

2023 starts are expected to be half of that delivered in 2022.

These issues we have mentioned – lenders pulling back, equity on the side lines and material costs increasing – have been somewhat overshadowed by rent growth. Certainly, in 2021 we saw unprecedented rent growth across most markets and especially true in coastal markets. In some cases, almost 100 percent rent growth.

We are involved in a transaction in the Inland Empire which was underwritten at $0.47 but in 2022 leased at close to $1 per square foot. Underwriting to execution of the lease was about 18 months resulting in a very significant increase in the value of the project. The rent growth continues to cover up some of the impact of rising interest rates.

A good share of interest rate increases has been absorbed by this unprecedented rent growth. We continue to forecast strong rent growth across the US with the average growth in Q3 of 2022 around 4.6 percent, with average rent of almost $10 a square foot. That is a 12.8 percent increase from a year ago. As deliveries decrease, continued demand will force rents up.

Q How do you think those drivers will play out in 2023?

When you look at where equity is today, the investment thesis is contracting because no one is certain where interest rates are going or where cap rates will be. Investors also don't know exactly where they should strike as capital market transactions have slowed significantly.

Investors are very resistant to taking on negative leverage. If you underwrite today at a SOFR rate of 300 basis points equating to a 6 percent cost of debt, tomorrow your cost of debt could be 7 percent. Sellers are not that flexible nor are they willing to track the interest rate hikes which would result in a low purchase price. Conversely, you do not want to lock in for very long as the yield curve may come in over the next 12-18 months.

That said, rent growth is certainly going to slow down a bit. We are seeing supply-chain disruption improving with the big consumer product companies not continuing to build inventory in quite the same way. Material cost escalations also seem to be contained at this point. They have not come down a lot, but they are at least stabilizing.

Q Which markets and subsectors are you particularly bullish about?

It is really about understanding the inbound and outbound movement of goods – where are the goods coming from and where are they going on their path to the consumer. In the Midwest, that is driven primarily by Chicago as the largest inland port in the US.

Southern California has the largest seaport and Texas benefits from Mexican goods coming north. Then, you look at the southeast and northeast with that huge population base and seaports. If you think about those factors, you can really start to see where the long-term demand is going to be.

Then there are also the outliers. Arizona has become a huge market with tremendous growth. Absorption there is keeping pace with Southern California. Onshoring of manufacturing, the chip market and the California migration is causing exceptionally strong job growth. The tech workers are moving out of markets like California to work in a more tax-friendly environment.

Phoenix has become a darling because of these factors and is growing very rapidly. We have several projects there and we are very bullish about the long-term prospects of Arizona.

Historically, the industry underwrote a 3 percent annual growth into their models whereas we have seen 100 percent, 50 percent and 30 percent more recently. I think rent growth will move back to more normal levels which is better for us, as we can plan better.

The rent growth model we track is forecasting an average of 6 percent per annum over the next five years, with coastal markets having more growth than non-coastal markets.

Q How have you changed your acquisition underwriting strategy?

Currently, we are targeting a yield on cost of 7 percent. That may move a little bit if rates continue to go up, but we are in a flat or maybe slightly positive interest rate perspective at that level of return on cost. We are very focused on rent growth, making sure we are comfortable with our rent growth projections.

We now underwrite a 10 percent contingency on hard and soft costs and have added a 5 percent material price increase on an annual basis. We have been very aggressively conservative on our cost structure. We are starting to back off that a little bit; especially if we can get a guaranteed maximum price from our general contractors, we will bring our contingencies down a touch.

Land is typically the most volatile part of our project cost. Land costs shot up dramatically over the last 36 months when land costs used to be no more than 20 percent of the project cost. In recent examples, it ended up close to 50 percent.

We are starting to see land prices come down a bit which is helping to achieve our yield on cost target. If exit cap rates stabilize or fall a little bit, our underwriting is very conservative and we anticipate outperforming our expectations.

We are reviewing strategies in addition to our build-to-core vehicles and think value-add will have a place. We are seeing more value-add opportunities such as existing buildings that are obsolete but could be redeveloped. There are also projects facing refinancing challenges where we might be in a better position to manage. We have a significant amount of capital enabling us to step in.

"No one is certain where interest rates are going or where cap rates will be"

Q How do you expect the supply and demand dynamic to play out in 2023?

We anticipate continued demand for warehouses. Most of the publicly traded industrial REITs are experiencing significant rent growth, while slowing down a bit on spec development, pursuing more build-to-suits. There are a number of factors that we point to: natural population growth; employment; and obsolescence in the industrial sector. We are seeing a tremendous flight to quality.

Electric vehicles and trucks, material handling, robotics and so on require more power, more staging areas and throughput requirements. Obsolescence will continue to create demand for the class A space.

If you take Chicago as a good example, I would say we have roughly 1.5 billion square feet of industrial space. If you assume an average WALT of five years, that means there is 300 million square feet of industrial space turning over every year.

There is a tremendous amount of rollover going on across the US industrial supply, which gives us the opportunity to work with companies and demonstrate the value proposition of being in a new class A building. It is about demonstrating how much more efficient from an operating perspective you can be in a "state of the art" building which will meet your needs or demands for the future from material handling to robotics, electric vehicles, etc.

On the supply side, certain communities are legislating against industrial development. There has been an oversupply of industrial real estate in their markets, with too many trucks and noise, etc. Some communities are not willing to zone properties for industrial. We see that as a positive thing especially for existing portfolios as we will continue to see rent growth based on a lower supply.

Geopolitical issues will also be important for supply chains and will have an impact on demand. If it flattens out companies will be less likely to feel the need to build inventory, so there will be less demand. If geopolitical issues continue and become disruptive, then companies may want to continue to build inventory to avoid potential disruption disruption. ■