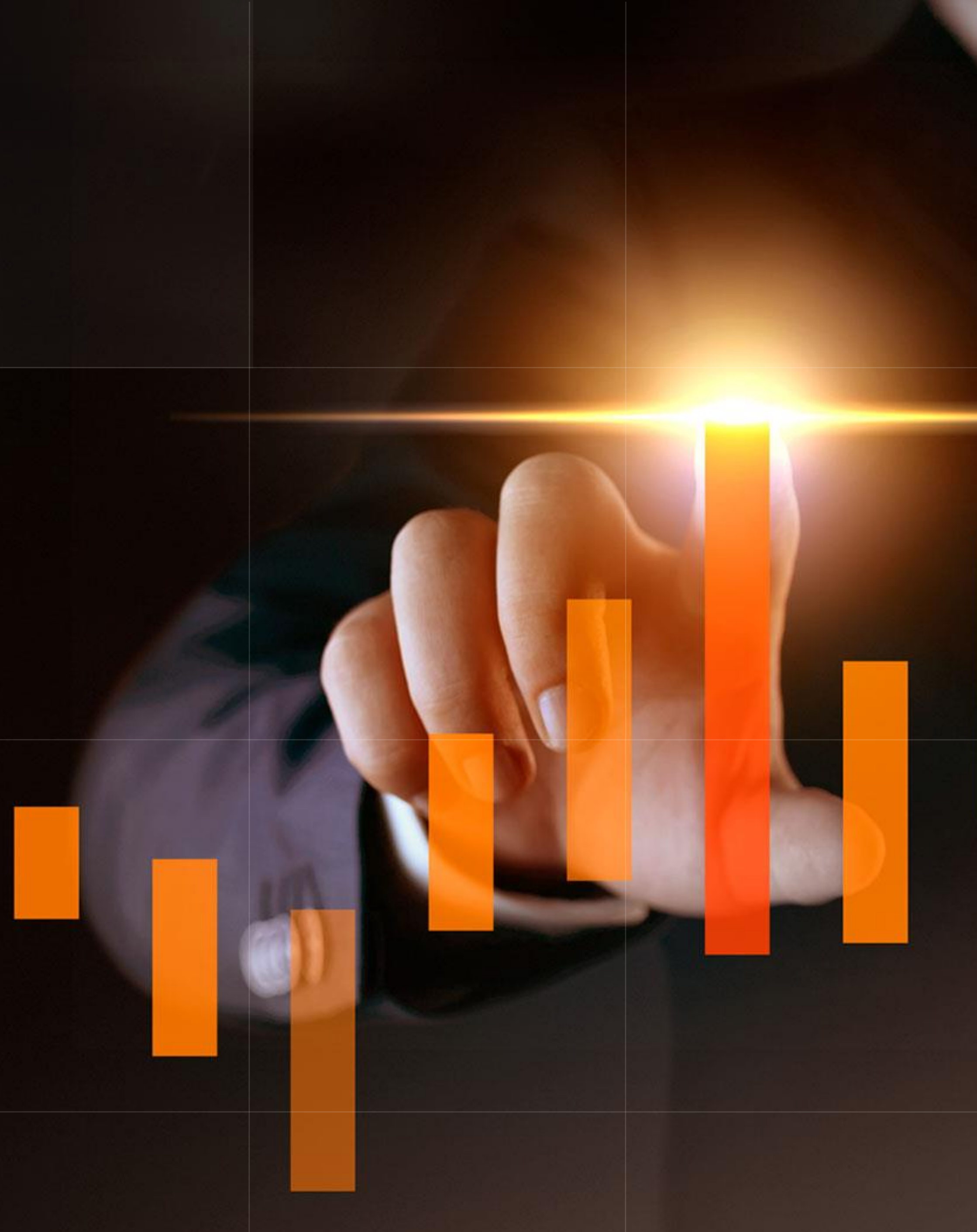
Industrial and logistics update - Part two

February 2023



Frontier Advisors

Authors

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Principal Consultant, Property Leader

Jennifer leads Frontier Advisors' real estate research program providing consulting and research for clients, both domestically and globally. Jennifer has significant global experience across the US, Australia and Asia. Previously, Jennifer was the Country Head and Director of Business Development with Savills Investment Management and Mercer's Head of Real Estate - Asia Pacific. Jennifer has worked with a number of Asian and European pension funds, insurers, universities and endowments. She is a frequent presenter at industry conferences.

Jennifer is a Senior Fellow of Finsia. She holds a Master of Finance and Bachelor of Business, Property (Distinction), RMIT.

Shrabastee Mallik
Senior Consultant

Shrabastee joined Frontier Advisors in July 2022 as a Senior Consultant. As part of the Real Assets Team, she has responsibility for undertaking manager and investment research with a focus on property. Prior to Frontier, Shrabastee worked at Dexus as a Senior Research Manager, specialising in the office and healthcare industries presenting to key internal and external stakeholders and contributing to key development and investment projects. Prior to this, Shrabastee led Savills' national research team. She began her career working at Charter Hall in Research.

Shrabastee has a Masters degree in Mathematical and Statistical Modelling from UTS and a Bachelor degree in Economics and Applied Finance from Macquarie University.

Chris Tran
Associate

Chris joined Frontier as an Associate in October 2021. As part of the Real Assets Team, he has responsibility for undertaking manager and investment research with a focus on property and infrastructure sectors.

Before joining Frontier, Chris worked for over four and half years in corporate finance with Pitcher Partners and ASIC, consulting on M&A and valuation engagements for his clients and stakeholders.

Chris holds a Bachelor of Commerce from The University of Melbourne and is a CFA Charterholder.

Summary

Strong fundamentals ahead for the industrial and logistics sector

Part one: Back to basics

December 2022

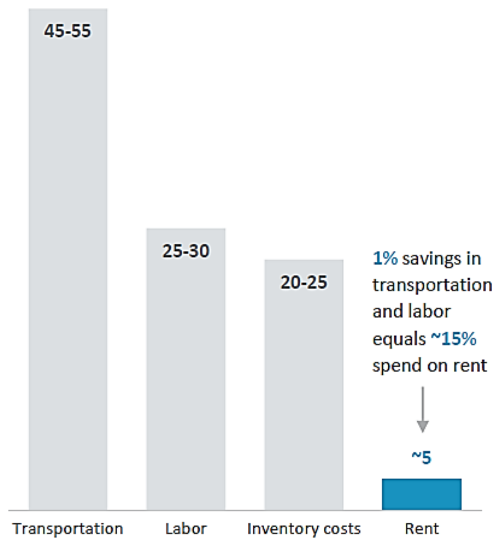
- We delved into property fundamentals and macro factors influencing various geographies.
- Explored key metrics that underpin supply and demand for the sector.

Part two: Looking through the froth

February 2023

- Rents are on the rise. Tenants' rent costs represent circa 5% of supply chain costs.
- A tenant can generally tolerate up to an additional 15% in rent for every 1% of transportation savings.

Chart 1: Distribution of supply-chain costs 2023



Source: Prologis

Key takeaway

There is some evidence of overheating and valuation write-downs in the industrial and logistics sector. Yet, we continue to see ongoing opportunities for investors underpinned by strong demand and rent growth over the next few years.

We prefer specialist and diversified strategies focused on prime locations, with enduring fundamental demand.

We believe the industrial and logistics sectors hold value, focusing on selective strategies, managers and markets.

The decision of where to locate facilities nearest to the end consumer drives rent affordability (commonly referred to as purchasing power).

US update

Looking back, looking forward

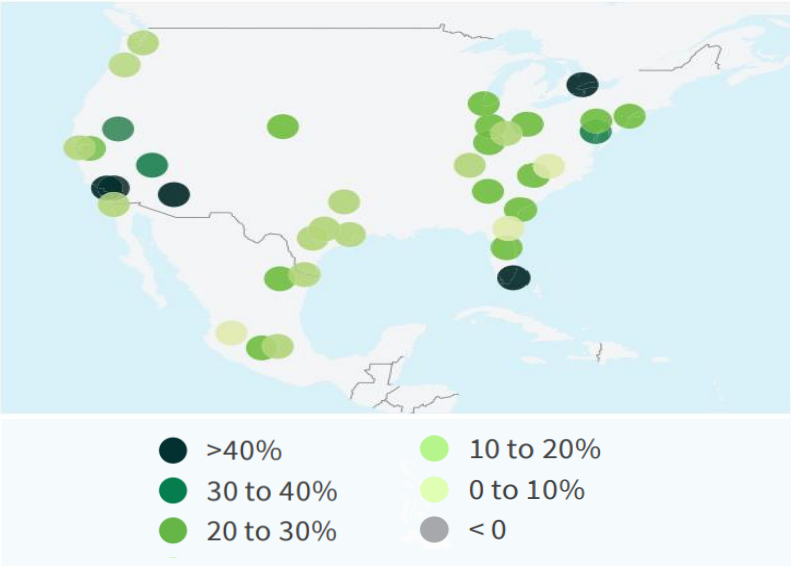
Performance to date

New supply was delivered at historically high levels, while net absorption concurrently increased by circa 27% over 2021.

Importantly, resolution of supply chain bottlenecks led to improved utilisation rates to meet consumer demand.

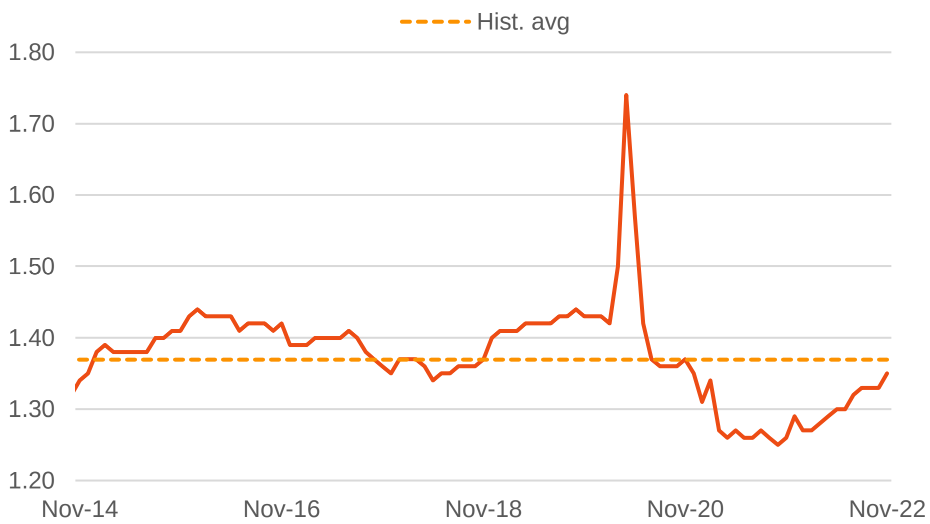
The average national vacancy rate was 3% (< 1% in the Inland Empire, California).

Chart 2: Rental growth (Prologis 2022)



Source: Prologis

Chart 3: Total business inventories-to-sales ratio



Source: US Census

US update

Looking back, looking forward

Future outlook

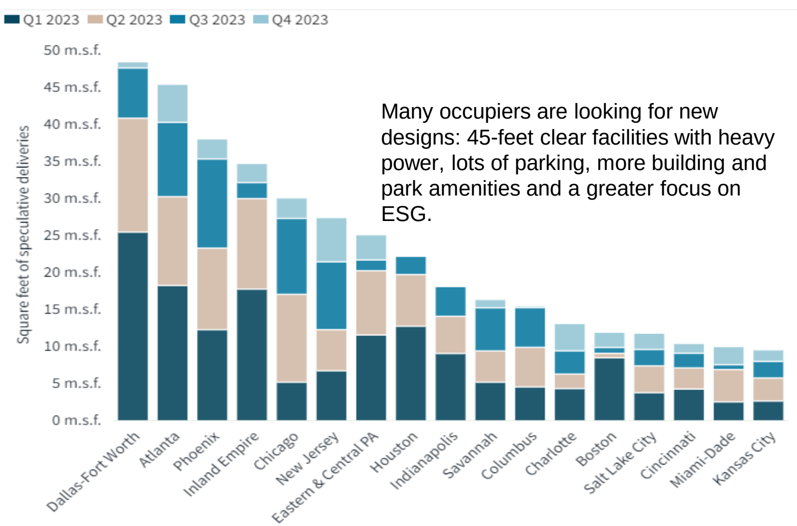
Real rent growth potentially at risk from rising occupancy costs. Prologis reports a large gap between in-place and market rents in most markets.

Near term regulatory constraints will lead to opportunities in newer markets, for example, a move from the Inland Empire, California to land-rich Texas (Chart 4).

True months of supply (TMS, as defined by Prologis), remain well below historic averages (Chart 5). We think this scenario will continue over the next few years before reaching equilibrium.

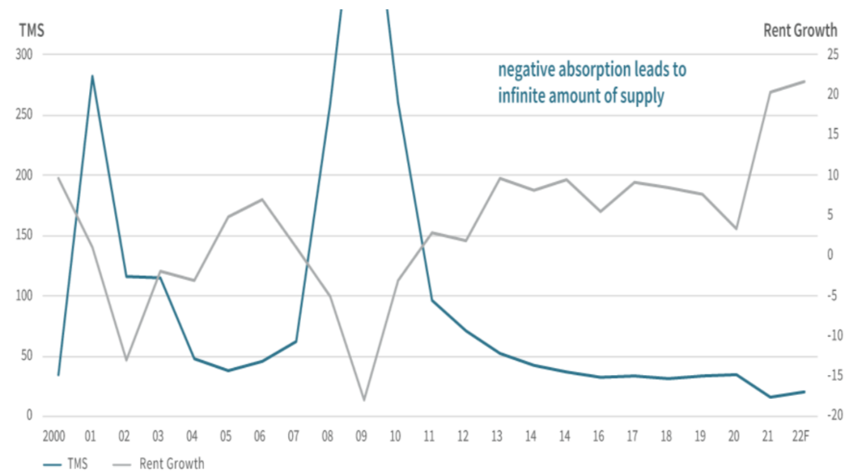
Positively, a recent CBRE survey found 81% of third-party logistics (3PLs) tenants plan to expand their footprint over the next three years and 75% of Food & Beverage and Building & Construction companies will do the same. Only 25% of manufacturers plan on expansion.

Chart 4: Speculative development 2023



Source: JLL Research

Chart 5: True months of supply - US



Source: Prologis

[1] TMS = $\frac{Existing\ stock + Unleased\ development\ pipeline}{Trailing\ 4\text{–}quarter\ net\ absorption} * 12\ months$

Europe/UK update

Looking back, looking forward

Performance to date

Rents grew at a record pace across Europe in 2022, circa 16%.

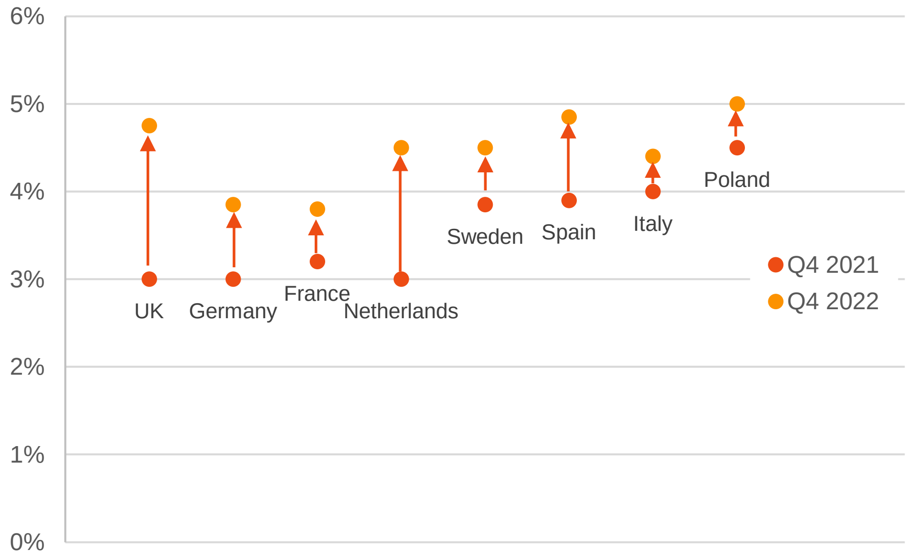
Vacancies were also at a record low level of 2.7% (Chart 7).

Importantly, resolution of supply chain bottlenecks led to improved utilisation rates to meet consumer demand.

Circa 70 basis points (bps) of cap rate expansion was attributed largely due to the rising cost of capital (Chart 6).

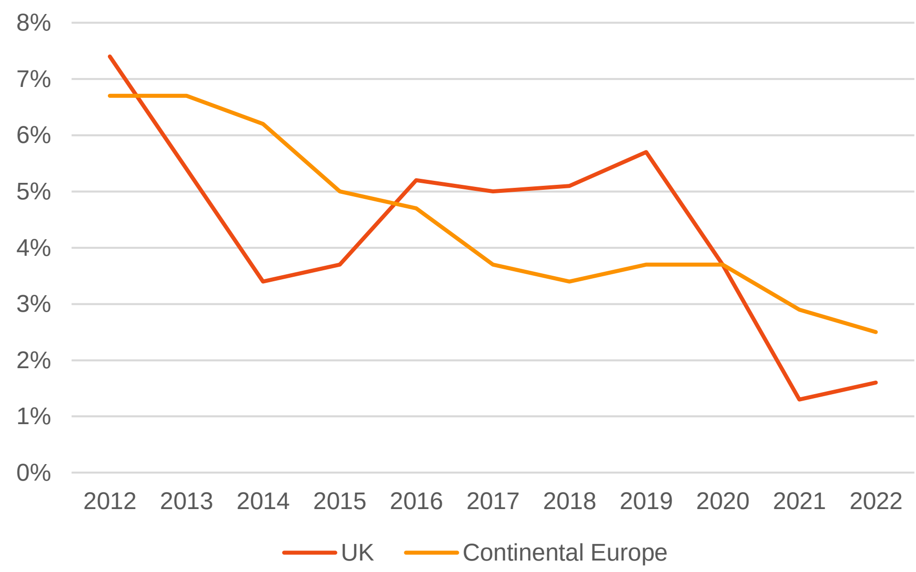
New development starts fell by circa 33% due to rising construction costs.

Chart 6: Net prime yields (%)



Source: Macquarie Asset Management

Chart 7: Vacancy rates (%)



Source: CBRE. Continental Europe includes: Belgium, Czech Republic, France, Germany, Italy, Netherlands, Poland, Slovakia and Spain

Europe/UK update

Looking back, looking forward

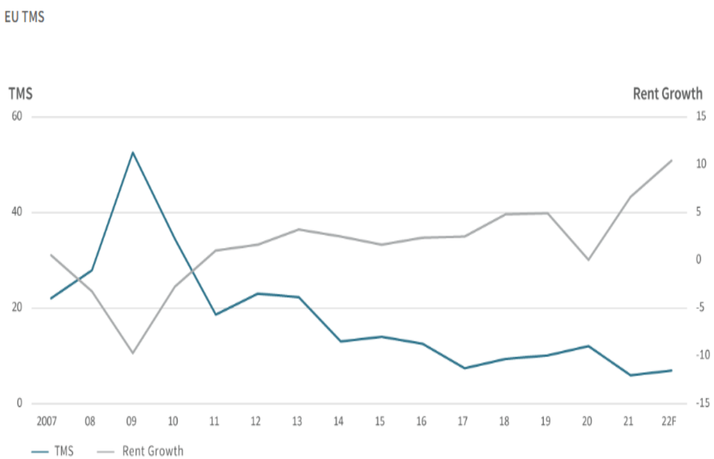
Future outlook

We think near term rent rises (as measured by Prologis TMS Chart 8) will persist, moderating to mid single-digit levels of net effective rents (Chart 9).

Build-to-suit activity is expected to increase in Europe, to meet demand for sustainable buildings. Cities with low-emission transportation zones will increase (60% of logistics markets as of 2022, up from less than 25% in 2015).

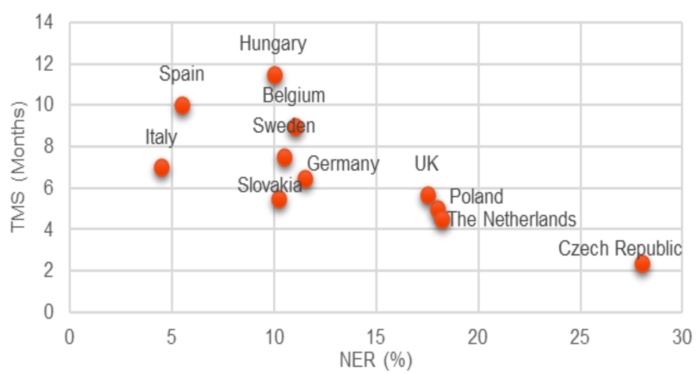
We expect 'near-shoring' to escalate across European land-rich hubs with some oversupply in marginal locations.

Chart 8: Correlation between supply and rent growth over time



Source: Prologis

Chart 9: TMS versus net effective rent growth in 2022, by country



Source: Prologis

> "Companies want to diversify risk, manufacture or source in more than one country and to limit complexity in transit times and freight costs. The closer your manufacturing or sourcing operations are to the end customer, you gain the benefits of lower freight costs and quicker transit times because you are not moving product as far."
>
> *Richard Thompson, International Supply Chain Director at JLL.*
>
> Source: JLL, Feb 7, 2023

Australia update

Looking back, looking forward

Performance to date

Gross take-up in 2022 exceeded 3 million square metres (sq m), surpassing the 10-year annual average, for the fourth straight year. E-commerce occupiers accounted for circa 46% of floorspace leased in 2022. The Transport, Postal and Warehousing sectors were the most active in 4Q2022, according to CBRE, accounting for 42% of gross take-up last quarter. This was followed by Manufacturing (25%) and Wholesale Trade (12%).

Completions for CY2022 totaled 1.7 million sq m (circa 6% above long-run average), primarily in Melbourne, followed by Sydney.

Sydney experienced the highest rent growth, globally. Record levels of leasing activity and limited supply continued to drive incentives lower and rents up to record high levels for a third consecutive year.

Secondary net face rents have experienced the highest rates of growth in Sydney, as the city's total vacancy rates fell to 0.2% in H2-22.

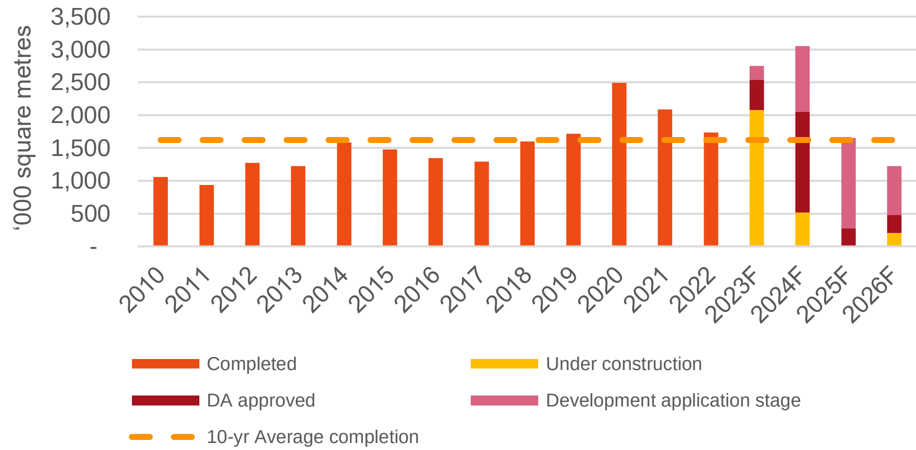
Future outlook

We expect softening in valuations in 2023, but this is yet to be reflected in valuations to date, largely due to strong rental growth and a lack of transactional evidence.

Pent up demand in Sydney, and to a large extent in Melbourne, should keep vacancy levels at record lows, offsetting short-term supply of new stock.

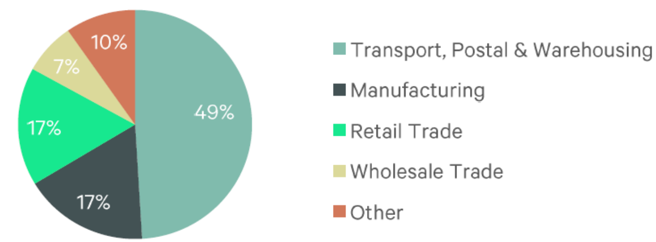
Chart 10: Australian logistics supply pipeline (historical and forecast)

(Total floorspace ('000 sqm)



Source: CBRE Australia National Logistics and Industrial Figures, Q4 2022

Chart 11: Take-up by industry sector

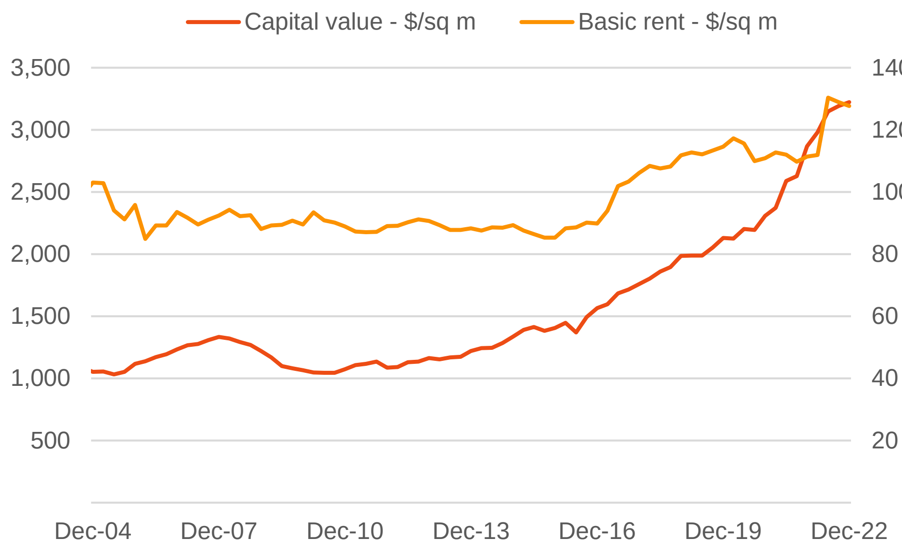


Source: CBRE

Australian industrial/logistics landscape

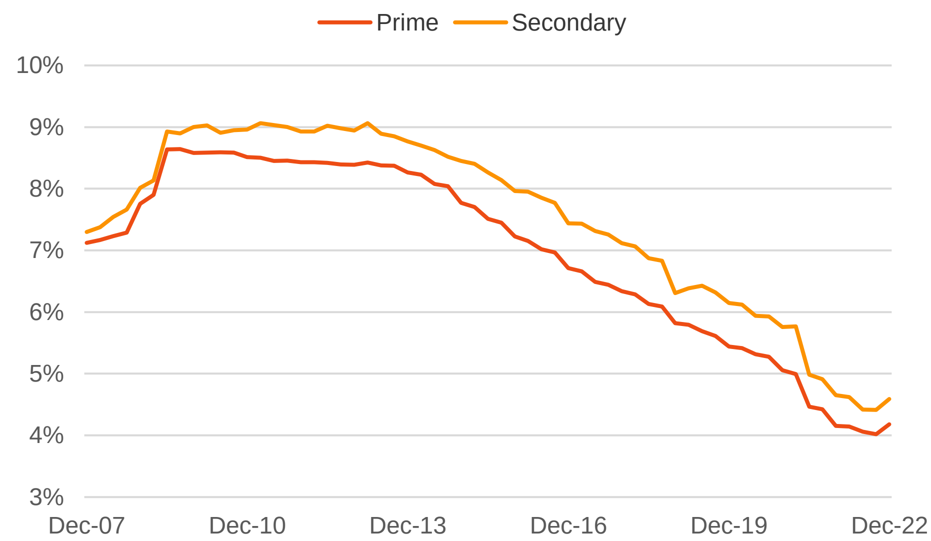
Expanding cap rates offset by strong rent growth

Chart 12: Capital values versus basic rent



Source: Frontier Advisors, MSCI

Chart 13: Industrial cap rates by grade



Source: Frontier Advisors, MSCI

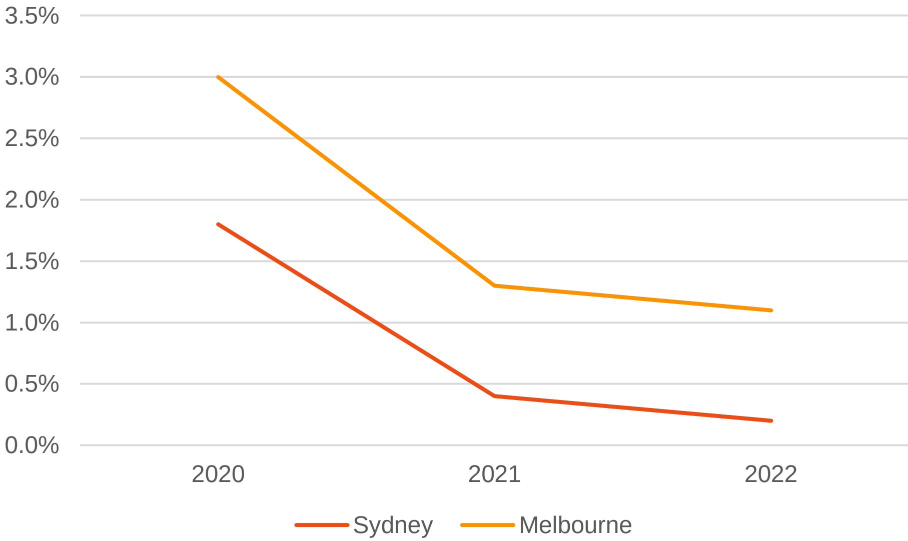
- Record levels of leasing activity and limited supply continue to drive incentives lower and rental growth to record high levels for a third consecutive year.
- Secondary net face rents have experienced the highest rates of growth in Sydney, as the city's total vacancy rates fell to 0.2% in H2-22.
- While pricing is expected to soften further in 2023, strong rental growth will help to offset capital depreciation.

- Rising debt costs disproportionately affect smaller, non-institutional investors, leading to moderating demand for lower-quality, smaller industrial assets.
- The gap between prime and secondary cap rates is starting to widen, indicating more discerning investors.
- Cap rate expansion was evident across all states in the Dec-22 quarter, with the exception of WA and SA.

Australian industrial/logistics landscape

Low vacancies continue into 2023

Chart 14: Vacancy rate (%)



Source: CBRE

Chart 15: Supply-weighted average net face rents and incentives by city

Source: CBRE

- Industrial vacancy rates in Australia were the lowest globally, with Sydney and Perth recording near 0% vacancy across most sub-markets.
- Pre-lease leasing activity is likely to remain strong in 2023, with much of the announced developments largely pre-committed. This is likely to keep vacancy rates at or near record lows.

- Super-prime rents continued to soar in 2022, particularly in Sydney, buoyed by demand for new, automated facilities by 3PLs and wholesale suppliers.
- Rental growth is likely to moderate in 2023, as new demand from logistics operators starts to slow.

The final word

Expect moderate correction in some markets but opportunities remain for strong performance

Strong fundamentals

- Rental growth peaked at 30% globally over last 12 months. We expect this to moderate to high single digits over the next two years.
- Absorption of new space in most infill markets is strong with evidence of demand for newer, greener space.
- Market share can only be controlled by being close to the end consumer. Competition is strong for newer, greener facilities.
- Limited competing vacant land (except in Nevada and Texas).

Potential headwinds

- Regulatory barriers. Prologis expects a drop in European development from 28% to 19% even as demand accelerates.
  - France, Italy, the Netherlands and Germany are all contemplating containment of unwieldy expansion via restrictive planning controls.
  - In the US, California, Oregon and New York are enacting moratoriums.
  - The Inland Empire in California is under critical scrutiny by residents and environmental groups calling for the Governor to declare the region's warehouse sprawl a public health emergency. Warehouses there total 1.5 billion square feet of land. An additional 170 million square feet of warehouses are planned or under construction[1]. Anecdotally, Texas is expected to benefit from this shift.
- Rising occupancy cost (rent)
  - Transportation and labour costs are less within an occupier's control.

Potential tailwinds

- Location, location, location. Insatiable demand for:
  - Great locations near end customer serviced by great transportation and seaport links.
  - Non-specialised buildings with sticky tenants who pay for capex (triple net leases in some geographies).
- Specialist and diversified strategies focused on prime locations, with enduring demand due to locational attributes.
- Near-shoring. Rapid development of new (and cheaper) markets such as Mexico and Poland as alternatives to future supply chain disruption during COVID-19 in China.

[1] Los Angeles Times

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