ASB Real Estate Investments | COVID-19 Commentary

Bloomington Logistics Center / Gateway - Los Angeles, CA

One of a series of reports from ASB on the impacts of the global pandemic on real estate investing and markets.

Industrial Sector Outlook

Overview. Industrial real estate—particularly distribution and logistics facilities related to e-commerce supply chains—has benefitted from the pandemic. Tenant demand should be further strengthened as consumers rely more on e-commerce and supply chains move to retool to protect against current and future inventory supply disruptions. New industrial demand is expected to total approximately 400 to 750 million square feet over the next two to three years, resulting from 140 to 185 million square feet generated by e-commerce demand growth and 285 to 570 million square feet from post-COVID supply chain retooling.

Consumers Adapt. COVID-19-related business closures and stay-at-home orders increased online shopping by more than 30% from March through mid-April[1] with many consumers adopting the practice for the first time. In addition, several low e-commerce adoption categories, including food and beverage and home improvement, are experiencing surging online sales volume. Strong growth in these categories could have lasting impacts on demand for warehousing, distribution, and cold storage space as consumers become accustomed to this new convenience and expect faster deliveries. E-commerce's market share alone is expected to increase demand for industrial space by 140 to 185 million square feet over the next two to three years[2], particularly for distribution facilities and last-mile warehouse. Notably, industrial space e-commerce requirements are typically three times greater than for traditional brick-and-mortar operations. Faster delivery expectations also have resulted in an expanded footprint of last mile distribution properties in locations closer to end consumers. Studies suggest that higher rents for these infill facilities is more than offset by tenant savings in transportation expenses, suggesting sustainable future demand for this industrial segment[3].

Supply Chains Retool. COVID-19 disruptions have also highlighted the fragility of supply chains, shifting attention towards new models focused on resiliency and prioritizing just-in-case over just-in-time inventory controls. Higher just-in-case inventories of 5% to 10% would generate 285 million to 570 million square feet in new incremental industrial demand[2]. COVID-related disruptions also have accelerated moves to diversify manufacturing to near-shore or on-shore locations and away from China. Nearly two-thirds of North American manufacturers say they are bringing production and sourcing back home[4],intensifying domestic industrial demand. Near-shoring could benefit U.S. states bordering Mexico, while on-shoring could increase industrial space demand around existing manufacturing hubs in states such as Pennsylvania, Texas, and Wisconsin.

Risk Assessment. Overall, industrial investments appear to have maintained their value better than other real estate asset classes since the start of the pandemic, but outcomes vary among different subcategories driven by expectations around income durability. Highly functional, super-regional distribution and fulfillment facilities are lower risk since they are positioned in the e-commerce supply chain with strong credit tenants focusing on nondiscretionary, essential consumer goods. Last mile warehouses in vibrant population centers serving e-commerce deliveries are also well insulated. But facilities are at greater risk if they serve smaller tenants with weaker-credit, focusing on non-essential goods and services. These higher-risk assets have reported up to 20-40% in rent-relief requests during the pandemic. Particularly vulnerable is warehouse and distribution space leased to struggling retailers, which may not survive the competitive e-commerce landscape. Reduced retailer footprints could add shadow supply softening fundamentals and undermining rent growth.

Recent leasing activity has been driven largely by major e-commerce and logistics companies, which accounted for 52% of the 100 largest warehouse leases in 2019[5]. These familiar users included Amazon, Geodis, Home Depot, and WalMart. Potential consolidation of e-commerce and logistics companies could pose a longer-term threat to institutional landlords if they leverage their scale to integrate vertically and own their facilities.

New logistics space construction has slowed—given recent disruptions and trade cutbacks—but remains near peak annual supply levels, with approximately 200 million square feet delivering in 2020 followed by an expected 175 million in 2021[6]. Given the healthy demand trends for new construction, this space is expected to be readily absorbed.

Summary: Industrial fundamentals will not fully escape negative COVID-19 impacts. Declines in GDP, industrial production, trade, and consumer spending will act to dampen short-term demand. High risk tenants include: bricks-and-mortar retailers, manufacturers, smaller service businesses, and companies in struggling industries like oil and gas, automobiles, transportation, entertainment, travel, and gaming. But long-term drivers—expanding space requirements and new distribution patterns—will increase demand and spur development. Industrial investments appear better protected against value erosion, particularly high-quality assets that serve high-credit, e-commerce tenants distributing essential products. Overall, industrial properties should outperform other property sectors, retaining income-generating capacity as the pandemic takes its uncertain course.

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[1] Rakuten Intelligence. Note: Measures from the beginning of March through mid-April compared with the same period last year.
[2] Prologis. (2020). Supply Chain Shifts Poised to Generate Substantial New Demand.
[3] Prologis. (2018). Supply Chain and Logistics Real Estate: Unlocking Supply Chain Value.
[4] Thomasnet.com
[5] CBRE. Dealmakers: E-Commerce & Logistics Firms Drive Demand for Large Warehouses in 2019.
[6] CoStar.

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