Industrial and logistics update
Part one - back to basics

December 2022

frontier

Authors

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Jennifer Johnstone-Kaiser leads Frontier's 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 is a Senior Fellow of Finsia. She holds a Master of Finance and Bachelor of Business, Property (Distinction).

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Senior Consultant

Shrabastee joined Frontier 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 for three years as a Senior Research Manager, specialising in the office and healthcare industries and involved in presenting to key internal and external stakeholders and actively 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.

Summary

Taking the temperature of the industrial and logistics sector

Frontier believes that the industrial and logistics sectors hold value, focusing on selective strategies, managers and markets.

In this two-part report, we attempt to unpick key signals and what they mean for clients.

Part one: Back to basics

December 2022

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

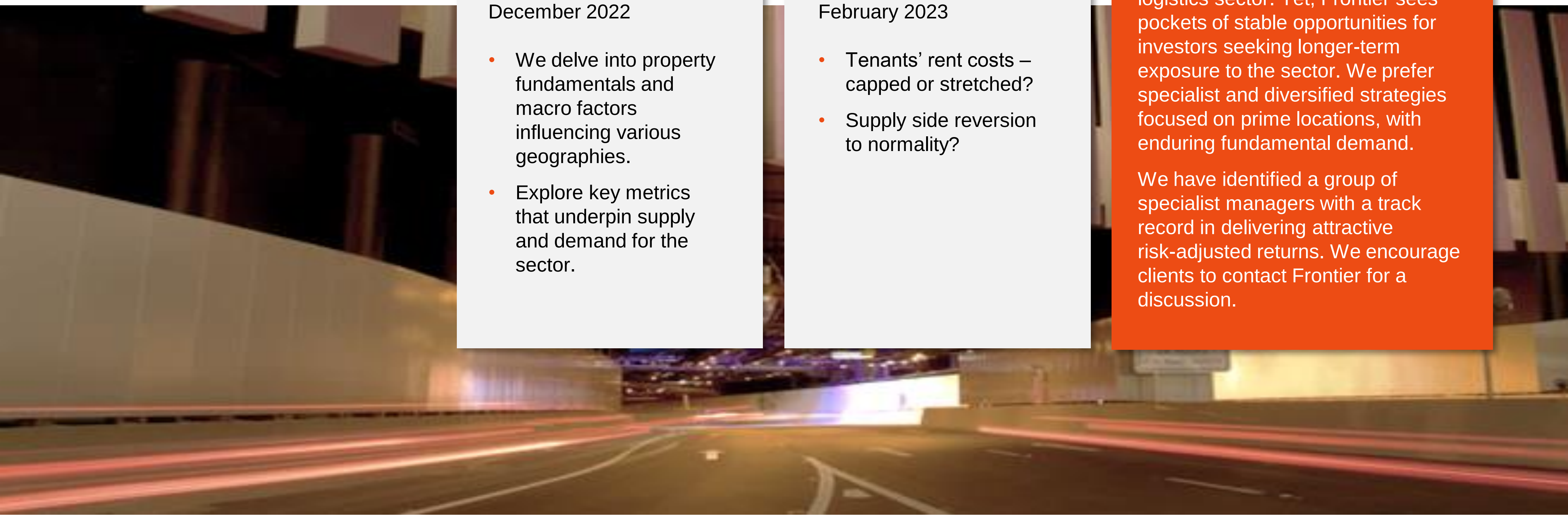
Part two: Looking through the froth

February 2023

- Tenants' rent costs – capped or stretched?
- Supply side reversion to normality?

There is some evidence of overheating and valuation write-downs in the industrial and logistics sector. Yet, Frontier sees pockets of stable opportunities for investors seeking longer-term exposure to the sector. We prefer specialist and diversified strategies focused on prime locations, with enduring fundamental demand.

We have identified a group of specialist managers with a track record in delivering attractive risk-adjusted returns. We encourage clients to contact Frontier for a discussion.



Overview

The industrial and logistics landscape in key global markets

Factor	Comments	Medium-term outlook
Economic backdrop	• 2023 recession highly likely - though length & breadth is unknown and will vary considerably by region:	
	- Global growth in 2022 has been revised downwards by around USD1.6t, with the largest downgrade occurring in Europe.	
	- Growth forecasts in 2023 for Europe and the UK have been revised down most sharply (-230 bps), followed by North America (-160 bps).	
	- Growth forecasts for Asia Pacific are little changed, down just -30bps from the view at the start of the year.	
	• Elevated periods of higher interest rates to prove an impediment to capital market performance.	
	• Elevated inflation and higher interest rates to slow discretionary spending considerably:	
	- In the Asia Pacific region, rising inflation is not far from uniform across the region, remaining more benign than elsewhere.	
	• Ecommerce moderating from COVID highs – but room to grow in regions such as Australia, Central and Eastern Europe and India.	
	• Supply chain issues and costs to normalise in 2023:	
	- The Freightos Global Index is currently 10-15% higher than pre-COVID levels, compared to 75-100% higher a year prior.	
	- Labour shortages to moderate as global migration starts to return to pre-COVID levels over 2023-2024.	
Demand/ Supply	• Ecommerce companies have been the greatest occupiers of industrial space due to higher rates of online shopping over 2020-2022.	
	- Industrial demand driven by ecommerce operators and third-party logistics (3PLs) to moderate as consumer spending slows.	
	• Actual supply below expected supply in 2022 due to supply chain issues and labour shortages.	
	• Supply to remain constrained over the next 12-18 months as markets normalise, though more pronounced in certain regions:	
	- In Australia, historic low vacancy rates to be a strong tailwind for the market – particularly in infill locations.	
	- Some Asia Pacific markets are at greater risk of over-supply, given higher vacancy rates than other regions.	
	• Moderating online shopping rates to reduce take-up. This is already evident in leasing activity in some markets.	
	• Supply at historic highs in the US – especially for bulk warehouses. Pre-commitment levels for larger warehouses are moderating.	

Overview

The industrial and logistics landscape in key global markets

Factor	Comments	Medium-term outlook
Income	• Strong occupier demand and record low vacancies drove double digit rental growth across nearly all industrial markets globally in 2021-2022.	
	• Industrial leases may be challenged by longer leases, limiting the ability of some landlords to capitalise on higher market rents.	
	• Constricted supply to keep rental growth strong for 12-18 months – particularly in Australian and Sun Belt and Coastal American markets.	
	• Medium-term supply to strengthen, curbing rental growth.	
Capital markets	• Industrial yields started to expand in Q3-2022, with forecasts of further increases as spread to bond rates remains low.	
	• Higher cost of capital leads to subdued transaction volumes as buyer and seller expectations widen further.	
	• Secondary assets in secondary locations at greater risk of significant re-pricing.	
	• Industrial pricing at greater risk of re-pricing in markets with record low premiums to bond rates.	
	• Smaller institutional investors face higher barriers due to rising cost of capital.	
Opportunity	• Re-pricing of secondary assets in infill locations offer opportunity to refurbish and lease at higher market rents.	

Future direction of the sector

Looking for signals

Industrial property has far exceeded expectations over the past five years. What trends could predict a reversal of fortunes for the industrial sector? We keep abreast of these main indicators to identify emerging patterns and which managers are best placed to take advantage of these factors.

Demand drivers

Population growth

The strongest demand driver for industrial space is population growth.

- According to agencies, every extra person drives demand of 2-4 square metres of industrial warehouse space.
- Population growth forecasts point to base future demand for industrial space.

Ecommerce penetration

In recent years, ecommerce retailers, logistics companies and third-party logistics services (3PLs) have driven much of the demand for industrial space.

- What are the forecasts for online retail? Is there a ceiling?
- What segments of retail are forecast to expand and in what regions?

GDP growth

Understanding of which industries within an economy drive industrial demand and the quantum of this demand.

- e.g. future growth in food storage and manufacturing is a reliable indicator of the amount of extra industrial space required in specific locations.

Reverse logistics

Online retailers are becoming more efficient and creative at addressing return of goods.

- Negative environmental impact of inefficient reverse logistics.
- How much industrial space is dedicated to ‘reverse logistics’?
- What are the requirements for space and location by market?

Yield premium to risk-free rate

Investor demand is affected by the yield premium to long-term bonds. Rising bond yields have pushed industrial yield premiums to their lowest levels in over 15 years.

- Rising 10-year bond rates negatively impact sentiment and cap rates.
- Investor and occupier risk tolerance impact investment appetite. The absence of demand leads to expanding cap rate movements.

Household savings

Record high levels of household savings have held up the retail sector.

- Net disposable income drives the amount of money consumers have to spend on discretionary retail, which in turn drives industrial demand.
- Exogenous events, rising interest rates and inflation impact disposable income and can reduce demand for logistics space.

Future direction of the sector

Looking for signals

Supply drivers

Vacancy rates

Above average demand and lower-than-expected supply have resulted in industrial vacancy rates being at or near historic lows, globally.

- The level of vacancy also drives time to lease available space post construction.
- As length to lease up increases so does vacancy rates.

Future supply

Given shorter development times (6-9 months), it is harder to track industrial supply past 1-2 years.

- What are the major development projects in the short-term?
- Land releases is a good proxy for where (and how much) industrial stock could become available over the medium-to-long-term.

Infrastructure projects

Industrial precincts are often planned around key infrastructure hubs, to allow efficient access to major arterial roads.

- Tracking government plans for infrastructure projects allow us to look at where industrial supply is more likely to be developed.

Land values

Recently, land values have skyrocketed. Particularly in strategic infill locations. Higher land values constrict development and also drive up rent.

- In which precincts will land values continue to grow and by how much?

Demographic drivers

Precincts with strong demographics will outperform over the long-term:

- Population growth and household formation.
- Number of dependents.
- Median net disposable household incomes.

Global supply chain pressures

Global supply chain pressures (and shipping container costs and traffic) impact building costs, delivery and timeliness of goods, materials.

- The start/stop nature of disruptions may create temporary dislocations and direct opportunities or costs for building owners and operators.
- There are a number of indices, developed by leaders in logistics such as Prologis, to track and predict these global challenges.

Most important metrics – Australia

Indicators we track

Vacancy rates

In Australia, industrial vacancy rates are at or near historic lows globally, due to above average demand in conjunction with lower-than-expected supply. Record low vacancies have driven above average rental growth. Vacancy rates will have to increase significantly more than their current levels before there is any significant pressure on rent. This is especially true in inner-city locations close to key population hubs.

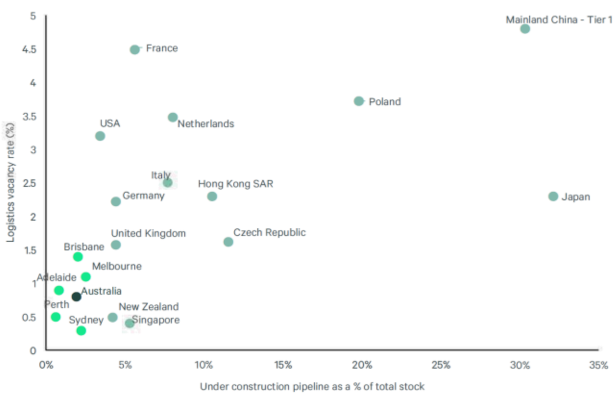
Future supply

The supply outlook in Australia remains benign, with the supply response insufficient across all major markets. In almost all industrial markets in Australia, with low logistics vacancy rates, the amount under construction (relative to total stock) is less than 2% (Chart 1). The supply outlook in the short-to-medium term is supportive of ongoing outperformance of the sector. However, over the long-term, land release schedules may create excess supply.

Online spending

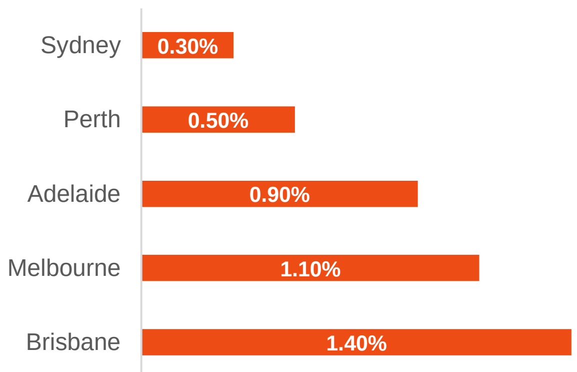
Ecommerce retailers and logistics companies and 3PLs have been responsible for much of the demand for industrial space over the past two years. Online spend as a proportion of total retail trade peaked at 15.3% in September 2021, before easing to 10.5% in September 2022. Much of this growth has been driven by demand for discretionary goods (Chart 3). The growth of ecommerce has increased demand for distribution centres and warehouses. However, consumer demand is already starting to moderate amid rising cost of living pressures and an impending recession. This will have an impact on ecommerce retailers and 3PLs and their ability and willingness to take up more (or even maintain) the industrial space they occupy.

Chart 1: Vacancy rates versus supply under construction



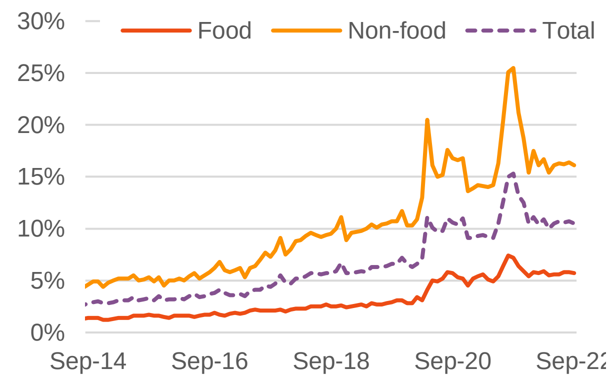
Source: CBRE

Chart 2: Industrial vacancy rates by market (Sep-22)



Source: Staista

Chart 3: Online spend as a % of total retail spend



Source: ABS

Most important metrics – US

Indicators we track

Bulk industrial space (>100,000 square feet) occupier activity

Over the past two years, demand for bulk industrial space has been driven by 3PLs and packaging companies. In the September quarter, 2022, of all bulk space transacted, 3PLs increased their market share to 30.2%, from 29.7% a year before. Additionally, the sector has driven much of the pre-commitment activity on new developments. These businesses derive their demand directly from retailers and wholesalers. In a recessionary environment, consumers tend to moderate spending on discretionary goods, which will have a direct impact on retailers and wholesalers. There is already evidence in the US of retailers contracting their operations, which will have a flow-on impact on their demand for 3PL services. The ecommerce industry has started to reduce its demand for industrial space (demand for bulk industrial space fell 20.6% in the 12-months to the September quarter, 2022).

Industrial supply (per capita and true months of supply)

The US has the highest rates of logistics space per capita globally – more than ten times higher than in Europe (though rates differ by markets – highlighting the importance of location selection). While demand for industrial space has been at historically high levels, supply too is now at historic highs. Over the past two years, pre-commitment rates on new developments have been high, but this is starting to moderate. What is likely to insulate US industrial markets is true months of supply (TMS), as defined by Prologis, which remain well below historic averages. However, TMS tends to increase rapidly during recessionary periods (Chart 4), and this will be a key risk to real rent growth.

Inventory-to-sales ratio

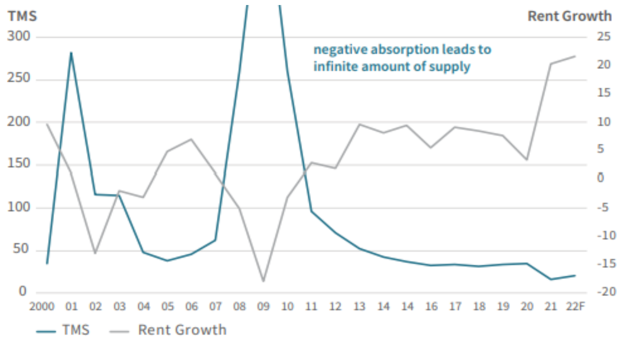
Wholesale and retail inventories have grown at a record pace, driving demand for warehouse space nationally. Inventory-to-sales ratios are now sitting at 1.33, up 11.5% from the year before. As global supply chain pressures ease considerably, there is evidence more companies are moving away from the just-in-case inventory method back to pre-COVID-19 norms of just-in-time. This will likely reduce demand for industrial warehouse space, though the extent of this remains to be seen.

Table 1: Top occupiers (YTD 2022)

Occupier	Industry	Space occupied (sqf)
Amazon	Ecommerce	43,729,945
Walmart	General retail	9,814,587
Home Depot	General retail	6,567,182
Tesla	Manufacturing	5,664,141
FedEx	3PLs & packaging	4,759,769
NFI Industries	3PLs & packaging	4,027,741
GXO Logistics	3PLs & packaging	3,445,422
Lowe's	General retail	3,358,931
ULINE	3PLs & packaging	3,323,441

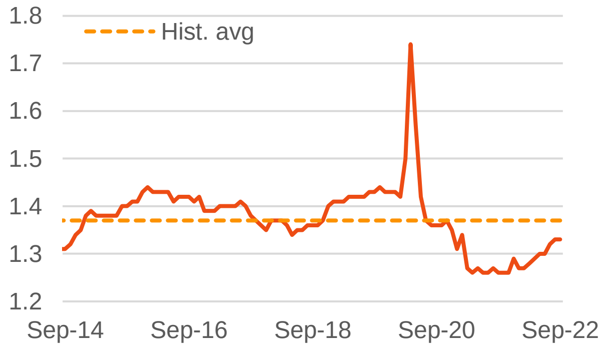
Source: Colliers

Chart 4: True Months of Supply - US



Source: Prologis

Chart 5: Total business inventories-to-sales ratio



Source: US Census

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

Most important metrics – Europe/UK

Indicators we track

GDP and consumption growth

A region's expected GDP – and the consumption ultimately fuelled by it – is a good proxy for demand for logistics space. With recession in Europe highly likely in 2023, rising inflation, higher energy costs and weaker household spending are dampening the outlook for goods-spending growth. A recession is likely to be more pronounced in Central and Eastern Europe (CEE) and these are also the markets that have had the highest rates of development activity.

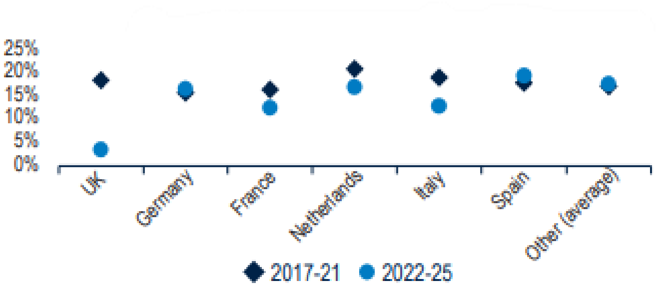
Investor demand and capital values

Capital values have started to soften in Europe as rising risk-free rates bring industrial yield premiums to historic lows. While tailwinds for industrial real estate remain strong, central bank responses in the EU and UK have been the most pronounced, with the 10-year government bond increasing 10-fold over a year. With industrial yields at record low rates, we are already seeing valuations being re-priced as investors readjust their expectations amid rising risk-free rates. The extent of the correction in industrial capital values remains to be seen.

Ecommerce penetration and adoption by region and sub-sector

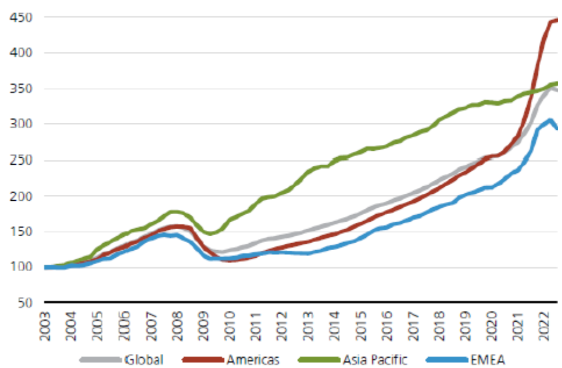
Even with household spending growth moderating, online penetration rates across continental Europe will rise above the current low base. Further expansion of space requirements will be fuelled by ecommerce operators and 3PLs as they seek to establish distribution space closer to urban centres and in proximity to big-box distribution corridors. In contrast, growth in the UK is set to ease back as online penetration starts to level off. Leasing evidence suggests that ecommerce retailers and 3PLs prefer prime quality, creating bifurcation in performance across prime and secondary assets, highlighting the importance of asset selection.

Chart 6: Growth in ecommerce related demand (% p.a.)



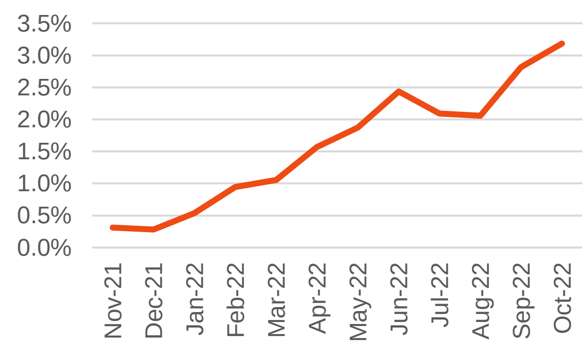
Source: Prologis

Chart 7: Industrial capital value index



Source: Resolution Capital

Chart 8: 10yr ECB* government bond yield



Source: CEIC data; *ECB = European Central Bank

Most important metrics – Asia Pacific

Indicators we track

Supply and vacancy

Industrial markets in the Asia Pacific region (except for Australia, India and Vietnam) have had higher vacancy rates than in other regions. Moreover, construction activity has been healthy through the pandemic. As expansionary demand starts to weaken, and a generous amount of incoming supply continues, vacancies in the region will likely increase.

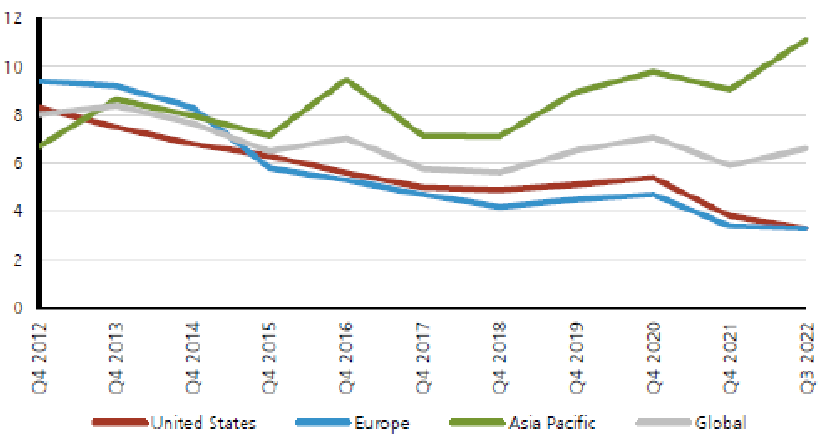
Weakening economic outlook

The economic outlook has weakened further for 2023, with interest rates rising faster than expected to combat persistently high inflation. In this environment, businesses are becoming increasingly cost-conscious. The 'just-in-case' approach is likely be abandoned by many businesses which seek to minimise capital expenditures (especially as supply chains continue to normalise). The pace of private consumption is anticipated to lose steam but remain resilient in 2023 (Chart 10), with consumers willing to spend less due to concerns about inflation.

China

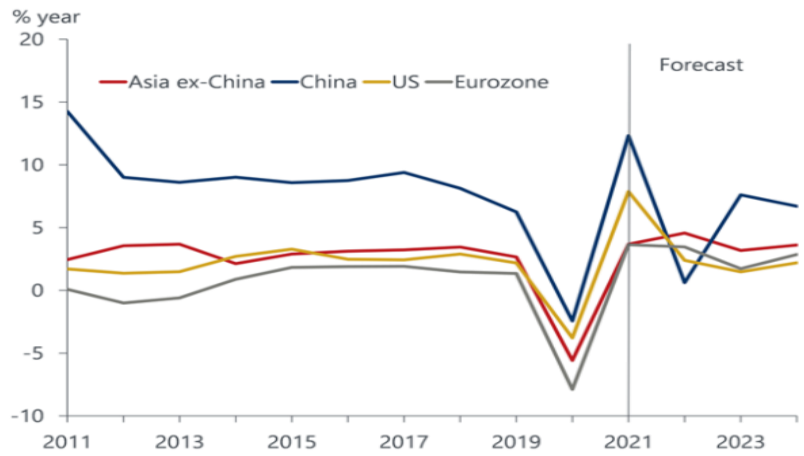
Much of the recovery in the logistics sector depends on China's ability to dominate as a trade powerhouse and maintain continuous activity in its factories and ports on top of stringent COVID-19 policies. To avoid further complications in supply chains, businesses are continuing to leverage on the 'China Plus One' strategy and diversify production into other markets.

Chart 9: Industrial vacancy rates by region



Source: Resolution Capital

Chart 10: Private consumption growth by region



Source: Knight Frank

The final word

Looking ahead - red, amber or green?

Part one: in summary

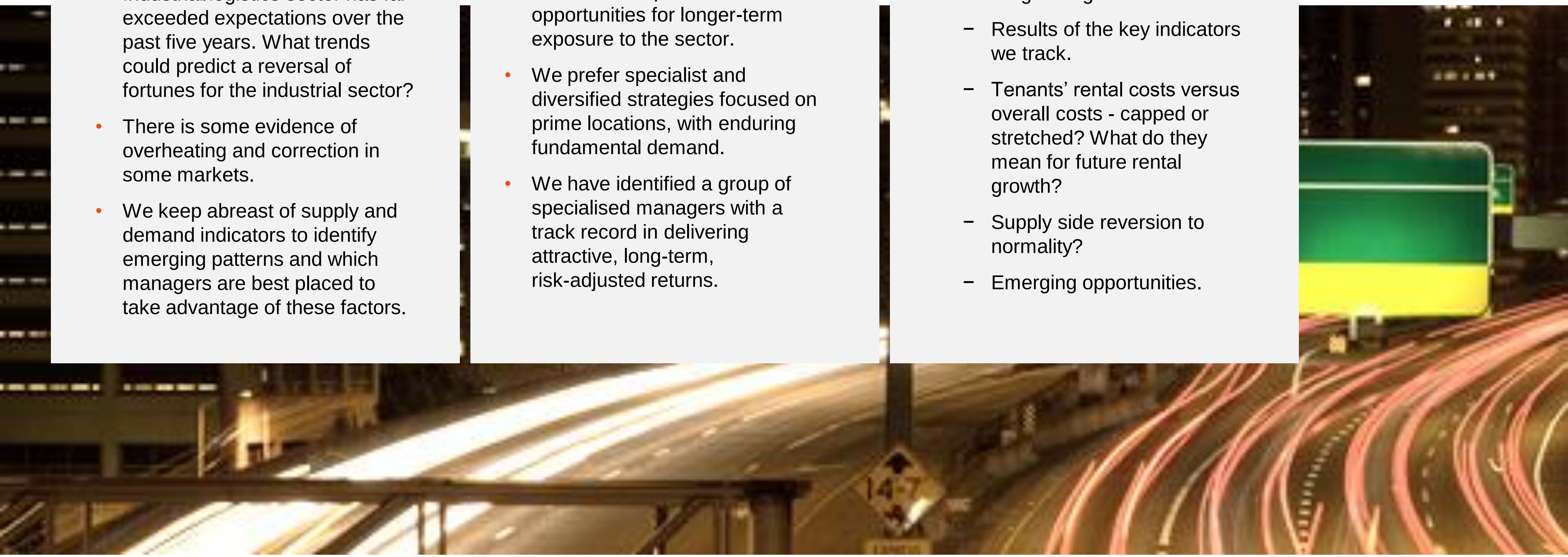
- Industrial/logistics sector has far exceeded expectations over the past five years. What trends could predict a reversal of fortunes for the industrial sector?
- There is some evidence of overheating and correction in some markets.
- We keep abreast of supply and demand indicators to identify emerging patterns and which managers are best placed to take advantage of these factors.

Message for clients

- Frontier sees pockets of stable opportunities for longer-term exposure to the sector.
- We prefer specialist and diversified strategies focused on prime locations, with enduring fundamental demand.
- We have identified a group of specialised managers with a track record in delivering attractive, long-term, risk-adjusted returns.

Part two: Release date Q3 FY2023

- Looking through the froth.
  - Results of the key indicators we track.
  - Tenants’ rental costs versus overall costs - capped or stretched? What do they mean for future rental growth?
  - Supply side reversion to normality?
  - Emerging opportunities.



Property and infrastructure transaction lists

September quarter, 2022

Authors

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 infrastructure and property 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 CFA Charterholder.

Jack Westcombe-Casey
Associate

Jack joined as an Associate in October 2022. Forming part of the Real Assets Team, he is responsible for undertaking manager and investment research in property, infrastructure and private equity.

Before Jack joined Frontier, he worked as an investment analyst at Mai Capital in private equity real estate with exposure in both funds management and property development. Jack also brings experience working at PwC in Financial Services covering institutional asset managers and superannuation clients. Jack holds a Bachelor of Commerce (Finance / Accounting) from the University of Melbourne and is currently studying towards his CFA.

Recent Australian property transactions

Key transactions – September quarter, 2022

Asset	Location	Grade/type	AUD ($m)	Yield	Buyer	Seller
Major transactions ($50m+)						
50% of Southern Cross Towers precinct	Melbourne	Office (Premium)	1,000	4.5%	Charter Hall Prime Office Fund (CPOF)	Blackstone & Brookfield
50% stake in 555 Collins St development	Melbourne	Office (A Grade)	400	4.3%	GIC	Charter Hall Prime Office Fund (CPOF)
205 North Quay, Brisbane (development)	Brisbane	Office (A Grade)	330	n.a.	Cbus Super	MJ Nielson
Allendale Square	Perth	Office (A Grade)	223	6.3%	CNI & MA Financial	Mirvac Group
50 Miller St, North Sydney	Sydney	Office (B Grade)	150	5.5%	Sun Venture	Sumner Capital
Portfolio of five Melbourne industrial properties	Melbourne	Industrial	107	4.5%	ESR Australia Logistics	Undisclosed
50% stake in 15 manufacturing plants	Australia	Industrial	208	n.a.	Goodman Group	Brickworks (BCW)
26.7-hectare parcel at Eastern Creek, Sydney	Sydney	Industrial	180	n.a.	Logos	Sargents Charity
Caneland Central Shopping Centre, QLD	Mackay	Retail (Large Format)	300	7.9%	Sentinel Property Group	Lendlease managed fund
Homeworld Helensvale, QLD	Gold Coast	Retail (Large Format)	265	n.a.	Undisclosed	Les Ansley family
Dandenong Plaza	Dandenong	Retail (Large Format)	145	10%	Pelligra Group	Unlisted MA Financial fund

Source: CBRE, Colliers, Knight Frank, press releases

Notable infrastructure transactions

Key transactions – September quarter, 2022

Region	Transaction	Sector	Vendors	Equity providers	AUD ($m)	EV/EBITDA	Description
Australasia	TPG Telecom Tower (1,239 tower assets)	Telecommunications	TPG Telecom	OMERS Infrastructure (Borealis Infrastructure) (100%)	950	32.1x	TPG is Australia's second largest internet service provider and is the largest mobile virtual network operator. It operates a network of 5,800 mobile sites on rooftops and towers. TPG owns the passive infrastructure on c1,200 of these mobile sites, 90% of which are in metropolitan areas.
	Transpacific New Zealand Waste	Waste	Beijing Capital Group	First Sentier Investors (100%)	1,696	9.3x	Transpacific is a Brisbane-based recycling, waste management and industrial services company.
	Uniti Group	Fibre Optic	Uniti Group	The Morrison & Co Infrastructure Partnership (30%), Brookfield Infrastructure Fund IV (BIF IV) (50%), Commonwealth Superannuation Corporation (20%)	3,620	27.6x	Uniti has a range of telecommunications' services, including building called 'last mile' fibre connecting the government owned National Broadband Network to homes, telco services to small businesses and it also resells broadband to individuals and businesses.

Source: Inframation

Notable infrastructure transactions

Key transactions – September quarter, 2022

Region	Transaction	Sector	Vendors	Equity providers	AUD ($m)	EV/EBITDA	Description
Europe	Albioma Take-Private	Renewables	Albioma	KKR Diversified Core Infrastructure Fund (DCIF)	2,406	11.6x	Albioma focuses on biomass and solar PV investments, operating in France (including its overseas territories) as well as Mauritius and Brazil.
	Lyntia Network	Telecommunications	Antin Infrastructure Partners III	Macquarie Asset Management, AXA Investment Managers (IM) Real Assets, The Morrison & Co Infrastructure Partnership	n/a	20.8x	Lyntia Networks includes the company's dark and enterprise fibre and operates a 43,643km fibre network across Spain.
	Refresco Majority Stake	Other	British Columbia Investment Management Corporation (BCI), PAI Partners	KKR Global Infrastructure Investors IV	5,064	5.8x	Refresco is the largest independent bottler. They are a leading contract packer, drinks producers and have created popular branded and private label juices, juice drinks, carbonated soft drinks, mineral waters as well as ready-to-drink alcohol and freezables.

Source: Inframation

Notable infrastructure transactions

Key transactions – September quarter, 2022

Region	Transaction	Sector	Vendors	Equity providers	AUD ($m)	EV/EBITDA	Description
North America	American Campus Communities (ACC)	Social Infrastructure	American Campus Communities	Blackstone Real Estate Income Trust (BREIT), Blackstone Group	18,732	30.4x	ACC owns 166 properties in 71 leading university markets. Most notably, Arizona State University, The University of Texas (Austin), Florida State University and the University of California Berkeley.
	Companhia de Concessoes Rodoviarias (CCR) (14.8% stake)	Transport	Andrade Gutierrez Concessões	Banco Itau (10.33%), Votorantim (4.53%)	1,180	11.6x	CCR is one of the largest infrastructure and mobility concession companies in Latin America and was the first company to join B3's Novo Mercado. This is the second attempt of this sale process. CCR in November 2021 had announced that private equity firm IG4 Capital Investimentos would not conclude the acquisition of Andrade Gutierrez's stake.
	Hawaii Gas (2022) (Formerly MIC Portfolio)	Transport	Macquarie Infrastructure Corporation (MIC)	Argo Infrastructure Partners	745	12.9x	Macquarie Infrastructure Corp planned to sell bulk liquid terminals' business International-Matex Tank Terminals LLC (IMTT); fuel, terminal, aircraft hangaring and airport service provider Atlantic Aviation FBO Holdings LLC; and gas distributor Hawaii Gas. IMTT was sold separately to Riverstone Holdings in November 2020. MIC put up Altantic Aviation for auction in March 2021.

Source: Inframation

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