



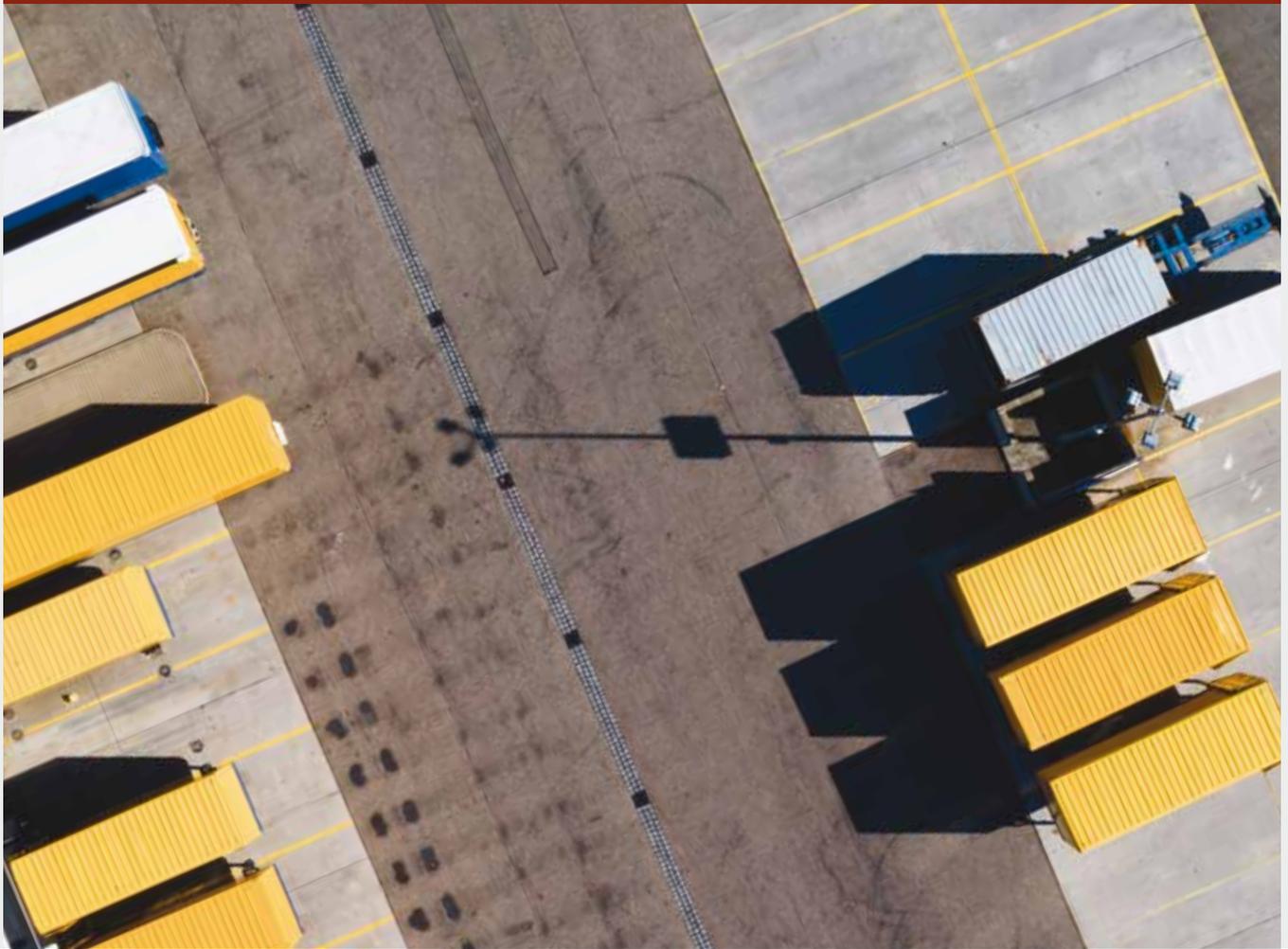
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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

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**INVESTING IN LOGISTICS & DISTRIBUTION**  
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# The investment case for US high flow-through logistics

Realterm's director of research, [Nathan Kane](#), explains the cyclical performance of general industrial and high flow-through, and why the latter could offer better return prospects

Commercial property values in the US have rebounded dramatically since reaching bottom in the wake of the global financial crisis (GFC). These gains are the result of a business climate improved by technological advances and lower taxes, and a post-quantitative easing shift to alternative assets. During this time, industrial properties have outperformed other property types, with values doubling since their post-recession low. Investors have gained confidence in the financial outlook for these properties in part because of their belief that e-commerce and general consumer demand for more rapid, cheaper delivery will drive demand for more industrial space. High flow-through (HFT) properties, logistics facilities critical to this mission, have been a primary beneficiary of these trends. Value increases of HFT properties have been similar to the broader industrial sector during this cycle.

As the current real estate cycle matures, investors may question the extent to which gains made during it are sustainable. In the last three recessions, real estate values declined by an average of 18 percent, according to NCRIF data. A review of previous investment cycles and the factors underlying their performance in a downturn helps to answer the following questions:

1. How has the industrial sector performed through previous real estate cycles?
2. What have been the drivers of superior industrial returns relative to other major real estate asset classes post-GFC to the present?
3. What conclusions can we draw for future HFT outperformance relative to other real estate asset classes, including the general industrial sector?

Realterm believes that the property performance characteristics



**In demand:** HFT properties like Realterm's cross-docked transload facility in Northlake, Illinois, are attractive prospects for investors

of the HFT sector provide an opportunity for higher risk-adjusted returns in the coming years, even as value growth across the broader commercial real estate universe, including the general industrial sector, may pause or start to reverse.

## Industrial sector performance from 1980 to 2007

Prior to 1994, industrial real estate demand was largely determined by domestic production and consumption patterns. Between 1980 and 1994, rent growth averaged around 1.5 percent per year, according to Costar, and deviated little from this average. HFT properties built before 1994 were primarily concentrated near major highway interchanges and in mature industrial real estate submarkets because of their proximity to other facilities with which they interacted and because of the lower cost to build in these areas. Often, they were small infill warehouse properties, and an excess of these properties led investors to attach little value to them.

During the 1994 to 2007 cycle, the success of the free trade movement, mainly through the North Atlantic Free Trade Association (NAFTA) and the World Trade Organization (WTO), led to a transformation in the performance of the industrial real estate sector. Trade globalization led to significant economies of scale requiring larger distribution centers from which to supply stores. This period experienced a boom in the development of new 'big box' general warehouse properties despite the generally commoditized nature of this type of space for tenants. In this cycle, Costar data shows net absorption averaged 1.9 percent of inventory annually and rents grew by close to 2 percent per year. However, this growth was more volatile because of the relative ease of adding new supply in the face of stronger demand. Much of this growth was lost in the wake of the GFC.

With the shift of distribution centers (DCs) to locations

**“Industrial returns are likely to be much lower in coming years. In contrast, HFT properties, especially those in infill locations, are likely to maintain their value”**

**Nathan Kane**

farther from stores, HFT facilities became an increasingly important component of the supply chain, serving as critical transfer points in the pipeline through which freight stored in the DCs was ultimately delivered to the end user. These newer HFT properties were much more efficiently designed than earlier constructed properties. Due to zoning restrictions and higher development returns for larger warehouse properties, they did not experience the supply response observed in the broader industrial sector. This helped to preserve the value gains made prior to the GFC.

### Post-GFC industrial sector performance

The GFC led to a crash in industrial demand that persisted for more than a year. This event provides a stark demarcation between two separate phases in industrial demand. Pre-GFC growth was based largely on trade globalization and generating efficiency for transnational freight movement of imported goods. Post-GFC, e-commerce has been the leading driver of industrial demand growth and has been responsible for the diverging performance between the industrial and retail property sectors. Between mid-2008 and mid-2018, the industrial sector experienced annual NOI growth of 3.3 percent. In contrast, retail NOI growth averaged 1.8 percent over this time.

Post-GFC to the present, industrial returns have outperformed the broader NCREIF Property Index (NPI) because of the property type's superior NOI growth. Occupier demand has been driven largely by the need for warehouse space to accommodate the expansion of e-commerce. Supply growth during this period has also been strong, catching up with demand in 2018. The national industrial vacancy rate, as measured by CoStar has fallen below 5 percent, the lowest level since tracking began. In turn, market rents have increased by 36 percent since they hit bottom in 2011. Rents in 2018 are almost 10 percent above their level a year ago.

Between mid-2008 and mid-2018, industrial properties experienced an average annual pace of capital appreciation of 1.5 percent, and a 2 percent annual increase in values when the value of capex is added. Over that same period, values of HFT properties increased at a much faster rate. The annualized appreciation return for HFT properties across Realterm's portfolio over that time was 6.2 percent.

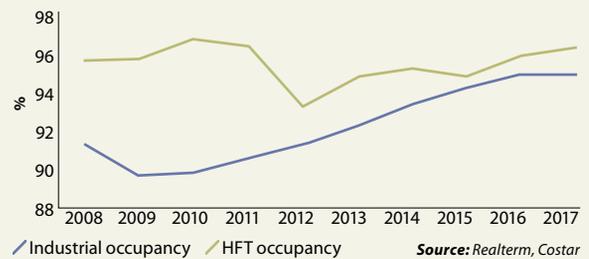
HFT occupancy and rents did not fall nearly to the same degree post-GFC as did industrial occupancy and rents, and therefore HFT NOI did not



**Kane:** supply constraints of the HFT sector will intensify the use of these properties

### Occupancy rising

HFT rates are consistently higher than general industrial, providing a stable income stream



benefit as much from the recovery in those factors. In contrast to lease renewal rates for most properties that range from 50-70 percent, HFT lease renewal rates are consistently much higher at around 90 percent. Because of historical constraints on new HFT supply, tenants rarely replace their HFT facilities unless they have been outgrown because there are often limited alternatives. Additionally, when properties are vacated, they typically require a shorter downtime before they are re-let. These factors lead HFT properties to have a higher occupancy rate than other core property types throughout an economic cycle, and a more stable income stream.

### Outlook

After an unprecedented run-up in values, US commercial property returns are starting to weaken. The NPI total return in 2017 was 7.2 percent, compared to a 20-year historical average of 9.2 percent. High prices paid in recent years have left little room for value increases, as they assume a pace of rent growth that is likely not sustainable, given historical trends.

Nearly doubling in value since reaching the cyclical bottom in 2010, industrial real estate values in this cycle have been supported by strong NOI growth and heightened investor demand. However, little has changed to alter the traditional heavy supply response in the general industrial sector that has eroded rent gains during previous market cycles. Industrial returns are likely to be much lower in coming years. In contrast, HFT properties, especially those in infill locations, are likely to maintain their value. The same structural economic factors generating increasing industrial demand are generating demand for HFT properties, especially near consumer population centers. However, unlike general industrial, supply constraints of the HFT sector will intensify the use of these properties as more goods flow through each HFT property. This increased utility to users will provide upward rent pressure supporting continued value growth for HFT properties even as increases weaken in the rest of the industrial sector. □

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Realterm is a global real estate operator with an over 25-year track record of executing niche investment strategies at the intersection of the global supply chain and evolving consumption trends. Realterm currently invests through three market-leading operating platforms capitalized through a series of closed-end and open-end commingled funds.



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