PERE

Logistics

February 2022 • perenews.com

Supply change

How logistics is racing to meet demand

KEYNOTE INTERVIEW

Soaring rents underline industrial's appeal

Heightened tenant demand and limited supply mean the sector's golden age is far from over, say Ares Management Corporation's Bill Benjamin and Dave Fazekas

In July 2021, alternative investment manager Ares Management Corporation closed on the acquisition of Black Creek Group's US real estate investment advisory and distribution business, which had approximately $13.7 billion of assets under management. Head of real estate Bill Benjamin says that the acquisition was complementary to Ares's existing opportunistic, value-add and debt real estate strategies in Europe and the US: "Black Creek's focus was on core and core-plus strategies, with mostly perpetual capital, including two non-traded REITs and various institutional fund vehicles."

Benjamin, and Ares CIO of industrial, Dave Fazekas, weigh the relative merits of the US and European logistics markets, and conclude that industrial will remain a "high-conviction bet" for investors on both sides of the Atlantic.

SPONSOR
ARES MANAGEMENT CORPORATION

Q What supply-demand dynamics are driving industrial real estate markets?

Bill Benjamin: The fundamentals of industrial real estate in Europe and the US are impressive. Demand in the sector is driven by GDP growth and the economies of both regions are expanding. Consumer spending is picking up, with higher e-commerce and e-grocery penetration driving a retail sales recovery. All of that boosts demand for industrial space, while supply cannot keep up because of planning and zoning constraints in markets with a high barrier to entry, coupled with rising construction costs.

Dave Fazekas: In the US, industrial vacancy stands at 3.5 percent nationally, the lowest level we have ever seen. Meanwhile, each of the first three quarters of 2021 saw record net absorption of industrial space. The level of demand has been incredible. On the supply side, obtaining entitlements to build remains difficult. Covid-19 has led to delays in the supply of construction materials, and over the last 18 months

we have seen the cost of materials increase. A new development used to take eight or nine months to complete, but that period has become substantially longer. This dynamic, combined with the heightened tenant demand we are seeing across markets, puts landlords in a very strong position to capture rental growth.

Q How do the European and US industrial markets measure up?

BB: Historically, economic growth has been higher in the US than in Europe. On the whole, the US is viewed as more tech-savvy and taxation levels are lower, so there is more private sector activity. And it is a very big market with a growing population, where the economic tailwinds are very strong.

In Europe, economic growth is generally around 1 percent lower than in the US. On the other hand, Europe has less existing industrial space per capita. In major markets such as the UK, Germany, Netherlands, France and southern Spain, occupancy also stands at around 96 percent, and research indicates that when the level is greater than 92 percent, the historical result is rental growth. While that growth is not at the double-digit level seen in the US, it is enough to constitute a strong buy signal for investors in almost every European market. The exception is Central and Eastern Europe – in Poland, Hungary and Romania, land is more plentiful and barriers to entry are lower, so supply and demand are roughly in balance.

DF: The coastal markets of the US are characterized by high population density and infill with proximity to ports. Those markets were always very supply-constrained, but sustained GDP growth, together with increased demand from e-commerce, which has been further accelerated by the pandemic, has driven vacancy down to less than 1 percent in some locations. In Southern California and New Jersey, for example, we have seen astounding rental growth relative to other locales.

Tenants have very few options, so occupiers are renewing their leases, while at the same time being subject to increased rents. We are also seeing rents increase in high-population growth markets, such as South Florida, Phoenix and Las Vegas, to name a few, where net migration and population growth is creating more demand for goods. For tenants, rent is still a comparatively small component of overall operational costs, at less than 10 percent. This is far less than they are spending on transport and labor, which have seen meaningful increases, so they should continue to be able to absorb increases in their property costs.

US market: Case study

High-barrier-to-entry speculative buildings preleased during construction

In 2020, at the onset of the covid-19 pandemic, Ares purchased 107 acres of land for the speculative development of two industrial facilities totaling 1.3 million square feet. "Both buildings were preleased prior to completion, which we believe demonstrates the intensity of demand in certain high-barrier-to-entry areas, particularly in top distribution markets in the US that provide access to top metropolitan statistical areas," says Fazekas.

"As long as rental growth continues at the pace we are seeing now, there will still be strong capital demand for industrial real estate. While cap rates are compressed, the mark to market on rents due to rent growth has continued to grow as well"

DAVE FAZEKAS

Q How are geopolitical and macroeconomic trends influencing the market?

BB: The combination of Brexit and the pandemic has made transporting goods from continental Europe to the UK substantially more difficult. As a result, businesses have had to reconfigure their supply chains and stock higher levels of inventory. Storing goods is expensive, and in the 1980s that prompted a powerful drive to establish 'just-in-time' arrangements.

However, that trend is being supplanted by 'just in case.' Firms do not want to be caught out, unable to meet their customers' needs, which is driving demand in the UK. A combination of geopolitical tension and the pandemic has also impacted certainty of supply from the Far East, so there will be more emphasis on economic and business autonomy across Western markets, which will generate further demand for space.

DF: The trends are similar in the US. Retailers are reconfiguring their supply chains to deliver omnichannel solutions in addition to brick-and-mortar retail. We are seeing inventories swell because they are under pressure to deliver goods to their customers and retail locations in a timely manner. We are also starting to see a bit more onshoring and

nearshoring here, although that is at an early stage. So far, that is happening mainly in pharmaceutical manufacturing. But we are also starting to see other critical manufacturing operations, such as microchip production, return to the US.

Q How are investors securing opportunities in this highly competitive market?

BB: In Europe, we're seeing creative investors do programmatic joint ventures and forward funding developers' pipelines. The developer secures the land, planning permission and a guaranteed maximum price construction contract, with or without some level of preleasing. Together with the banks, the investor will forward fund projects to build up large-scale portfolios. In these situations, certainty of capital is a higher priority than cost of capital for the developer. Having a partner that can provide funds quickly helps them to secure deals.

Meanwhile, construction prices are high, so certainty of cost is important for an investor. That can be controlled to some extent by forward buying materials. And while material costs are going up, because industrial buildings are single-story boxes, it is possible to quantify those increases accurately or to put in enough contingency. For high-rise construction with lots of services and expensive finishes, there is a much greater risk of being impacted by rising prices. We also believe that if a seller knows that they can approach a potential purchaser and get a swift yes or no answer in a wholly or partially off-market deal, then that is a powerful calling card and potentially favors buyers that do a majority of deals off-market.

DF: In the US, investors that are vertically integrated on the development side not only have greater visibility over factors such as construction cost increases and potential delays to building schedules, but are also likely able to obtain desirable basis point spreads relative to current core cap rates with projects that lease prior to completion because tenants have so few options. It is hard to predict that cap rates will continue to compress, but we also thought that in 2015. As long as rental growth continues at the pace we are seeing now, there will still be strong capital demand for industrial real estate. While cap rates are compressed, the mark to market on rents due to rent growth has continued to grow as well.

Key asset: an Ares distribution facility in Saarbrücken, Germany totaling 29,540 square meters

Europe market: Case study

Scarce logistics assets

Ares provided equity capital through an off-market exclusivity arrangement to fund the pipeline of a European developer, which resulted in the forward funding of 34 logistics assets across a number of European countries. "Despite the scarcity of these types of logistics assets, we believe that our emphasis on long-term relationships was attractive to the developer," says Benjamin.

> *"Unanchored inflation seems to me like the biggest risk for many asset classes, not just real estate"*
>
> **BILL BENJAMIN**

Q What are the potential downside risks for industrial investors?

BB: The two dangers that can bring a real estate cycle to an end are overbuilding and overlending. On an absolute basis, industrial development has been growing in Europe and in the US. However, in Europe, there is less than a year's supply in all the major markets and, in the US, vacancy is also very low. We are not seeing instances of overlending as banks are at 60 percent LTV. If we get inflation, and it is good inflation because it is driven by GDP growth, we will see rents grow.

Therefore, even if yields soften a little, total returns should still be protected. The worrisome thing would be if you cannot pass that inflation on to tenants, and cap rates drift up because investors need to be compensated for the cost of their money. Unanchored inflation seems to me like the biggest risk for many asset classes, not just real estate. ■

Experienced Leadership. Investment Discipline. Dependable Partner.

The Ares Management Real Estate Group manages comprehensive public and private, equity and debt strategies.

We maintain a time-tested and consistent approach across our equity and debt strategies focusing on major property types that we believe have value creation opportunities, located in liquid markets with diversified economies.

INDUSTRIAL AND LOGISTICS

MULTIFAMILY AND RESIDENTIAL

OFFICE

HOSPITALITY

MIXED-USE

Ares Management's global platform has approximately $282 billion of assets under management with approximately 2,000 employees operating across North America, Europe, Asia Pacific and the Middle East*

For more information, please visit aresmgmt.com

* As of September 30, 2021. AUM amounts include funds managed by Ivy Hill Asset Management, L.P., a wholly owned portfolio company of Ares Capital Corporation and registered investment adviser. All investments involve risk, including possible loss of principal; no guarantee is made that investments will be profitable. This material is for informational purposes only, and does not constitute investment advice or an offer to buy or sell any security, financial instrument or service. REF – AM-01356