RREEF Real Estate Minute
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After Recent Volatility, the Industrial Market is Normalizing to Pre-COVID Levels

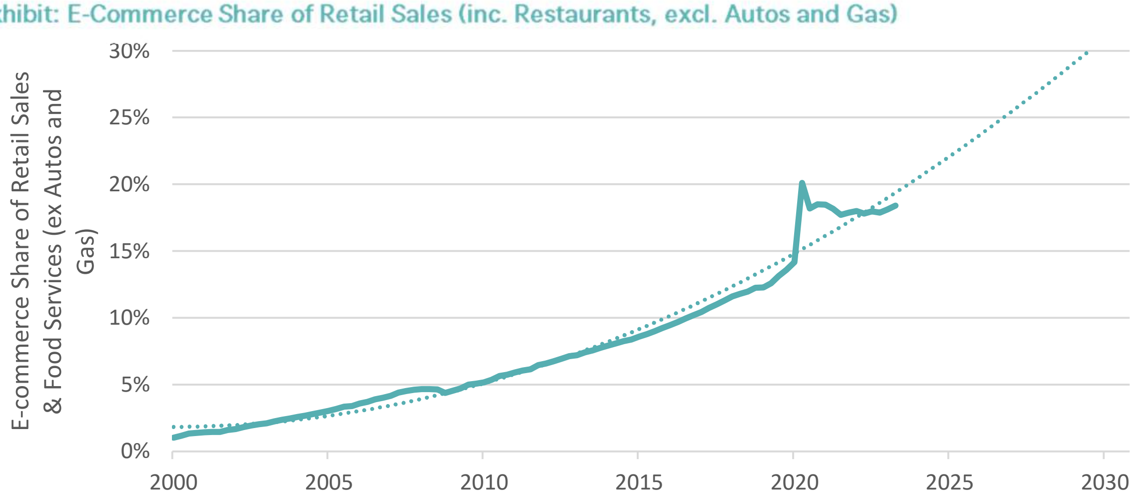
Not all commercial real estate is created equal. While some office properties are struggling, Industrial real estate continues its strong performance. Average market rents closed the second quarter of 2023 at an all-time high of $10.40 per square feet., up 10.5% from a year earlier, led by large coastal port markets.[1] Availability rates remain historically low, averaging 5.9% across the nation, well below the long-term historical average of 9.8%.[2] A post-COVID normalization of consumer spending patterns has dampened absorption, but we believe this correction is largely complete. E-commerce growth has stabilized (up 7.5% year-over-year in the second quarter) and industrial demand in the second quarter ticked higher as well.[3]

Nonetheless, Industrial real estate is not immune to the hit in property values arising from rising interest rates. The Industrial sector performed well on a relative basis in the second quarter with total returns of -4.0% (trailing four quarters), 260 bps above the overall NCREIF Property Index (NPI).[4] Despite declining valuations, impressive fundamentals continued to fuel double-digit NOI growth (11.5% year-over-year), the highest growth achieved across the overall NPI during the second quarter.

Record levels of new supply have been delivered in recent quarters at the same time that demand has normalized relative to the unprecedented levels seen during the pandemic. Nationally, 638.1 million square feet of Industrial space is under construction, representing 3.5% of stock. So far this year, 220.8 million square feet of Industrial space has been delivered.[5] The record development pace of the last few years is almost certain to moderate. JLL recently reported that the pace of new ground breakings decelerated 41.3% in the second quarter, year-over-year. The expected decelerating pipeline is due to increased costs and rising interest rates/tightening credit standards for construction loans.

Structural demand drivers remain intact: E-commerce's share of core retail sales ("e-commerce penetration") increased in the second quarter, moving from 18.1% to 18.4% (see Exhibit below).[6] This was the largest quarterly increase since the fourth quarter of 2020. In our view, e-commerce penetration is poised to increase from 18% to nearly 30% by the end of the decade, while efforts to protect supply chains from geopolitical and other disruptions will accelerate the pre-COVID trend toward increased inventory accumulation.

Exhibit: E-Commerce Share of Retail Sales (inc. Restaurants, excl. Autos and Gas)



1. CBRE-EA. Data as of 2Q 2023.
2. CBRE-EA Data as of 2Q 2023.
3. U.S. Census Bureau & CBRE-EA. Data as of 2Q 2023.
4. National Council of Real Estate Investment Fiduciaries (NCREIF). Data as of 2Q 2023.
5. CBRE-EA Data as of 2Q 2023.S.
6. Census Bureau & Moody's Analytics. Data as of 2Q 2023.

Despite near-term economic risks and capital markets uncertainty, Industrial real estate is well-positioned to be a resilient investment performer relative to the overall commercial real estate universe. While the pace of rent growth is expected to decelerate to pre-pandemic levels, an important support for near-term performance is expected to come from strong mark-to-market repricing in new leases and renewals. Market rents on average are about 35%-40% higher than five years ago, with the coastal port markets able to increase rents significantly more.[7] Potential income growth is compelling, exhibited by the 9.7% average NOI growth over the past five years.[8]

7. CBRE-EA & DWS. As of August 2023.
8. National Council of Real Estate Investment Fiduciaries (NCREIF). Data as of 2Q 2023.

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