TA Realty

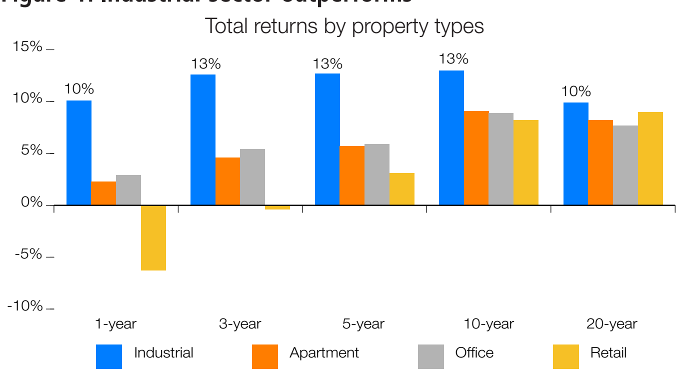
# The durability of industrial demand: Ecommerce and beyond

## Industrial sector outperforms

The health crisis has structurally changed life across the United States and many facets of the industrial investment market. In recent years, the outperformance of logistics real estate has been underpinned by multiple structural drivers, including ecommerce and customer demand for modern logistics facilities. COVID-19 not only validated these structural demand drivers, but it also accelerated their growth trajectory.

Industrial commercial real estate fundamentals are stronger than ever. In the current COVID-induced recession, the overall industrial vacancy rate has ticked up moderately to 5.6 percent and is expected to remain low through 2021. Meanwhile tight market conditions continue to push pricing. Triple-net asking rents averaged $8.09 per square foot in the third quarter of 2020 — up 6.4 percent year-over-year.[1]

**Figure 1: Industrial sector outperforms**




*Sources: NCREIF, TA Realty Research, data as of Q3 2020*

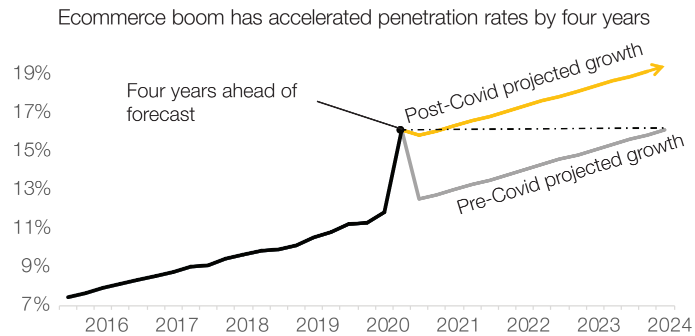
## Ecommerce driving industrial growth even faster due to pandemic

Ecommerce sales have risen quickly in recent years, but — as COVID-19 emerged — the adoption of online retail sales has created unprecedented growth. In 2020, during the initial impact of the pandemic, there was a dramatic shift upward in ecommerce's share of total retail sales, and year-over-year ecommerce growth surged to 45 percent.[2] This growth increased the pressure on retailers, wholesalers and third-party logistics companies (3PLs) and fueled demand for industrial space across markets.

Pandemic-related impacts that spurred a faster online adoption have fueled significant demand for nearly all types of industrial properties, but particularly for large, newer, state-of-the-art spaces. Online retail sales require more than three times the logistics space of brick-and-mortar sales for a variety of reasons, including deeper inventory levels and space-intensive parcel shipping operations.

Every $1 billion in incremental ecommerce sales generates 1.25 million square feet of warehouse space demand.

**Figure 2: Pandemic pulls forward ecommerce demand by four years**




*Sources: U.S Census Bureau, eMarketer[3]*

As a result, net absorption is projected to reach nearly 250 million square feet in 2021, more than 18 percent greater than the previous five-year annual average of 211 million square feet, according to CBRE.[4]

Over the coming decade, rising ecommerce sales are expected to further increase industrial demand by 15 percent, according to Capital Economics.[5] A survey by McKinsey & Co. found that COVID-19 prompted three out of four people to try a new method of ecommerce, and more than 70 percent intend to continue after the pandemic is over[6] — early evidence that the accelerated ecommerce trends will have staying power and continue to boost online spending and delivery needs.

## The multiplier effect of reverse logistics

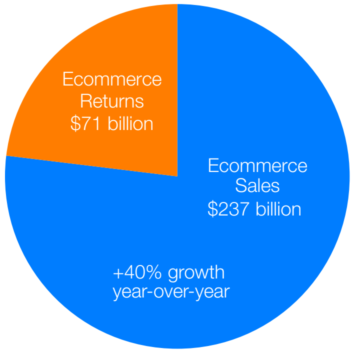
The rise in online sales is not the only reason ecommerce companies typically need more space. Soaring online purchases create billions of dollars worth of returns. In fact, 30 percent of all products ordered online are returned, as compared with less than 10 percent in brick-and-mortar stores.[7] Returns put enormous stress on already tight warehouse space, labor and distribution networks that are not designed to handle reverse-flow inventory.

Real estate plays a key role in reverse logistics, given that a supply chain requires approximately 15 percent to 20 percent more space than a traditional outbound supply chain and twice the labor to process a return as it does to send out a package.[8] Retailers and shippers alike are pursuing multiple strategies for processing online returns, including outsourcing the handling of returns to third-party logistics (3PL) companies. As a result, both 3PLs and some larger retailers are expanding supply-chain networks or building separate supply chains for reverse logistics, creating another driver of growth for industrial real estate. 3PLs now occupy an estimated 700 million square feet nationwide, and their footprint is growing by 3 percent to 5 percent annually.[9]

Reverse logistics is also driving a new industrial subtype: sorting centers. These close-in facilities have numerous dock doors and parking for the transfer of goods from tractor-trailers to delivery vehicles, such as vans. As a result, the increasing

**Figure 3: Online holiday sales and returns create a second surge in logistics demand**

Estimated 2020 U.S. holiday ecommerce sales and returns ($ billion)




*Source: National Retail Federation*

amount of reverse logistics will be a key driver for second-generation space and warehouse demand in lower-rent markets as ecommerce retailers seek cost savings.

Peak return periods further exacerbate the impact of reverse logistics on industrial real estate requirements. CBRE estimates that retailer supply chains require four to seven times more space allocation during peak buying periods, while space for forward fulfillment is already at a premium.

Entering the 2020 holiday peak season, nearly half of the top U.S. industrial markets had vacancy rates below the national average of 5.6 percent.[10] The impact on space demand from accelerated ecommerce adoption, multiplied by the effect of reverse logistics, further intensified the pressure on these already tight markets.

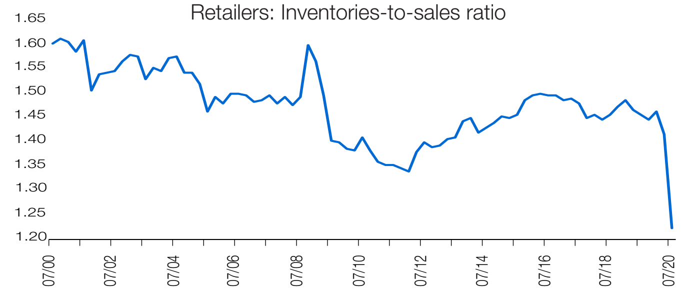
## Moving from just-in-time to just-in-case inventory fuels new demand

The COVID-19 crisis underscored the fragility of "just-in-time" distribution strategies and turned the emphasis to risk management and resilience. In response, supply-chain strategies are shifting to "just-in-case," and many occupiers are holding "safety stock"— increasing inventories from 15 days to as high as 60 days in case of any supply-chain disruptions.

These adjustments to supply chains have the potential to significantly increase the demand for warehouse space. The downward trend in inventory-to-sales ratios since the early 1990s (which reached a record low at the onset of the pandemic) could reverse as manufacturers, wholesalers and retailers build resiliency into their supply chains. Returning to the retailer inventories-to-sales ratio average of 1.65 would require inventory growth of 15 percent, holding sales constant.[11]

As many occupiers will increase their footprints to store this "safety stock," a 5 percent increase in business inventories requires an additional 400 million square feet to 500 million square feet of warehouse space.[12]

**Figure 4. Returning to higher inventories could produce substantial demand tailwinds**




*Source: Federal Reserve, Economic Research Division, seasonally adjusted, data through Q2 2020*

## Outlook: With demand comes opportunity

Industrial real estate will continue to outperform other commercial property types negatively impacted by the pandemic. Strong fundamentals will put upward pressure on rents and fuel investment. According to the Pension Real Estate Association's Consensus Forecast Survey, forecast average annual total returns for industrial between 2020 and 2024 are expected to outperform apartment, office and retail assets by 240 basis points, 400 basis points and 670 basis points, respectively.[13]

Looking to the post-pandemic era, the shift toward ecommerce and an increased desire to carry more inventory relative to sales will drive demand for a variety of logistics facilities. The U.S. industrial sector successfully navigated the turbulent market in 2020, and these structural trends favor increased demand and strong performance in both the near and long term.

Notes: [1] CoStar, U.S. Industrial Market, Q3 2020; [2] U.S. Census Bureau, "Quarterly Retail E-commerce Sales Bulletin," Q3 2020; [3] Lipsman, Liu, "U.S. E-commerce 2020," eMarketer, July 8, 2020; [4] CBRE, "U.S. Real Estate Market Outlook 2021," November 2020; [5] Wood, Engin, Khan, "Global Property Focus," Capital Economics, Nov. 19, 2020; [6] Briedis, "Adapting to the Next Normal in Retail," McKinsey & Company, July 2020; [7] Khalid Saleh, "E-commerce Product Return Rate — Statistics and Trends," Invespcro.com, updated April 2020; [8] Erik Caldwell, "Perspective: Solving the Reverse Logistics Puzzle," *Transportation Topics,* Feb. 4, 2020; [9] CBRE, "Reverse Logistics Stress in an Era of Free Returns," December 2019 ; [10] CoStar data as of Q3 2020; [11] Prologis, "COVID-19 Special Report #5: Supply Chain Shifts Poised to Generate Substantial New Demand," May 2020; [12] CBRE, "Distribution Hubs Will Benefit from Increased Business Inventories & Supply Chain Restructuring," May 14, 2020; [13] Pension Real Estate Association, "PREA Consensus Forecast Survey of the NCREIF Property Index," Q4 2020

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