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FEBRUARY 2021

The Industrial Property Revolution

Highlights

- COVID-19 has brought a tide of change not seen before, accelerating the structural transition towards e-commerce and causing the appetite for industrial property to surge.
- In Australia, this transition towards e-commerce has meant that in 2020 there was an additional $10 bn spent on online sales, which is forecasted to translate into an increase in demand of approximately 890,000 sqm of warehouse space.
- Demand for modern logistics and warehouse assets will outpace supply in the short to medium term, with Trident Real Estate Capital forecasting that cap rates will compress to below 5% by the end of 2021.
- Big box warehouses are the relative winner coming out of COVID-19 offering efficiencies associated with scale and centralisation. Recent survey results suggest that 30% of Australian industrial occupiers intend to relocate to a larger warehouse over the next 12 months.
- Smaller warehouses, typically 1,000 to 3,000 sqm, strategically positioned close to consumers in urban areas are also enjoying positive dynamics. For e-commerce retailers in particular, having a hub-and-spoke style operation might be more cost-effective due to the expensive nature of last-mile delivery costs, which can be up to 40% of supply chain costs for such retailers.
- As warehouse space becomes increasingly more expensive for occupiers, warehouse automation will become an imminent measure to drive growth and profitability and maintain a competitive advantage.

Introduction

Since COVID-19 struck fear in the global economy, there has been an accelerated structural transition towards e-commerce causing investor appetite for industrial property to surge and for the asset class to outperform all other mainstream real estate sectors.

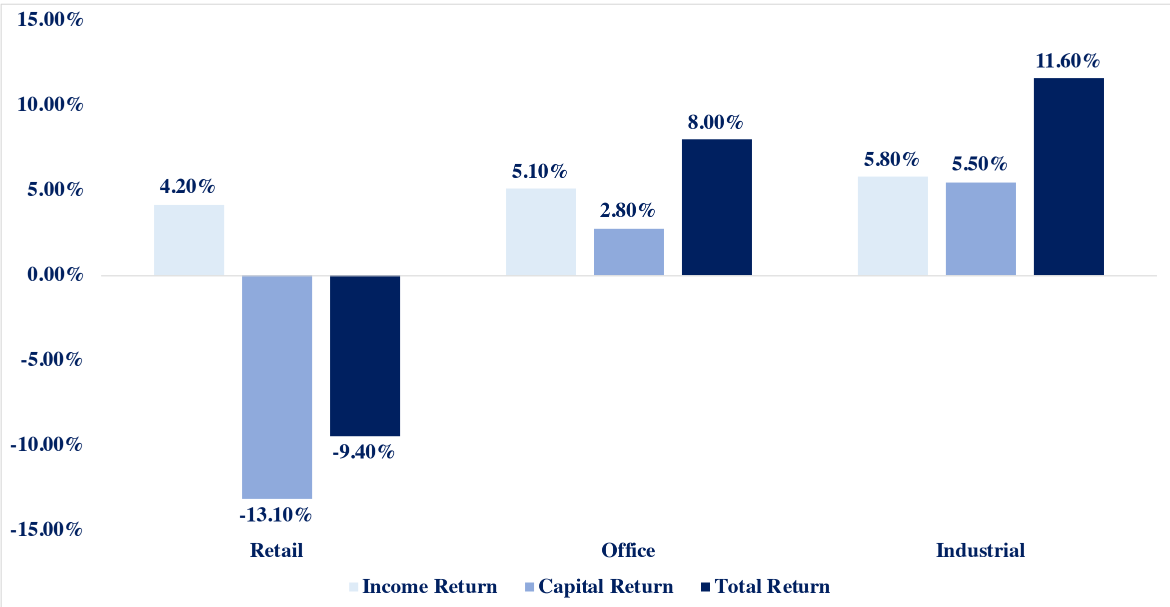
The funds chasing industrial properties have driven capitalisation rates for A-REIT industrial assets to firm to an average of 5.4% and it is forecast that this yield will further compress to below 5% by the end of 2021. Debt capital markets are singing to the same tune. Banks are actively reweighting their lending books towards the industrial sector and are prepared to increase loan to value ratios for industrial developments based on the perceived attractive risk profile of the asset class.

The question remains, has the surge gone too far, or is this simply the tip of the iceberg? In this paper, we explore the reasons behind the increasing investor demand for industrial property, and the changing nature of the asset class as it evolves to the new economic environment.

Industrial Property Market Overview

In 2020, the industrial sector outperformed all the other mainstream real estate sectors. In the 12 months to June 2020, according to MSCI research, Australian industrial property returned a total of 11.6%, approximately evenly split between capital and income return. In contrast, office and retail returned 8.0%[1] and -9.4% respectively, over the same period.[2]

Figure 1. Commercial Real Estate Returns By Sector 12 Months to June 2020. Source: MSCI



According to Colliers, new completions of industrial property was forecasted to be roughly 600,000 sqm in the Sydney Market in 2020, down from 755,353sqm added in 2019.[3] Unsurprisingly, COVID-19 stalled a number of projects, particularly speculative developments not supported by pre-commitments. In 2021 and beyond, supply is expected to rebound upwards as developers gain more clarity about

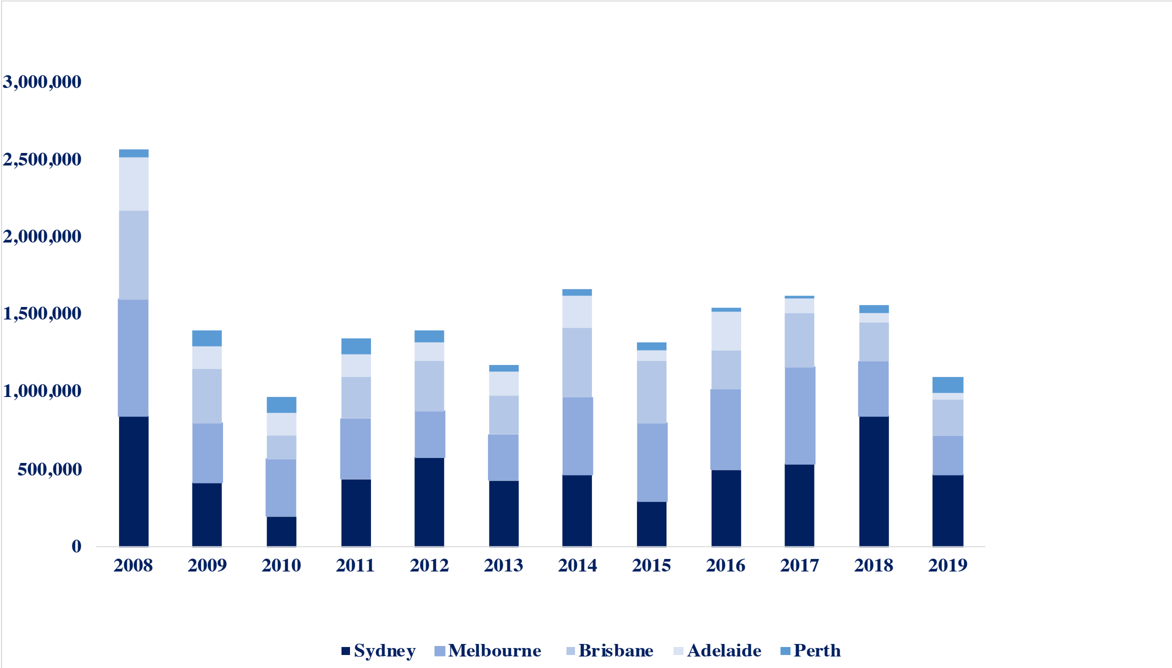
1 We expect office returns to further deteriorate in 2021 as the impact of rising incentives, which have exploded from 10% to 30%, as well as growing vacancy rates, which have ballooned from 3.7% to 11.9% in NSW, place significant downward pressure on the returns from this sector

2 McCallum, Mitchell. "Australian Property Performance Continues to Soften, as the Impact of COVID-19 Moves beyond Retail." Property Council, 20 Aug 2020, research.propertycouncil.com.au/blog australian-property-performance-continues-to-soften

3 Colliers International. "Industrial Second Half 2020." Colliers, www.colliers.com.au/en-au/research/industrial-rfr-h2-2020.

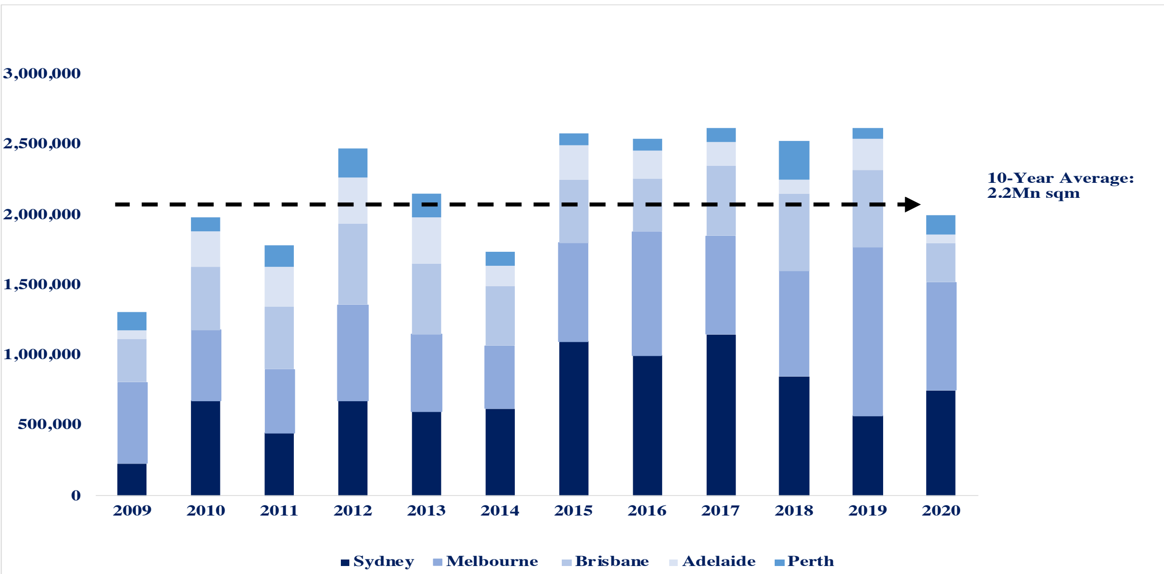
the implications of COVID-19 and confidence returns to the leasing market. A persistent theme underlying the restricted supply has been the lack of developable land with the Sydney market being limited to only 313 ha of immediate developable land with access to sufficient transport infrastructure.

Figure 2. New Supply of Australian Industrial Property (SQM). Source: JLL



On the demand side, tenants have been reluctant to commit to long-term leases resulting in significant increases in lease gestation in 2020. Notwithstanding, according to JLL, industrial take-up in Sydney has been healthy with just over 775,000 sqm of industrial space (5,000sqm+) being leased in 2020 compared to circa 550,000 sqm in 2019.[4]

Figure 3. Gross Take-Up of Australian Industrial Property (SQM). Source: JLL



4 J-Baleh, Sass. "Australia's Industrial & Logistics Market Overview". JLL Research Australia, 2020, Australia's Industrial & Logistics Market Overview

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Leasing demand for industrial property has stemmed from a growth of online retail and food logistics (including demand for short term overflow space from supermarkets), with several significant pre-commitments being recorded in 2020. A couple of examples include Amazon's 200,000 sqm commitment at Goodman's Oakdale West and Woolworths 75,300 sqm commitment at Moorebank Intermodal. According to Prologis' most forward-looking metrics, 2021 is projected to be a strong year with leasing proposals up 8.1% and leasing activity levels increasing by 18%.

At present, Colliers have found that incentive levels across Sydney range between 10% to 17.5% for both prime and secondary grades, up from 7.5% to 15% pre COVID-19.[5] While industrial rents in most submarkets remained relatively unchanged, net effective rents fell on average by 2.7% across both grades.[6] As such, landlords have opted to preserve asset value by offering incentives instead.

Going forward, we are forecasting rental growth acceleration, as economic conditions improve, with inner ring submarkets expected to outperform. This trend has been reflected in the fourth quarter of 2020 and is expected to build momentum in 2021 as consumer sentiment rebounds and a COVID-19 vaccine is rolled-out, allowing businesses to recommence and execute on capital expenditure plans with more clarity and certainty.

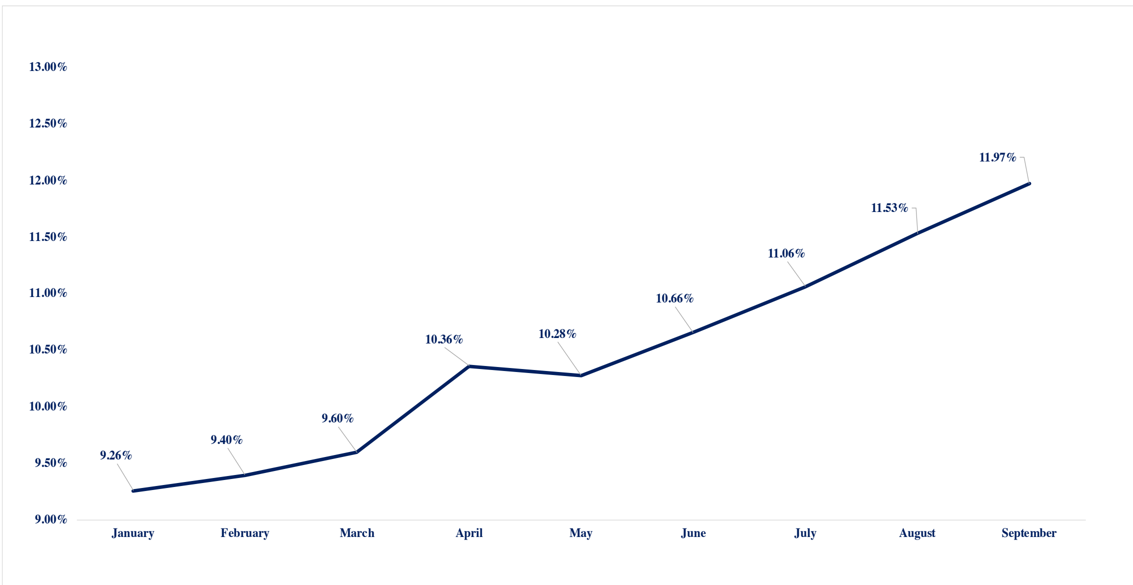
Part 1: Why the Sudden Love Affair with Industrial Property

The E-Commerce Pandemic

In an already shifting e-commerce landscape, COVID-19 delivered a strong push to help propel e-commerce into a new era. The latest data from NAB highlights an impressive year-on-year online sales growth of 62.7% (September 2020), and an increase of $10 bn in total spending over the last 12 months – roughly five times the average annual growth of $2bn.[7] To put things into perspective, an average of 1.6 mn households made online purchases on a weekly basis in April 2019. In April 2020 2.5 mn households had made online purcahses.[8]

With e-commerce increasing sharply to an expected 15% of total retail sales by the end of 2020, the e-commerce time line has effectively been brought forward by 3 to 4 years.

Figure 4. Australian E-Commerce % of Total Retail Trade 2020. Source: NAB,ABS, JLL



5 Colliers International. "Industrial Second Half 2020." Colliers, www.colliers.com.au/en-au/research/industrial-rfr-h2-2020.
6 Ibid
7 NAB Group Economics. "NAB Online Retail Sales Index September 2020." NAB, 2 Nov. 2020, business.nab.com.au/nab-online-retail-sales-index-september-2020-43372/.
8 Australia Post. "Inside Australian Online Shopping: 2020 eCommerce Industry Report." Auspost, a

So what are the reasons behind the burst in e-commerce activity?

- Store closures have forced the hand of many bricks-and-mortar retailers to sell on the online marketplace.

- Stuck at home, the transition to working from home arrangements has contributed to further online browsing and spending. With travel restrictions, quarantine rules and lockdowns, COVID has caused a shift in spending behaviour away from experiences towards material items.

- Stimulus payments and Buy Now Pay Later, further exacerbated online shopping. A recent report by ASIC found that the number of transactions made, the number of transacting users and the total value of transactions have each grown more than 20% in the 12 months from June 2019 to June 2020.[9]

E-Commerce Swallows Up Supply

Data from the US indicates that for every $1 bn spent on online sales, approximately 85,000 sqm of warehouse space is required.[10] So every dollar of online sales requires on average around three times the logistic space compared to a dollar of sales made through brick-and-mortar channels. So why is e-commerce so inefficient when it comes to warehouse space?

1. Inventory stored in warehouses: Unlike brick-and-mortar retailers who stock either some or all inventory in-store, e-commerce retailers house all inventory within warehouses;

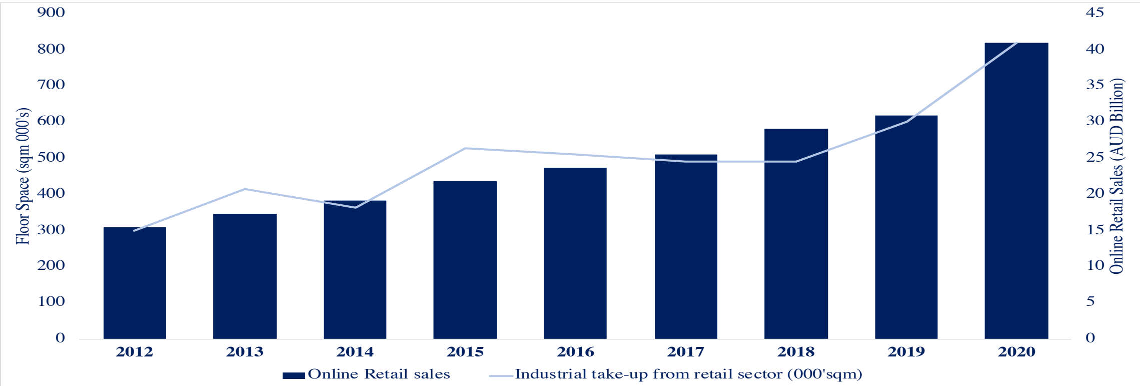
2. Greater product variety: E-commerce retailers generally offer greater product variety and therefore require greater amounts of space for their diverse product variety;

3. Higher inventory levels: E-commerce retailers generally hold higher inventory levels and require more sorting space; and

4. Reverse logistics: E-commerce retailers require reverse logistics (return processing) space.

In Australia, the newfound accelerated growth in e-commerce, which has meant there is now an additional $10 bn spent on online sales over the past year, will translate into an increase in demand of circa 850,000 sqm of warehouse space. To put this into perspective, Colliers forecasted 2020 Sydney industrial and logistics development supply to be 600,000 sqm. Demand is therefore expected to outpace supply in the medium term . Furthermore, Trident Real Estate Capital expects e-commerce tenants to continue leasing space rather than purchasing warehouse spaces as it is likely more accretive to tenant businesses to reinvest capital to expand versus buying real estate.

Figure 5. Warehouse Take-Up from the Retail Trade Sector and Online Retail Sales (12 mth rolling) Source: NAB, JLL



9 ASIC. "Buy Now Pay Later: An Industry Update." Asic, 16 Nov. 2020, asic.gov.au/regulatory-resources/find-a-document/reports/rep-672-buy-now-pay-later-an-industry-update/.
10 Colliers International. "Industrial Second Half 2020." Colliers, www.colliers.com.au/en-au/research/industrial-rfr-h2-2020.

Reshoring to Create Further Demand

COVID-19 spiralled the world economy into a major recession and highlighted a startling vulnerability in global supply chains. Australia, like many nations, has been forced to review its over-dependence on imports and the "lowest cost proposition" offered by offshore manufacturing.

The China lockdown resulted in several supply chain knock-on effects. Initially, companies that relied on outsourced Chinese parts were caught off-guard with the closure of Chinese factories and the sudden halt to manufacturing output. More pertinently, the scramble by countries to source respirators, PPE and hand sanitisers shed light on a clear weakness in the global supply chain in dealing with supply shocks.

In an effort to combat this vulnerability, the Australian Government initiated the Modern Manufacturing Strategy which includes scattered investments of $1.3 bn into SMEs focused on medical products, defence products and clean energy manufacturing to encourage further private investment and build scale. This initiative also includes an additional $107 mn investment into reinforcing Australian supply chain resilience.[11]

The prospect of reshoring is likely to have some effect on industrial property demand albeit a modest one given cost pressures and high labour costs in Australia and the competition from Asia. Reshoring when coupled with e-commerce growth will ensure that the industrial asset class remains in high demand.

Higher Inventory Requirements Means More Demand for Logistic Space

By exposing supply chain vulnerabilities and reminding suppliers that demand can fluctuate erratically, COVID-19 has forced many businesses to carefully review and reconsider their "just-in-time" inventory policy. At the onset of the global pandemic, this issue became abundantly clear when consumer goods, particularly consumer staples, quickly flew off the shelf. During this period of panic buying, the businesses that benefited were the ones with solid supply chain systems and inventory control.

Unsurprisingly, almost a third of industrial occupiers are now storing more local stock to avoid possible future shortages, and 18% are expanding warehouse space to facilitate this change to the business model.[12]

Part 2: Developing Industrial Property of the Future

The shifting economic landscape caused by the (1) burst in e-commerce activity, (2) companies holding more inventory, and (3) reshoring of manufacturing, will ensure logistics assets will continue to grow as a preferred asset class. Trident Real Estate Capital expects capital inflows to only increase in the short to medium term. There are important design considerations that investors and developers ought to keep top-of-mind, as logistics warehouse designs are evolving and deviate significantly from those of traditional manufacturing sheds. Below, we discuss several of the most important considerations.

Size and Inventory Control

Increased e-commerce sales translate to increased inventory, throughput and product variety and therefore increased demand for logistics space by tenants. But when tenants are faced with a shortage of space, in many cases it is preferable to lease a larger warehouse rather than lease another warehouse in addition to maintaining the current lease. This is primarily due to the efficiencies associated with scale and centralisation, such as the ability to avoid the doubling up of machinery and equipment, as well as the greater incrementalism allowed by the leasing of only marginally larger spaces.

The fact that larger warehouses are preferred has led and is leading to big box warehouses being the relative winner coming out of COVID-19. Recent survey results suggest that 30% of Australian industrial occupiers intend to relocate to a larger warehouse over the next

11 Australian Government. "Make It Happen: The Australian Government's Modern Manufacturing Strategy." Augov , www.industry.gov.au/sites/default/files/October%202020/document/make-it-happen-modern-manufacturing-strategy.pdf.
12 Crawford, Luke. "COVID-19 Impacts on Industrial and Logistics Occupiers." Colliers, 28 May 2020, www.colliers.com.au/en-au/research/covid-19-impacts-on-industrial-logistics-occupiers.

12 months.[13] This contributes to the secularly increasing popularity of big box, with the average size of industrial developments rising from around 10,000 square meters to 20,000 square meters over the last decade.

With that said, however, there are some positive dynamics concerning smaller warehouses as well. For e-commerce retailers in particular, having a hub-and-spoke style operation might be more cost-effective due to the expensive nature of last-mile delivery costs, which can be up to 40% of supply chain costs for e-commerce retailers. In these scenarios, smaller warehouses, typically 1,000 to 3,000 sqm, are strategically positioned close to consumers in urban areas. Larger consolidation and fulfilment warehouses are located outside city limits instead. A good example of such a model is Amazon's warehouse network, which employs the hub-and-spoke approach and is currently in the process of adding 1,000 small delivery hub warehouses in suburban neighbourhoods across the US.[14]

This demand theme is especially interesting as it relates to Sydney, given its population density and the extremely limited supply of urban warehouses. Supply of such warehouses is restricted by the following factors:

- Rezoning: The rezoning of industrial land (though this trend is most pronounced in Sydney and Melbourne);

- Repurposing: The repurposing of industrial sites on flexibly zoned land, such as B6 Enterprise Corridors and B7 Business Parks, towards business, office and retail uses; and

- Value Growth: Land value growth exceeding rental growth, which lowers the buy-develop-lease value proposition.

These factors have contributed to an extremely tight market, with the supply of developable land falling 36% between 2010 and the end of 2019, and pre-COVID vacancy standing at 2.6% in the fourth quarter of 2019.[15] This phenomenon has seen small industrial pockets of land in urban areas skyrocket, in some cases by an average of 23% per annum over the last three years in Sydney.[16]

Automation

Warehouse automation is the process of automating the movement of inventory into, within, and out of warehouses to customers with minimal human assistance.[17] As part of an automation project, a business can eliminate labor-intensive duties that involve repetitive physical work and manual data entry and analysis.

Automation systems and solutions vary greatly across businesses, however, ultimately, all automation technology aims to simplify and improve otherwise repetitive and labour-intensive activities, such as picking an packing. A surge in automation is on the horizon and 55% of businesses are already investing in automation solutions.[18] Also, an estimated $30 bn of investor capital is expected to fuel the development of large-scale automated warehouses in Australia over the next decade.[19]

One example of a business embracing warehouse automation is the Australian e-commerce "Catch.com.au". Prior to adopting automation into its operation, Catch had 60 workers to move 6,000 orders per day. Through its implementation of an AutoStore storage and retrieval system, the business managed to slash its order cycle in half and now fulfills over 10,000 daily orders across 9,000 products.[20]

According to a recent study carried out by eft (Eyefortransport) in 2019, 55% of businesses rated automation as a top investment priority. Components of automated warehouses may include:

1. AS-RS (Automated Storage and Retrieval Systems): These systems allow for incredibly dense and tall racking solutions with automatic

13 Crawford, Luke. "COVID-19 Impacts on Industrial and Logistics Occupiers." Colliers, 28 May 2020, www.colliers.com.au/en-au/research/covid-19-impacts-on-industrial-logistics-occupiers.
14 Soper, Spencer. "Amazon Plans to Put 1,000 Warehouses in Suburban Neighborhoods." Bloomberg, 16 Sept. 2020, www.bloomberg.com/news/articles/2020-09-16/amazon-plans-to-put-1-000-warehouses-in-neighborhoods?sref=aYhJG6I5.
15McDougall, Nicola. "Shortage of Small Industrial Sites in Sydney 'a Serious Impediment'." Commercial Real Estate, 20 May 2020, www.commercialrealestate.com.au/news/shortage-of-small-industrial-sites-in-sydney-a-serious-impediment-3-953923/.
16 Ibid
17 Jenkins, Abby. "Warehouse Automation: The How, When & Why." Oracle NetSuite, Dec. 2020, www.netsuite.com/portal/resource/articles/inventory-management/warehouse-automation.shtml.
18Colliers International. "Whitepaper: The Industrial Property of the Future." Colliers, 15 May 2020, www.colliers.com.au/en-au/research/whitepaper-the-industrial-property-of-the-future.
19 Schlesinger, Larry. "Wall of Money to Drive Logistics Development Boom." Afr, 13 Feb. 2020, www.afr.com/property/commercial/wall-of-money-to-drive-logistics-development-boom-20191231-p53ns5.
20 Supra note 17

crane systems that enable fast unit retrievals. AS-RS greatly cuts down on manual labour, saving costs, and allows for efficient rack volume maximization which translates to rent per-unit minimisation. AS-RS will have two main impacts on warehouse design, namely (1) higher internal clearances[21] and (2) higher floor loading capacities given the higher and denser racking;[22]

2. Conveyor Systems: There is nothing new about conveyor systems . These systems are implemented to minimise walking within a warehouse and allow for the standardizing the transport of items. However, the next step involves incorporating sortation systems that connect conveyor systems with sortation software that identifies products typically using a barcode. Once identified, the scanned items are then split into lanes that correspond to a pre-determined category where orders are consolidated in preparation for dispatching; and

3. AMRs (Autonomous Mobile Robots): AMRs are mobile robots that can carry heavy loads across the warehouse and have built-in sophisticated software that continuously communicates with the WMS (Warehouse Management System). In addition, AMRs provides real time data and analytical tools that drives continuous operational efficiencies. These devices, albeit expensive, remain popular with e-commerce companies.

4. GDP (Goods to Person): Automated systems pick up goods from shelves which are delivered to a picker's work stations. The main objective of this systems is to reduce foot traffic and walking travel time by transporting goods to employees, contrary to conventional picking systems, where employees walk around the warehouse to fulfill orders.

As warehouse space becomes increasingly more expensive for occupiers, they will be forced to utilize space more efficiently by thoroughly controlling their inbound supply chain. Warehouse automation using warehouse management systems, that automate manual processes, has tremendous potential to significantly ehance space efficiency, control, accuracy, productivity and safety. The movement of products from one location to another with minimial human intervention creates supply chains capable of rapid, seamless order fulfillment.

Multi-level Warehousing

Multi-level warehousing is a solution executed in densely populated cities across Asia. These facilities are built vertically with truck ramps and docks located on multiple floors and are ideal in larger cities where land is selling at a premium and consumers expect same- or next day deliveries. Due to limited supply of industrial zoned property, coupled with rising demand for last-mile logistics space in urban areas around Sydney, it is likely such warehouses will emerge over the next few years. However, developments of this magnitude are far more expensive that your ordinary warehouse, and only around 75% of total floor space is rentable. As such, the first multi-level warehouse in Australia is expected to be purpose-built for a large blue-chip company.

Conclusion

Strong tailwinds created by (1) a burst in e-commerce activity, (2) retailers electing to maintain higher inventory levels, (3) the reinvigoration of the local manufacturing sector, and (4) a restricted supply of developable land, particularly in urban areas close to the consumer, have all worked in tandem to incentivised investors to allocate more capital towards industrial assets.

Yet changing customer habits, emerging technologies, the e-commerce and omnichannel phenomena are all impacting the design of industrial facilities and threatening to make existing industrial stock obsolete. Big box warehouses seem to be the way of the future offering efficiencies associated with scale and centralisation. As warehouse space continues to become more expensive, warehouse automation will become more prevalent, allowing users to improve on space efficiency, productivity and control. The implementation of automation will require the design of warehousing to evolve to include higher internal clearances and improved floor loading capacities.

21 Many modern warehouses are built most efficiently to 13.7m to the reach of the warehouse. This enables greater operational savings to be achieved from increased storage density and minimised internal travel distances; whilst also simplifying the picking of an order.

22 Colliers estimates that traditional selective racking involve around 0.85 square meters per pallet under a 7.4m – 5-pallet height arrangement. In contrast, an AS-RS arrangement with 27m – 16-pallet height would result in roughly 0.23 square meters per pallet. Under these circumstances, the floor loading would be approximately 3.7 times greater with the AS-AR system.

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In the post COVID-19 environment, industrial property has been the big winner proving its resilience to the effects of lockdowns and quarantine rules. This resilience has translated to stronger as well as less volatile returns, incentivising investors to continue to allocate more capital towards this asset class in 2021 and beyond.

Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial and residential property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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