CBRE FLASH CALL

COVID-19 IMPACT ON INDUSTRIAL & LOGISTICS REAL ESTATE

APRIL 1, 2020 CALL SUMMARY

Thank you to our clients and colleagues who attended CBRE's April 1 Flash Call–COVID-19 Impact on Industrial & Logistics Real Estate. CBRE experts and a Stifel Nicolaus equity analyst examined current conditions in the global economy, capital markets, public equity, occupier markets, and provided an outlook on the long-term impact of COVID-19 on industrial and logistics real estate.

- Listen to the call recording
- Get the Latest Coronavirus Updates: Visit CBRE's Global COVID-19 Resource Center

CALL PARTICIPANTS

- Val Achtemeier – Executive Vice President, Capital Markets, Debt & Structured Finance, CBRE
- Richard Barkham – Global Chief Economist & Head of Americas Research, CBRE
- David Egan – Head of Strategy & Consulting, CBRE Capital Markets
- Jack Fraker –Vice Chairman and Managing Director, CBRE Capital Markets
- John Guinee – Managing Director, Stifel Nicolaus
- Spencer Levy –Senior Economic Advisor and Chairman of Americas Research, CBRE
- John Morris – Executive Managing Director, Americas Industrial & Logistics Leader, CBRE
- Chris Riley – Vice Chairman. Capital Markets, Institutional Properties, CBRE

ECONOMY

Global and U.S. macro outlook: short term brutal, medium term optimistic

Overview Assumptions

- The rate of new infections starts to decline in the next two weeks but does not fall significantly until around April 21
- Restrictive stay-in-place orders continue until mid-May, but the roll out of mass testing over the next two weeks allows for the implementation of less intrusive virus-control methods.

Labor Market Conditions

- The downturn in the labor market will persist into 2021 with unemployment rising at least to 6.2%.
- This reflects an overall loss of 16 million jobs, but the rise in the unemployment rate will be mitigated by employment creation in sectors such as health care and e-commerce.
- Retirements among Baby Boomers may be accelerated, which will shrink the overall labor force.
- Employment in warehousing and logistics will likely remain stable.

Drivers of Recovery and Overall Outlook

- Pent up demand for goods and services when outbreak is stabilized.
- Economic stimulus across the world, including the recent federal CARES package in the U.S., which accounts for 26% of GDP, will help fill the tremendous loss of economic activity in the first half of 2020.
- Recently downgraded CBRE forecasts show a 6.3% GDP decline in Q1 and a 20.5% decline in Q2. Full-year 2020 GDP is expected to be negative 2.8%. The U.S. economy is expected to start bouncing back in Q3 (8.6% growth), accelerate in Q4 (15.9% growth) and continue its rebound into 2021. The 2021 GDP is currently forecasted at over 5%.

CAPITAL MARKETS

Activity on both debt and equity has slowed but the markets are still open for business

Capital Markets Overview

- Commercial real estate capital markets felt the brunt of the rapid slowdown in the form of slower sales and debt and structured financed transactions in the last two weeks.

- This slowdown is expected to continue for several weeks or months until there is a material improvement in the COVID-19 case load and restrictions on freedom of movement and forced government shut down of businesses are removed.
- Despite the slowdown and several transactions falling out of contract or financings cancelled, many are still getting done.
- Most of the deals CBRE completed in the last two weeks were in multifamily and industrial, the two asset types likely to be most resilient during the crisis.
- CBRE also closed several hotel and retail sales and construction and bridge financings.
- The debt and equity commercial real estate capital markets are and will remain open during this crisis as most industry professionals believe the crisis to be short term which does not fundamentally alter the long-term outlook for commercial real estate.

Buyer Profile

- As expected, there has been a falloff in institutional buyers due in large part to the denominator effect. According to CBRE Capital Markets data, in the week of March 30th, 22.4% of buyers were institutional; this week it is 16.2% for all Capital Markets Transaction Activity and it is expected that may fall further.
- At the same time, for those institutional investors with strong liquidity/balance sheets, there has been an increase in those saying they have different forms of rescue capital increments for individual assets and portfolios.

Industrial Capital Markets/Investment Sales

- Price discovery has become more difficult in the current situation.
- Given the uncertainty, there has been a definite flight to quality and investors are clearly targeting properties that will outperform in either a down or up market.
- This doesn't just mean long-term net lease properties with credit, but properties in "A" locations, market appropriate design and construction, stabilized occupancies, bankable tenant credit and the potential for long-term rental rate growth, basically the best-of-the-best core and core plus offerings.
- Those assets that are deemed hard to replace are still being pursued by a subset of investors who are taking a long-term approach, but this is based upon new pricing metrics.
- Properties on the margin that benefited from a white-hot market only have liquidity based upon discounted pricing. Lease to core or value-add offerings are very fragmented as the lease up underwriting is challenging and causing investors to be more conservative.
- CBRE's recent experience with buyers suggests that:
    - Approximately 10% are out of the market
    - 40% are active, but at price points well above pre-COVID-19 returns
    - 40% have shifted their investment strategy to core offerings and remain active, but disciplined in what they pursue, their underwriting and pricing

    - 10% have been bridesmaids too long and view this as an opportunity to purchase while their competitors have their pencils down
    - Active buyers are hopeful that they can purchase properties at pricing that is at or below pre-COVID-19 guidance levels, which is below the stretch pricing that was being achieved
- Where are the buying opportunities?
    - A core or core plus offering with a hard to replace profile will offer an opportunity for an attractive value proposition based upon a long-term viewpoint.
    - Given the lack of distress at the moment and the long-term belief many owners have in the industrial sector, there are very few buildings "on sale" with owners prepared to sell at a discount.
    - The development cycle can be two to three years and new construction is slowing down. This is an opportunity to purchase new, market appropriate product that could be poised for success when the market recovers.
    - Lastly, land prices are most elastic during turbulent times. There will be an inflection point in the future when land acquisitions can be made with a clearer understanding of market leasing assumptions and the exit pricing.

Debt Capital Markets Overview

While markets have been tumultuous the past three to four weeks, liquidity is still available, although changing daily, if not hourly. They remain very fluid.

Indexes

Key rate indexes have fallen from levels at the beginning of the year to unprecedented levels.

- 10-year treasuries were 1.88% at the beginning of the year, dropped as low as 0.54% on March 9 and are now at around 0.68% on April 6.
- One-month LIBOR averaged 1.67% in January, closed at 0.99% on April 3.

Spreads

Commercial real estate debt spreads are widening and are following all other fixed asset categories and are tied to corporate bond spreads. However, we have had a surge in corporate bond deals to provide positive and improving data points.

- Spreads have gapped out for all product types and all forms of lenders.
- Pricing discovery among many lenders, difficult to price given volatility, some have temporarily halted quotes and almost all have instituted rate and index floors.
- Floating rate debt is especially difficult to price given the volatility in LIBOR.
- Despite the widening spreads, overall rates are still attractive.

View on industrial & logistics from various lending sources

Banks

- Banks are still lending but are being very selective, are using their balance sheets, and are focused on key clients.
- Banks have been inundated with loan requests and can afford to be very particular. Current underwriting is drilling down on borrower asset strategy and risk profile.
- While construction loans are very limited, some local and regional banks will quote after extreme scrutiny.

Life Companies

- Some Life companies are taking a pause, but most are committed to mortgage production. In general, Life companies are quoting and honoring commitments.
- Life companies are all using interest rate floors which, while fluid, are ranging between 3.5% and 4.25%

CMBS & Debt Funds

- The securitized lenders—CMBS and debt funds—are both very disrupted at the moment and largely out of the market. Some debt funds have closed their operations, but other well-capitalized debt funds not dependent on CLO execution and leverage are looking at new business.

PUBLIC MARKETS - REITS

REITs provide a good lens into investor sentiment, but pricing is dislocated from real estate values

- Real-time REIT data provide a window into the broad market and investor sentiment but in moments like this are not priced in line with the underlying real estate values.
- Most REIT shares are held by ETF, Index Funds, and managed mutual funds which will buy or sell based on broader market conditions rather than NAV or implied cap rates. Only 15% of the shares are held by REIT-dedicated investors who are analyzing the real estate at a detailed level.
- As a result, REIT pricing has been driven down beyond what the underlying NAV would suggest. Market participants and analysts are looking ahead to Q1 and Q2 earnings and appear to be writing off 2020 and looking ahead to a better 2021.

- Industrial REITs have held up better than most sectors and are best positioned for the post-COVID-19 world:
    - Growth of e-commerce will benefit industrial.
    - Increased inventory levels will drive demand for warehouse space.
    - Near-shoring and onshoring of manufacturing will drive domestic production which is closely tied to warehouse demand.
    - The supply/demand dynamics are very much in the landlord's favor and are projected to remain that way.
    - In-place rents are 15-20% below market so there is still upside when leasing resumes.
    - CARES Act provides a backstop for many tenants that could be feeling a short-term business crunch.

MARKET FUNDAMENTALS / OCCUPIER PERSPECTIVE

Near-term sentiment is mixed but strong fundamentals protect against major disruption and lead to good long-term outlook

Near-term Occupier Overview

- Broker sentiment is mixed overall and became only modestly more cautious/concerned in our most recent weekly survey. Roughly one-third are "concerned, thinking this disruption will have a distinct impact on the business near and mid term," roughly one-third are "cautious, with an uncertain impact and possible recession," and about one-third are "mostly positive, seeing an impact but mostly only on timing."
- Brokers generally feel positive about the mid and longer-term prospects for their occupier and landlord clients, with exceptions indicated for some smaller clients in those businesses most immediate impacted.
- Shelter-in-place mandates in most states have impacted markets. Existing deals seem to be proceeding and in some places it's "business as usual" or "status quo." Overall, larger companies seem to remain active with their supply chain operations while small companies are uncertain. Larger logistics parks in general have normal levels of activity.
- Rent relief discussions have been initiated by many clients. Most landlords are engaging in the dialogue. Some landlords are agreeing to it or offering rent deferral and tagging it on the back end of the lease. Topic is a major share of time and resources for landlords, presently.
- There is increased tenant interest in shorter term renewals than has been typical though many landlords are pushing back and will not accept a term less than five years.
- On average, tenant deals are slowing, 30 or maybe 60 days, with plans to continue, so there is some revenue and completion delay expected. Only a handful of projects

disappeared, and a few have been accelerated. Food, Grocery, Consumer Goods, E-commerce and 3PL deals are still very active.

- Boom or bust in the food sector. Grocery and consumer/packaged goods companies are adding shifts and running as fast as they can go. Produce demand has fallen off sharply, however.

Near-term Market Fundamentals Outlook

- While the near-term situation for industrial is mixed, there are signals that the market may remain somewhat stable through this crisis and emerge on solid footing.
- First, from a fundamentals perspective, industrial was well positioned to absorb a short-term disruption with the vacancy rate at an all-time low and with supply relatively constrained.
- In situations like this, sudden oversupply is a major risk and creates a headwind to growth when the shock to the system ends. The combination of the sudden collapse of demand and the inevitable delivery of properties under construction can create a glut of vacancy that can take years to absorb.
- However, in this situation, a number of factors are at play that mitigate against this risk:
  - The amount of quality vacancy in most markets was already extremely low.
  - Due to stay-at-home measures, the pace of deliveries will slow.
  - A substantial portion, approximately 50%, of the projects due to deliver in 2020 are either BTS or pre-leased.
  - The growth of the pipeline was already shrinking and will shrink further as very few new projects will break ground in the near-term.
  - On the demand side, absorption will certainly be impacted but with many users on hold, a number of large logistics and retail users expanding, and very few examples of business downsizing or vacating, the overall impact on vacancy and, perhaps, rents due to negative user demand may be negligible.
  - As a result of both the constraint to supply and the continued demand for logistics space, the current CBRE Econometrics Advisors outlook projects a small 70 bps increase in availability over 2020 and only a 40 bps increase over the pre-COVID-19 forecast.

Long-term Market Outlook

- If you were a believer in industrial three weeks ago, you should be a believer today and when this is over. The fundamentals are so strong and the structural evolution that is still ongoing and may even be accelerating, are still valid and will position the sector to weather this storm.
- Due to the ongoing changes in supply chains in response to consumer demands and behavior it is expected that the market will pick up largely where it left off just a few weeks ago. Over a longer time horizon, there is a strong expectation that not only will we see "business as usual" but, actually, growth in two areas–e-commerce and inventory held on hand–which will significantly impact demand for warehouse space across the country.

- E-commerce: E-commerce has been growing at a steady rate of 15% annually and its share of overall retail sales has been growing at a rate of about 100 bps per year, now at 11%.

- The main obstacle to even greater growth has been 1) an objection by some consumers to online commerce and 2) product segments, such as groceries, that have been slow to gain acceptance in e-commerce. But, given shelter-in-place measures, e-commerce adoption rate has spiked and is expected to be very sticky.

- It is well established that growth in e-commerce sales results in growth in demand for logistics space in all sizes (large hubs down to small last mile) and in all markets. An increase in e-commerce adoption rate will accelerate this need for space. CBRE research has found that each incremental $1B of e-commerce sales growth requires approximately 1.25 M sq. ft. of warehouse space.
    - If e-commerce grows at an annual 20% rate over the next five years (instead of the projected 14%), that implies a need for up to an additional 400 M sq. ft. above and beyond the 500 M sq. ft. that was projected given the 15% growth rate.

- Inventory: Modern supply chains have been designed to perfection with the goal of holding the minimum amount of inventory in pursuit of a Just In Time model. However, we are seeing the weakness in this strategy when source of production shuts down.

- Going forward, the amount of inventory held in reserve–safety stock–will increase and will necessarily sit in a warehouse.
    - Research has indicated that occupied warehouse stock is extremely sensitive to U.S. business inventory levels. A 5% increase in business inventories would require an additional 700M to 1B of occupied sq. ft.

- Finally, and this is a trend that will develop over a longer term, the trend of near-shoring and reshoring manufacturing to North America will accelerate. This has been occurring, albeit slowly, over the past several years. A need for risk mitigation will encourage manufacturers to diversify their points of production out of Asia and closer to home.
    - This will have a positive impact on markets in the middle of the country that are in the north/south corridor and especially those that have existing intermodal infrastructure.