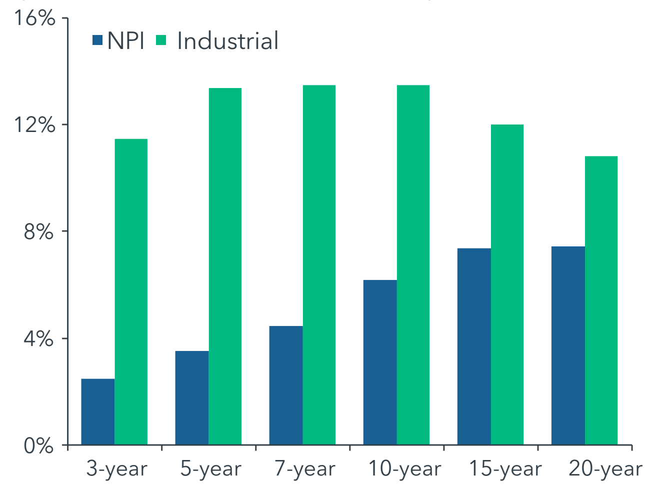
CLARION PARTNERS

The ongoing outperformance of U.S. industrial real estate

Portfolio allocations rise significantly amid ongoing outperformance

Investor interest in U.S. industrial real estate has reached a record high amid historically strong property-level fundamentals. The sector has been the best-performing property type tracked by the private real estate return benchmark during the past two decades (Figure 1). Although industrial property values have been affected by the interest-rate driven correction that began in the second half of 2022, as have all property types, Clarion Partners is optimistic that values will stabilize in the year ahead as debt rates improve.

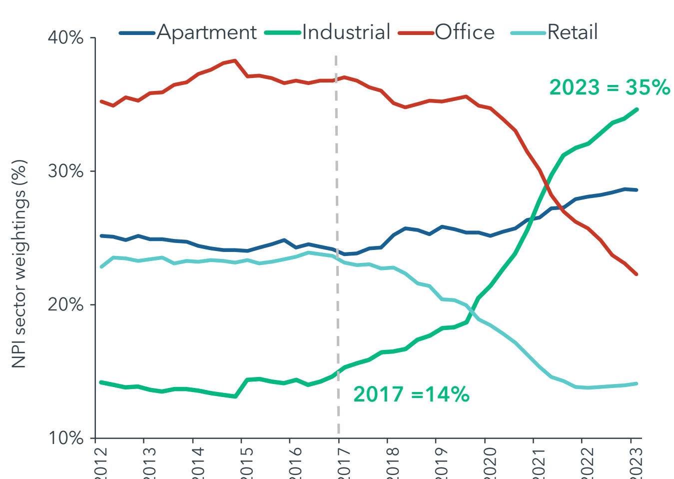
Figure 1: NPI vs. industrial total return history



Note: Based on the Expanded NPI.[1]
Sources: NCREIF, Clarion Partners Investment Research, Q2 2024

Strong performance has attracted significant capital flows, and institutional investor allocations have reached a record high, rising from 14 percent in 2017 to 35 percent in 2023 (Figure 2). Clarion Partners believes industrial property will remain a compelling long-term investment opportunity due to a robust set of demand drivers.

Figure 2: NPI sector allocation in recent history



Sources: NCREIF, Clarion Partners Investment Research, Q4 2023

CRE fundamentals update: 2024 to 2028

Nationwide, industrial real estate rent levels have remained at record highs. While the U.S. industrial vacancy rate has risen to 5.7 percent, an increase from the all-time low of 2.9 percent in second quarter 2022, it remains well below the long-term average (LTA) of 6.7 percent.[2] Year-to-date, new construction starts have fallen significantly, which bodes well for the sector's future outlook.[3]

Looking ahead, we anticipate new supply will moderate, vacancy will remain low nationwide and net operating income (NOI) growth will continue to outperform from 2024 to 2028.[4]

Demand drivers

During the past decade, demand for warehouse and distribution property has remained very strong, with annual net absorption of more than 200 million square feet almost every year. Overall industrial stock has risen by nearly 25 percent, with new construction (or class A assets) driving much of this growth.[5]

The demand drivers for industrial are structurally diverse as well. A few include ecommerce, expanding global trade, more onshoring/nearshoring of manufacturing and obsolescence (Figure 3). At this time, there is a significant need for high-quality, modern facilities to accommodate the demand from occupiers looking for more modern facilities.

Figure 3: U.S. industrial demand drivers

Logistics demand drivers	
Consumer spending	Supply-chain resilience
Ecommerce	Onshoring/Nearshoring
Shifting globalization	Manufacturing
Regionalization	Last-mile
Modernization and obsolescence	Inventory stockpiling

Source: Clarion Partners Investment Research, August 2024

More recent supply-chain disruptions (post COVID-19 global pandemic) have had an impact on international logistics dynamics. More specifically, shifting global trade partners, building supply-chain resiliency, greater "regionalization," a domestic manufacturing boom and inventory stockpiling have all heightened industrial demand.

A good entry point

Clarion Partners believes the current market dynamics present a good entry point to acquire logistics assets.

Increasing investor confidence. The Fed continues to signal that interest rates have reached their peak, which may prompt further easing of monetary policy in the months ahead, depending on incoming economic data. Capital markets have shown cautious optimism, particularly in the context of the industrial sector, and we expect greater improvement in liquidity and deal flow in the second half of 2024.

Stabilizing valuations. Since the spring of 2022, industrial real estate has reported a more modest value decline relative to the NPI (–11.6 percent vs. –16.4 percent). Overall, industrial property values now appear to have "bottomed," especially if interest rates continue to moderate with peak rates behind us.

Moderating new supply. Year-to-date in 2024, new construction starts have fallen sharply following a record level of new supply in 2022 and 2023. New supply is forecast to remain subdued in 2025 and 2026, which is likely to support rent growth.

At this time, we recommend the following tactical investment and management strategies: (1) seize opportunities presented by market dislocation, (2) focus on asset and location quality, and (3) maximize operational performance.

Investment opportunities

Currently, we are focused on the following opportunities in the industrial and logistics landscape.

Class A stock. Class A warehouses currently account for less than 20 percent of total industrial stock; however, class A space has accounted for 70 percent of total industrial net absorption since 2018.[6] Updating the widespread functional obsolescence at existing buildings presents a sizable opportunity, especially in many large U.S. cities, where vacant land is often scarce and expensive.

Last-mile facilities. Ecommerce as a share of total retail sales is expected to rise from around 20 percent now to about 35 percent by 2035 (based on annual growth of 5 percent to 10 percent).[7] Clarion Partners expects that another 340 million square feet will be required to meet online sales fulfillment alone (much of which will be last-mile facilities).[8]

Industrial outdoor storage (IOS). IOS has emerged as a specialized and high-performing industrial subtype serving logistics distribution.[9] The NPI IOS subtype has beat out the industrial average and overall NPI total return over all time frames.

Key considerations and risks

The global COVID-19 pandemic spurred historic demand for industrial real estate due to the surge in ecommerce, as lockdowns prevented the movement of people. This led to unprecedented appreciation, rent growth and very low vacancies nationwide. Since 2020, U.S. industrial effective rents have grown by 40 percent.[10]

During the past two years, the sector has returned to more typical, pre-2020 demand levels relative to the pace of the last four years. Going forward, we see the following as key considerations and potential risks:

- The completion of the recent surge in supply
- More moderate rent growth
- Capital markets uncertainty

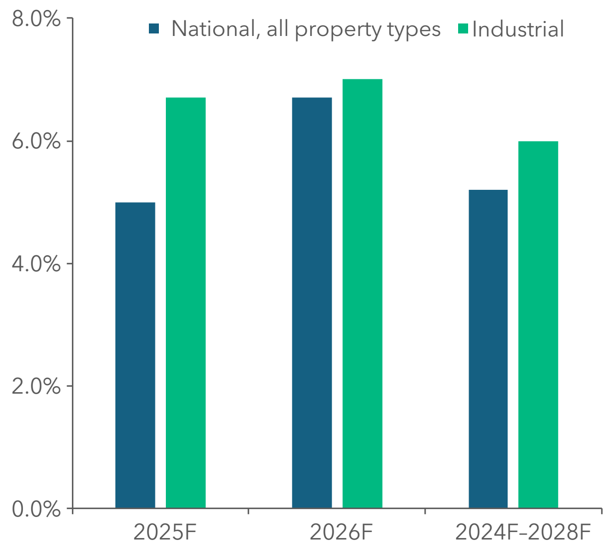
The near-term surge in supply, however, is diminishing rapidly given expensive development financing, higher construction costs, and lengthy entitlement and permitting processes in many jurisdictions. Year-to-date in 2024, NOI and rent growth have remained very strong and are expected to reaccelerate and be above the commercial sector average in the years ahead.[11]

Conclusion: U.S. industrial outlook – likely to outperform from 2024 to 2028

Clarion Partners anticipates industrial will continue to be a top-performing commercial real estate sector due to powerful and durable long-term demand catalysts. It has had an extraordinary decade-long boom with most markets reporting double-digit annualized returns.[12]

Furthermore, the PREA Consensus Survey forecasts that industrial will continue to outperform the major sector average from 2024 to 2028 (Figure 4). The enduring strength of omni-channel consumption in an increasingly interconnected global economy will continue to drive steady demand at new and existing warehouse and distribution properties across the United States.

Figure 4: PREA consensus total return forecast (2024F-2028F)



Note: Major sector average includes apartment, retail, office and industrial.
Sources: PREA, Clarion Partners Investment Research, Q1 2024

[1] Based on expanded NPI data, which includes all NPI properties and all qualified alternative assets; [2] CBRE-EA, Q2 2024; [3] Ibid.; [4] Clarion Partners Investment Research, Q2 2024; [5] CBRE-EA, Q2 2024; [6] Ibid.; [7] Moody's Analytics, Q2 2024; [8] Clarion Partners Investment Research, Q2 2024; [9] Note: IOS is defined as land zoned for industrial outdoor storage of items, such as vehicles, construction equipment, building materials or containers; [10] CBRE-EA, Q1 2024. Note: Based on Q4 2019 to Q1 2024; [11] Clarion Partners Investment Research, CBRE-EA, and Green Street Advisors, June 2024; [12] NCREIF, Q1 2024. Note: More than 60 out of approximately 90 markets reported double-digit returns over three-, five- and 10-year timeframes.

CONTRIBUTORS

Indraneel Karlekar
Managing Director, Global Head of Investment Research

Pedro Niño
Senior Vice President, Investment Research

Julia Laumont
Vice President, Investment Research

CORPORATE CONTACT
Hugh Macdonnell, Head of Client Capital Management
clarionpartners@clarionpartners.com | +1 212-883-2500 | www.clarionpartners.com

CORPORATE OVERVIEW

Clarion Partners has been a leading U.S. real estate investment manager for more than 40 years. Headquartered in New York City, the firm has offices in major markets throughout the United States and Europe. With $74.2 billion in total assets under management as of June 30, 2024, Clarion Partners offers a broad range of both debt and equity real estate strategies across the risk/return spectrum to its approximately 500 domestic and international institutional investors.