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The Bulletin

Amazon-led sell-off: have industrial REITs overreacted?

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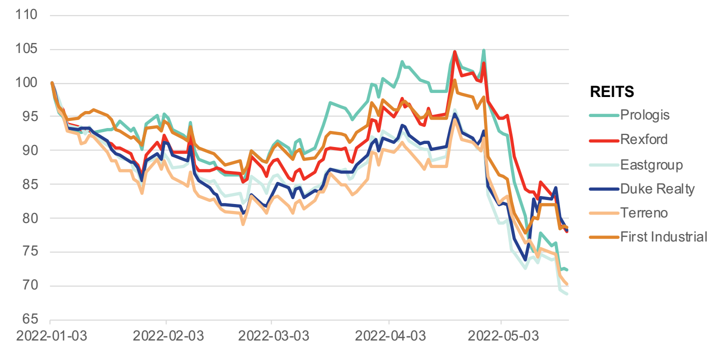
In recent years, Amazon has been an important contributor to the increasing demand for industrial warehouse space in the United States and globally.

However, in its 1Q earnings announcement on April 28, the company commented that it now has excess capacity in its fulfillment network and plans to slow down or delay its capital spending. While this spending could resume at a later stage, it also appears that Amazon might have learned to be more efficient within its current space. Following this announcement, industrial REIT shares fell sharply (Exhibit 1). While Amazon represents an important proportion of industrial leasing demand, the current slowdown is not surprising and growing demand for industrial leasing from other segments should step in to counter this impact.

In addition, supply chain problems have caused customers to shift from 'Just in Time' to 'Just in Case' inventory models, creating a need for an additional 10-15% in buffer stock.

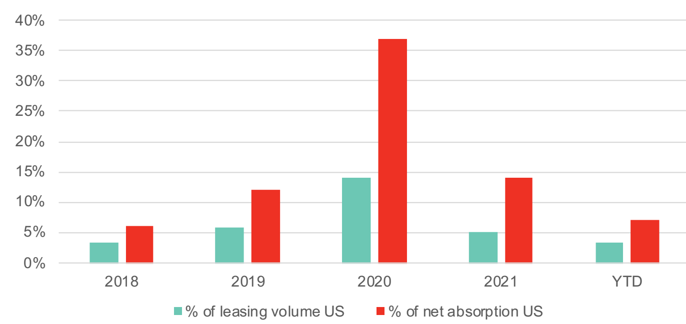
Exhibit 1 : Performance of selected US Industrial REITS



Source: S&P Capital IQ

> We believe that the current sell-off is an over-reaction and that fundamentals remain robust for industrial REITs.

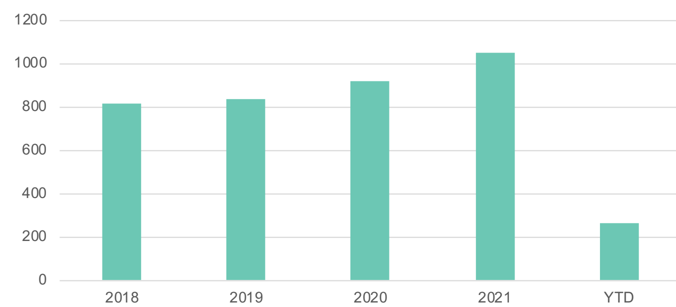
Exhibit 2: Amazon leasing in US as a % of total is significant



Source: JLL, BofA research

Amazon has represented on average 4-5% of total US leasing demand over the last decade (Exhibit 2). The demand went particularly up in 2020 when Amazon represented ~ 13% of total US leasing. This was mainly attributed to a surge in e-commerce demand at the start of the pandemic. In 2021, that number fell back to 5% but remained above the previous decade's average. A slowdown in Amazon demand was therefore already taking place and given excessive leasing during the last two years, a pullback does not come as a surprise to warehouse landlords.

Exhibit 3: US Industrial Total Leasing (Million sqf.)



Source: CoStar, Mizuho Research

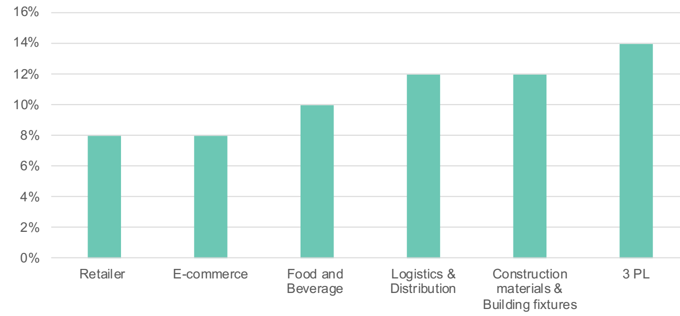
The demand for warehouse space has been growing from sectors other than e-commerce, such as food & beverage, third-party logistics (3PL), construction materials & buildings.

This is evidenced by the fact that overall leasing in the US increased in 2021, despite Amazon cutting its demand by 50% (Exhibit 3). The recently growing demand is also reflected in market rents, which have continued to increase at a relatively fast pace. For instance, market leader Prologis reported a 22% annual rent growth forecast for 2022, revised upwards by 10.3% from 4Q-2021 to 1Q-2022. The record low vacancies coupled with still solid demand outside Amazon mean market rents should continue to increase. The acceleration in market rents has led to differences of up to 50% between in-place and market rents for some assets, according to Prologis' first quarter of 2022 financial results briefing.

This showcases what could be strong internal growth embedded in the company's portfolio to be realized in the coming years

The industrial REITs have also highlighted the fact that demand is broad-based across different categories (Exhibit 4). Another positive factor has come from the supply chain issues.Inventory to sales ratio remains depressed with some sectors, such as food and auto, operating at 40% below the pre-pandemic levels[1]. The net impact has been companies fundamentally building buffer stock, which could mean an additional 10-15% warehouse space requirement[2]. Moreover, the current elevated construction costs and labor challenges add more pressure on the supply side.

Exhibit 4: US warehouse demand by sector



Source: JLL, BofA research

CONCLUSION

To conclude, while the Amazon statement led to a significant negative reaction for industrial REIT shares, we believe the fundamentals remain strong for the near future. REITs are operating at record low vacancy rates, and it would take a significant drop in occupancy levels for the tenants to gain any material negotiating power over rents.

Given the broad-based demand and supply chain issues, we do not forecast a decrease in the market rents, and Industrial REITs should continue to enjoy pricing power which could lead to sustained earnings growth.

REFERENCES

1. Source: GreenStreet Advisors Industrial report 20220304
2. Source: Prologis Q1-2022 earnings call

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