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Corporate Research

Industrial Strength--REITs' Performance Supported by Surging Rents, Strong Demand

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Authors:

Mike Magerman, CFA | Vice President | mike.magerman@morningstar.com | +1 267 960-6022
Chris Wimmer, CFA | Vice President | chris.wimmer@morningstar.com | +1 646 560-4585

Morningstar Perspective

Economic expansion, particularly from e-commerce sales, has fueled demand for warehouse and distribution space, lifting rents and occupancy rates. Nationwide, industrial rents and occupancy have been climbing nonstop. Morningstar Credit Ratings, LLC, which recently initiated coverage of five of the biggest industrial REITs, believes the recent pace of rent growth can't be maintained indefinitely. Nonetheless, key performance benchmarks for industrial REITs should improve over at least the next year or two.

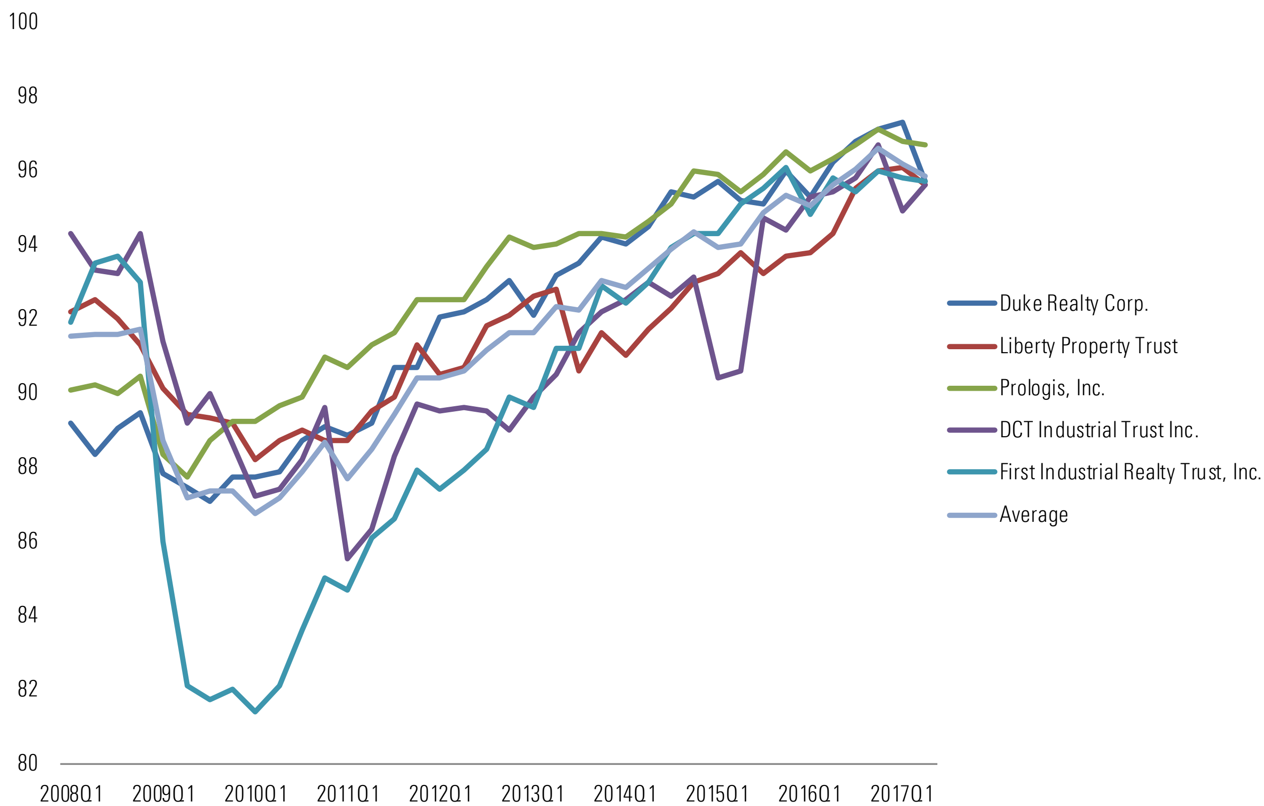
Economic Growth Bolsters Industrial Occupancy

While economic growth has been tepid since the recession ended, it has nonetheless supported demand for industrial space, bolstering occupancy and rents at warehouse and distribution facilities. While industrial rents have climbed for the past five years, for the most recent two years, rents rose 6% or more year over year, according to real estate data provider CoStar Group, Inc. The New York-based research company also reported that occupancy, since hitting a low of 90.1% in 2010, has rebounded, topping 95% in the third quarter, a high not seen in more than three decades.

In a call to discuss third-quarter earnings, Prologis, Inc. CEO Hamid R. Moghadam noted that U.S. market conditions are "very tight," as consumption outpaces available stock. Later in the call he said, "I would say the interest and the desire on the part of tenants to lease space is as high as it's ever been."

As shown in Exhibit 1, average occupancy for the five industrial REITs rated by Morningstar bottomed at 86.8% in 2010. The average occupancy of the five companies climbed to 96.6% by the fourth quarter of 2016, before slipping to 95.9% two quarters later.

Exhibit 1 – Percent of Industrial Space Occupied (Quarterly Data)



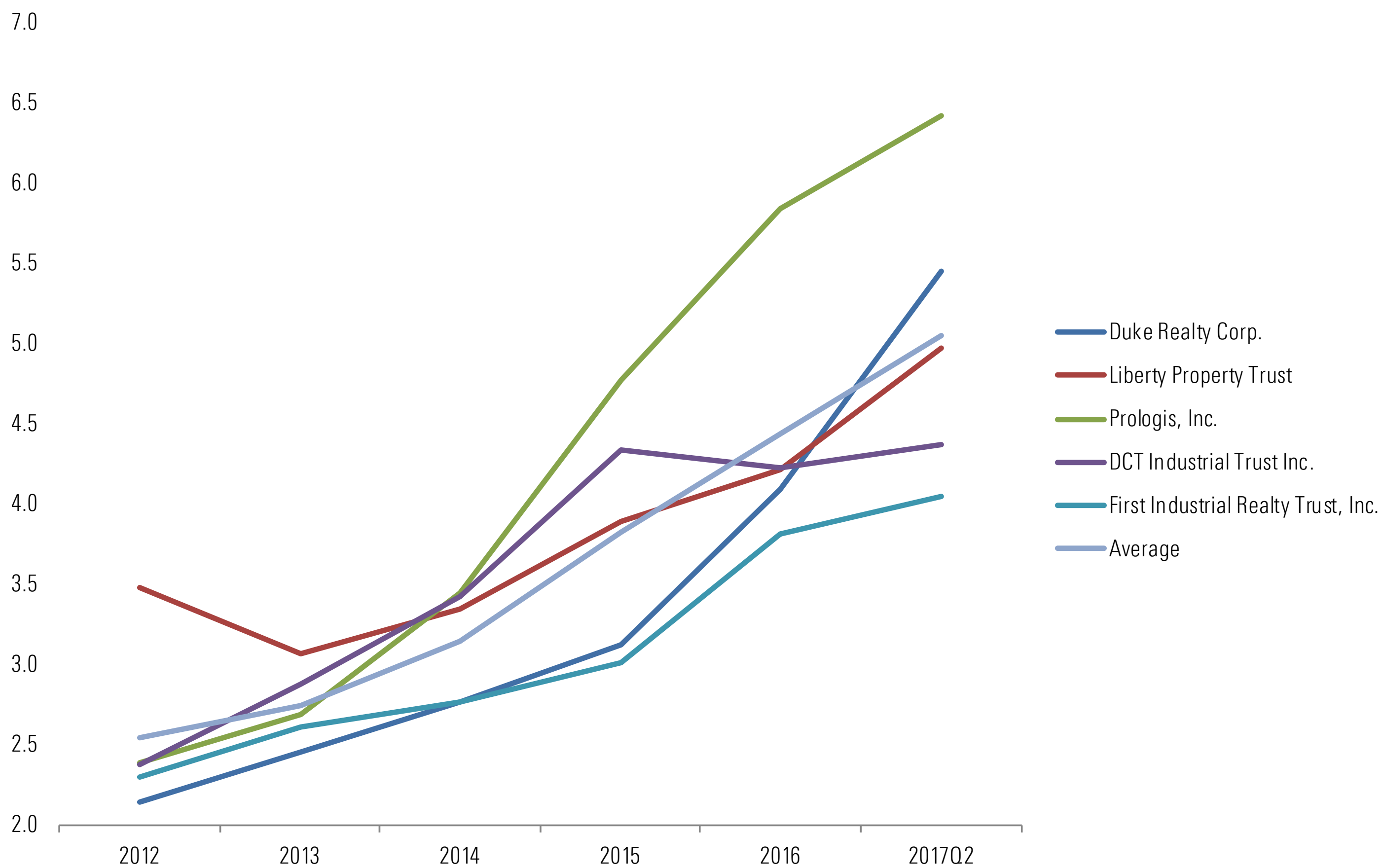
Sources: SNL, the companies, and Morningstar Credit Ratings, LLC

The industrial REITs rated by Morningstar include Chicago-based First Industrial Realty Trust, Inc. (BBB, stable), with more than 64 million square feet of distribution centers and light-industrial space; Denver-based DCT Industrial Trust Inc. (BBB, stable), which owns 74 million square feet; and Indianapolis-based Duke Realty Corp. (BBB+, stable), which owns and operates about 138 million square feet of industrial space. Morningstar also initiated coverage of Liberty Property Trust (BBB, stable), based in the Philadelphia suburb of Malvern, Pennsylvania, which owns 99 million square feet of industrial and office space, and San Francisco-based Prologis (A-, stable), which owns or has investments in about 687 million square feet worldwide. These companies are concentrated in markets near areas with high population density, and many of their properties are near highways, airports, railways, and sea ports.

Performance Indicators Improve

An important performance benchmark, the ratio of earnings before interest, taxes, depreciation, and amortization to interest expense, has strengthened among the five REITs covered by Morningstar. Averaging figures from the five REITs, Morningstar found that this metric, commonly referred to as interest coverage, rose to 5.0 times in the first half of 2017 from 2.5 times in 2012, as shown in Exhibit 2.

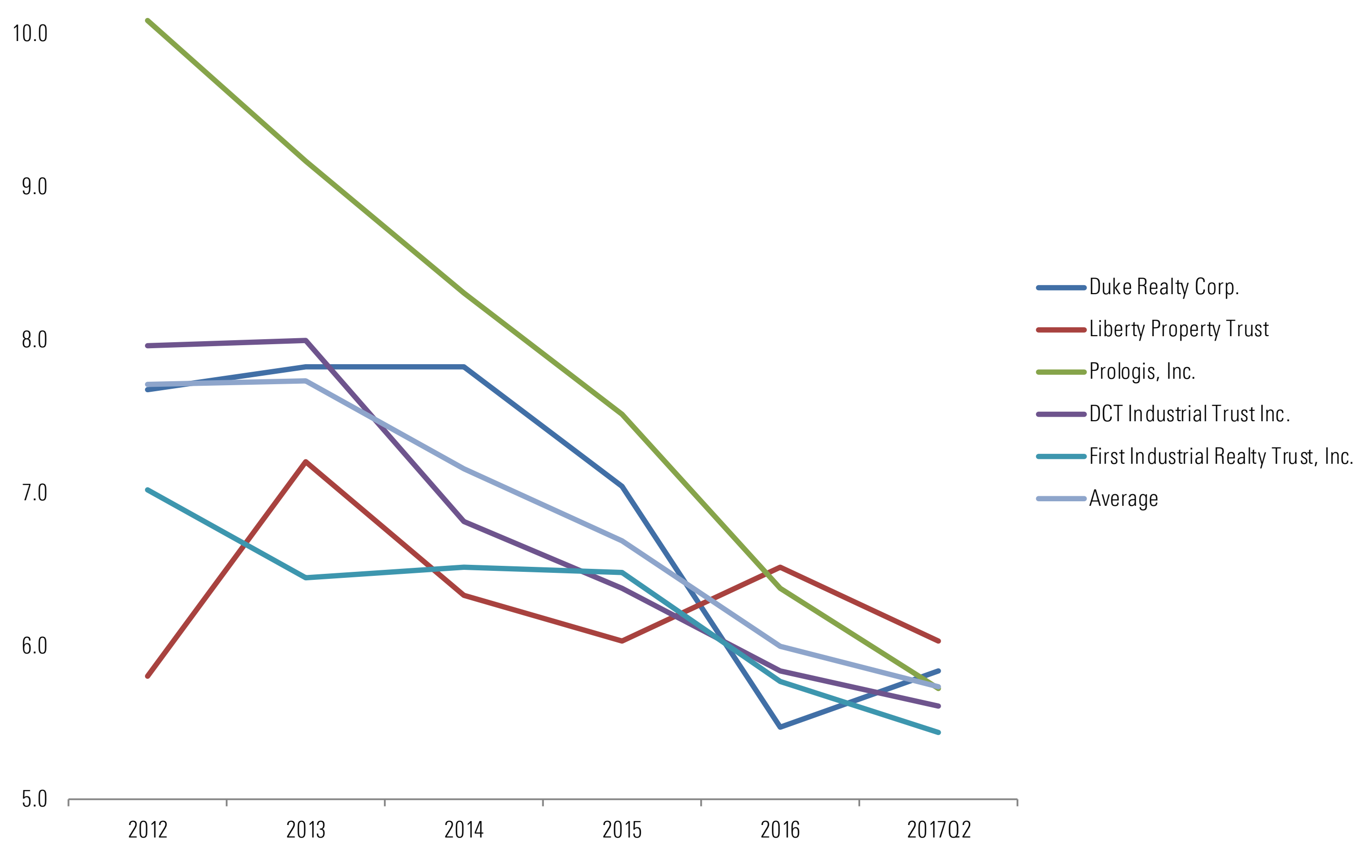
Exhibit 2 – EBITDA/Interest Expense (x)



Sources: SNL, the companies, and Morningstar Credit Ratings, LLC

Separately, leverage, or debt as a multiple of EBITDA, also shifted favorably over the past five years. The average for the five REITs improved to 5.7 times as of June, from 6.0 times in 2016 and 7.7 times in 2012, as shown in Exhibit 3. While Liberty Property Trust experienced deterioration of the ratio in 2013 as it shifted its focus to bolster industrial property holdings and reduce office properties, its debt-to-EBITDA ratio improved to 6.0 times as of the second quarter of 2017, down from 6.5 times six months earlier.

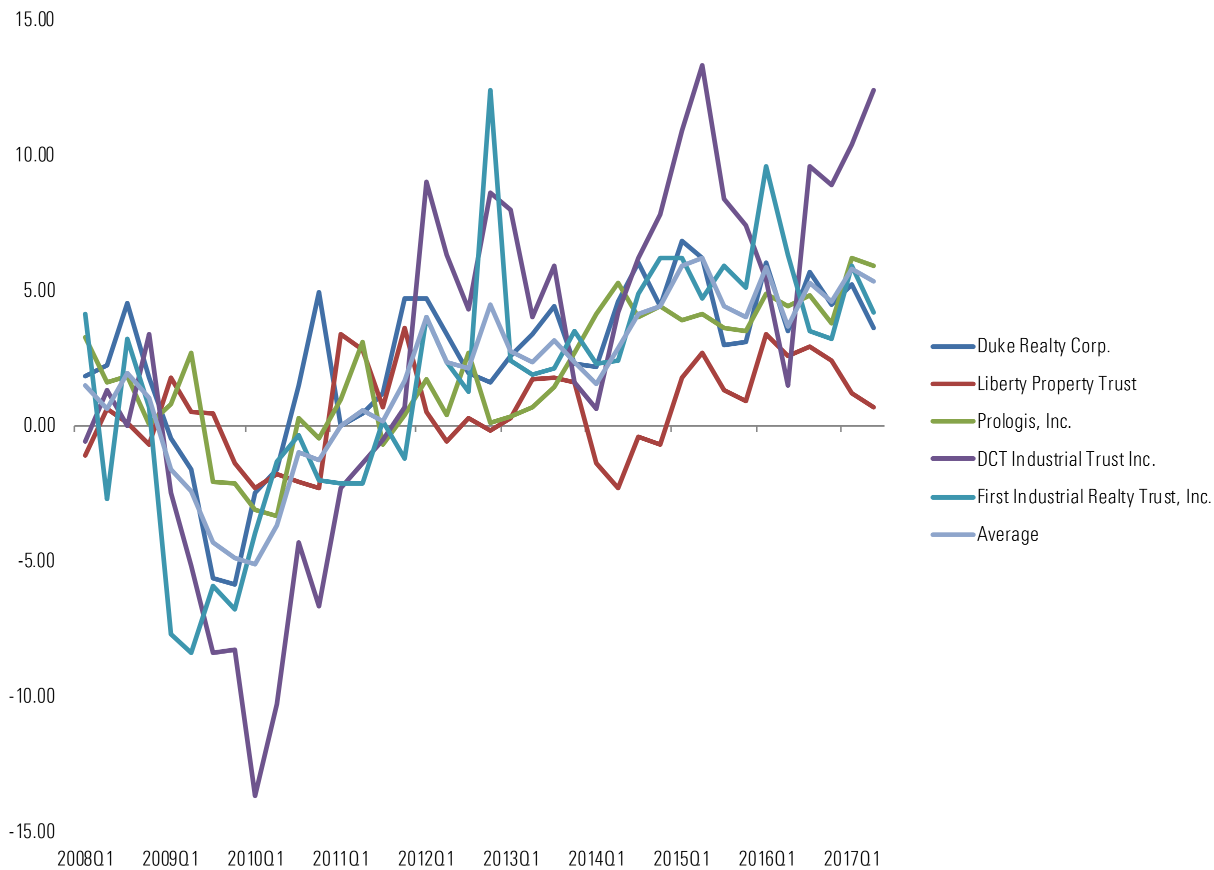
Exhibit 3 – Debt/EBITDA (x)



Sources: SNL, the companies, and Morningstar Credit Ratings, LLC

A third measure commonly used in REIT analysis is same-property net operating income. Same-property NOI provides a useful look at the portfolio's productivity, and year-over-year changes reveal how well the properties are faring in their markets in terms of rent increases. With rare exceptions over the past five years, these five REITs have produced solid year-over-year growth in same-property NOI. The strength in NOI reflects healthy rent gains.

Exhibit 4 – Quarterly Year-Over-Year Percentage Change in Same-Property NOI



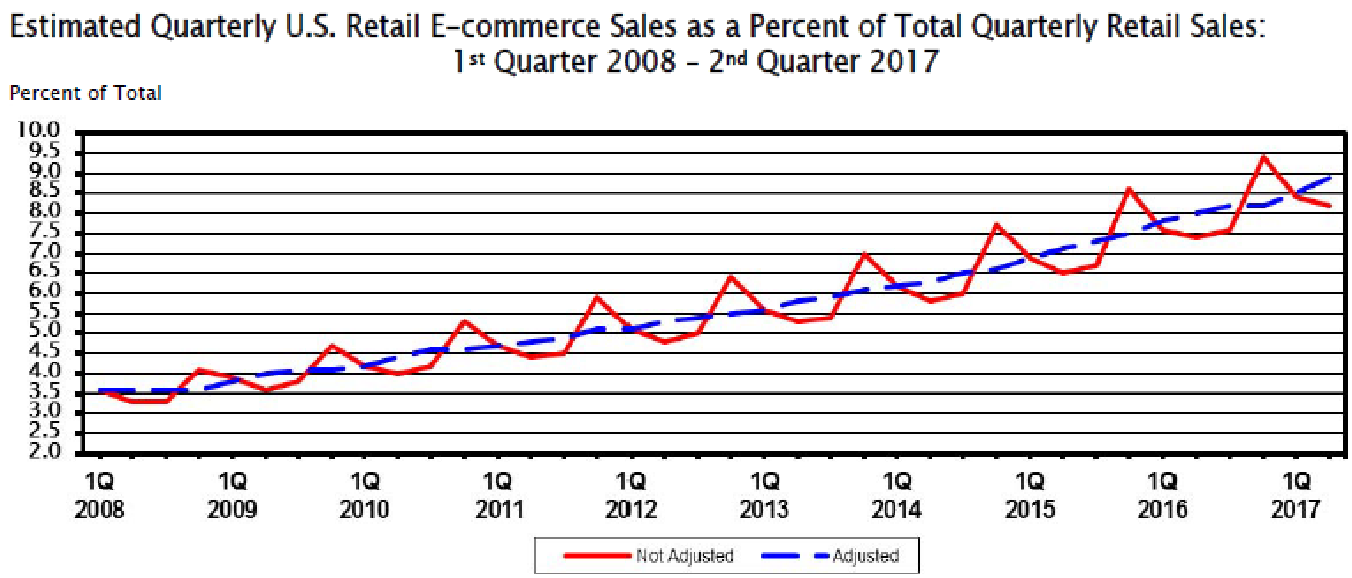
Sources: SNL, the companies, and Morningstar Credit Ratings, LLC

The rate of improvement of these measures, particularly rent, which is a primary driver of property NOI, is unsustainable. We do believe, however, that the level of performance is supportable for the next year or two.

The well-documented rise of e-commerce as a portion of retail sales is a factor, as is the relatively restrained pace of new industrial construction. E-commerce is in large part responsible for the surge in demand for warehouse space. According to the U.S. Census Bureau, sales reported from e-commerce increased to a seasonally adjusted $111.54 billion in the second quarter, up 16.2% from the year-earlier quarter. Furthermore, e-commerce sales as a percentage of total retail sales rose to 8.9% from 8.0% over the same period. Putting this in historical context, in the first quarter of 2008, e-commerce sales represented 3.6% of total retail sales. The growing contribution of e-commerce to total sales has been almost constant, with an increase of roughly a percentage point every two years.

According to an investor presentation by Prologis at the Bank America Merrill Lynch real estate conference in September, every dollar of e-commerce sales requires three times more warehouse space than brick-and-mortar sales.

Exhibit 5 – Quarterly E-Commerce Sales as a Percentage of Total Retail Sales



Source: U.S. Census Bureau

Meanwhile, amid the solid demand, more industrial facilities are being built. More than 335.8 million square feet were completed during 2015 and 2016, adding 3.1% to the year-end 2014 inventory, according to CoStar.

Even with more supply expected over the next two years, we expect net absorption trends to remain positive. Absorption, the total square footage that is leased during a specified time period, is used to measure how the balance between supply and demand affects occupancy. Netted against absorption is the amount of space that is released by tenants because of expiring leases or other circumstances in which leases are terminated, such as a tenant bankruptcy. New building inventory that has not been preleased may be leased during the period when it becomes available. According to CoStar, there has not been a quarter with net negative absorption of industrial space since 2010. As mentioned, while 335.8 million square feet of industrial space were completed in 2015 and 2016, 458.7 million square feet were absorbed. From 2011 through 2016, net absorption exceeded new building additions by 472.3 million square feet, or 76.9%. Morningstar expects demand to remain healthy enough to absorb at least the anticipated additions to distribution space inventory over the next 12 to 24 months.

Economic expansion and the proliferation of online sales have lifted performance metrics of the major industrial REITs. Providers of goods ordered online require a great deal of warehouse and distribution space as part of their logistics infrastructure. The demand for industrial facilities closer to urban areas to reduce delivery times has resulted in tighter occupancy and tremendous rent growth, while absorption trends remain positive. While Morningstar expects rent growth to cool eventually because of new supply chasing strong demand at a time when the economic expansion may be played out, the industrial REITs rated by Morningstar should experience solid operating results for at least the next two years.

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