Industrial REITs

Strong Balance Sheets and E-Commerce Will Support Credit Profiles When the Cycle Turns

Morningstar Credit Ratings, LLC
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Executive Summary

Demand for warehouse space continues to outpace supply. The factors are both cyclical, such as an overall healthy economy supporting strong manufacturing activity, and secular, with e-commerce steadily increasing its share of retail sales. New construction of warehouses has been robust—though not enough to prevent vacancies from reaching cyclical lows, driving solid rental growth above all other property types. Investors of all types have taken notice and increased valuations for the sector. Despite all of this, industrial REIT management teams have been characteristically prudent in their deployment of capital, and we expect them to not only weather the next downturn without incident but also benefit when less disciplined owners of quality industrial assets encounter distress and are forced to make difficult choices.

Exhibit 1: Industrial REITs

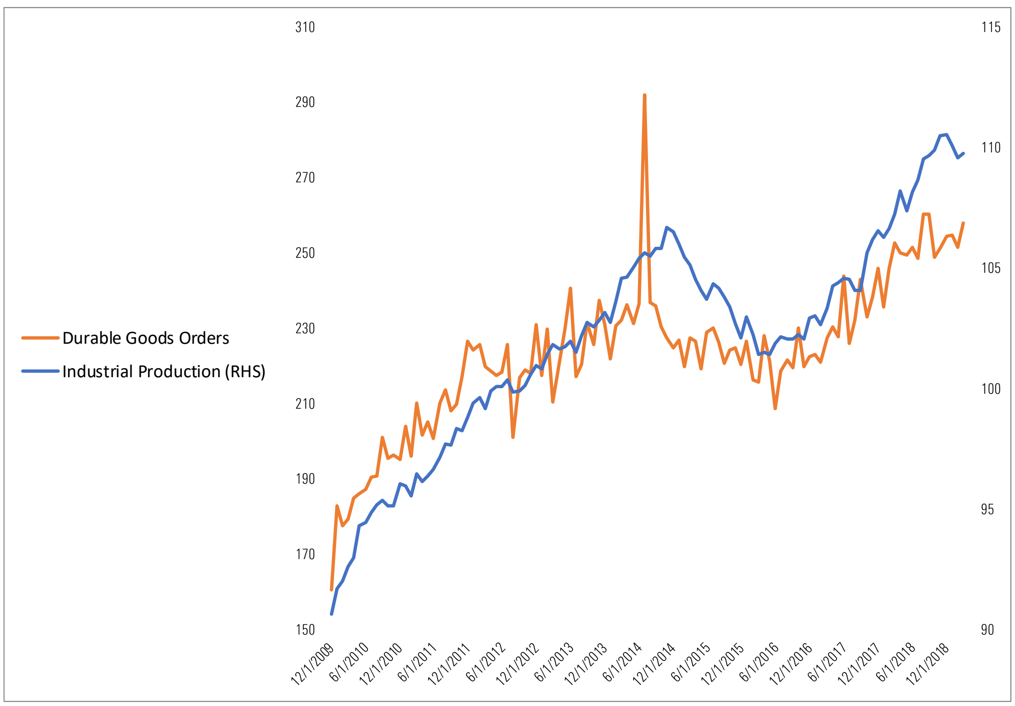
Industrial REIT	Ticker	Headquarters	IPO Date	No. Properties	Square Feet (millions)	Annual EBITDA ($000s)	Gross Assets ($ billions)	Total Debt Outstanding ($ billions)
Duke Realty Corporation	DRE	Indianapolis, IN	10/4/1993	509	146.5	143.3	9.3	2.9
EastGroup Properties, Inc.	EGP	Ridgeland, MS	12/30/1971	380	39.6	55.1	3.0	1.1
First Industrial Realty Trust, Inc.	FR	Chicago, IL	6/23/1994	458	61.8	68.2	4.0	1.3
Liberty Property Trust	LPT	Wayne, PA	6/16/1994	583	103.2	110.8	7.9	3.1
Prologis, Inc.	PLD	San Francisco, CA	11/21/1997	3,466	705.9	731.8	43.3	11.1
STAG Industrial, Inc.	STAG	Boston, MA	4/15/2011	395	78.2	62.5	3.8	1.4
Terreno Realty Corporation	TRNO	San Francisco, CA	2/9/2010	207	12.9	30.2	2.0	0.4
TOTAL				**5,998**	**1,147.9**	**1201.9**	**73.2**	**21.4**
AVERAGE				**857**	**164.0**	**171.7**	**10.5**	**3.1**

Source: the REITs, SNL. Data as of March 31, 2019.

Industrial Demand Drivers

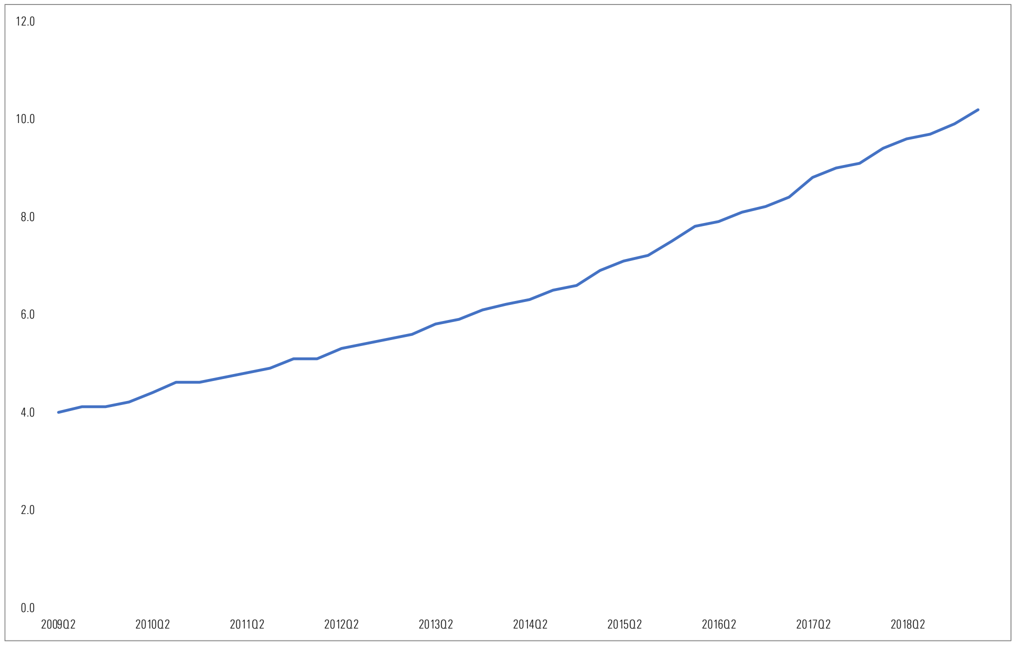
Demand for industrial warehouse space remains significantly elevated, despite the highest levels of newly completed properties in 2017 and 2018 since the end of the recession. Two factors have been key in driving this trend, one cyclical and one secular. Aside from weak investment resulting from the collapse in oil prices in 2014 and 2015, manufacturing activity has been on a rising trajectory over the past 10 years (Exhibit 2). It remains to be seen whether weakness resulting from trade or other international disputes will mark the end of this cycle; it is more a question of "when" rather than "if." The other factor compelling demand is the growth of e-commerce, which represented more than 10% of total retail sales for the first time in the first quarter of 2019 (Exhibit 3). As the retail trade moves online from physical store locations, it requires more space in warehouses, modern varieties of which can require larger buildouts or better locations, often much closer to or within population centers for "last mile" delivery purposes. We anticipate the growth of e-commerce to provide more support to fundamentals when the current cycle loses steam.

Exhibit 2 Durable Goods Orders ($ Billions, SA) and Industrial Production (2012=100, SA)



Industrial Production Source: Board of Governors of the Federal Reserve System (U.S.), Industrial Production Index [INDPRO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/INDPRO, May 20, 2019.
Durable Goods Source: U.S. Census Bureau, Manufacturers' New Orders: Durable Goods [DGORDER], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGORDER, May 20, 2019.

Exhibit 3 E-Commerce Retail Sales as a Percent of Total Sales (SA)

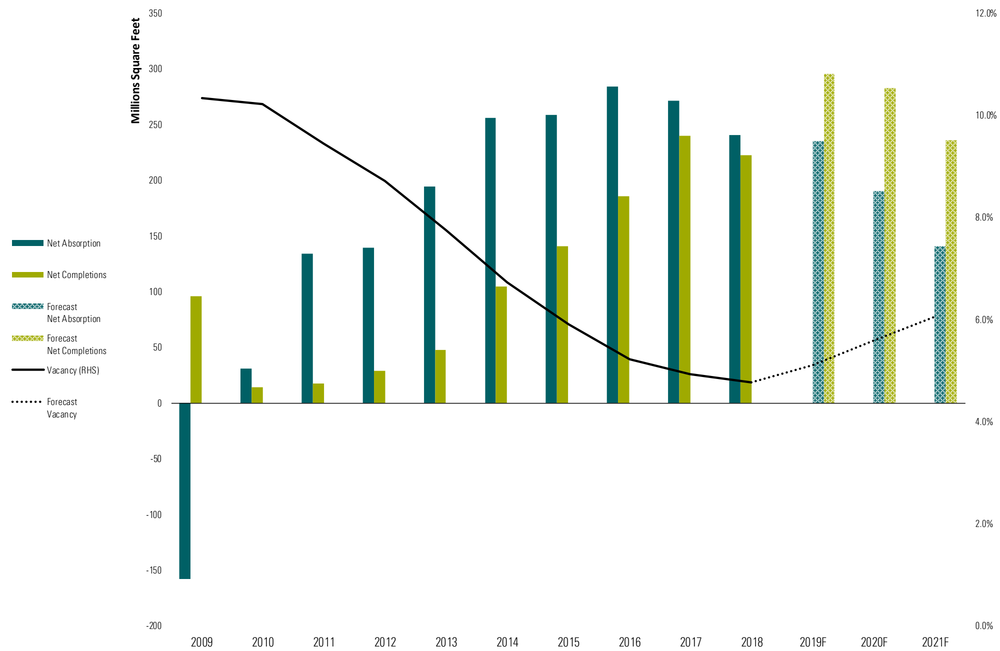


Source: U.S. Census Bureau, E-Commerce Retail Sales as a Percent of Total Sales [ECOMPCTSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ECOMPCTSA, May 20, 2019.

Warehouse Supply and Demand

Since the end of the recession, developers have struggled to keep up with warehouse absorption, which has resulted in vacancy levels that are among the lowest recorded in the sector (Exhibit 4). Between 2009 and 2019, a total of 1.8 billion square feet were absorbed versus a total of only 1.0 billion square feet completed, resulting in a national vacancy rate of only 4.8% and down from 10.3% in 2009, according to CoStar. Confirming these trends, Nareit also notes that the industrial REITs had the highest occupancy rate of any REIT sector in 2018 at 96.2%. CoStar forecasts supply finally beginning to exceed demand and result in increasing vacancies in the coming years, though the robust fundamentals have challenged similar predictions in recent years.

Exhibit 4 Industrial Warehouse Absorptions, Completions, and Vacancies

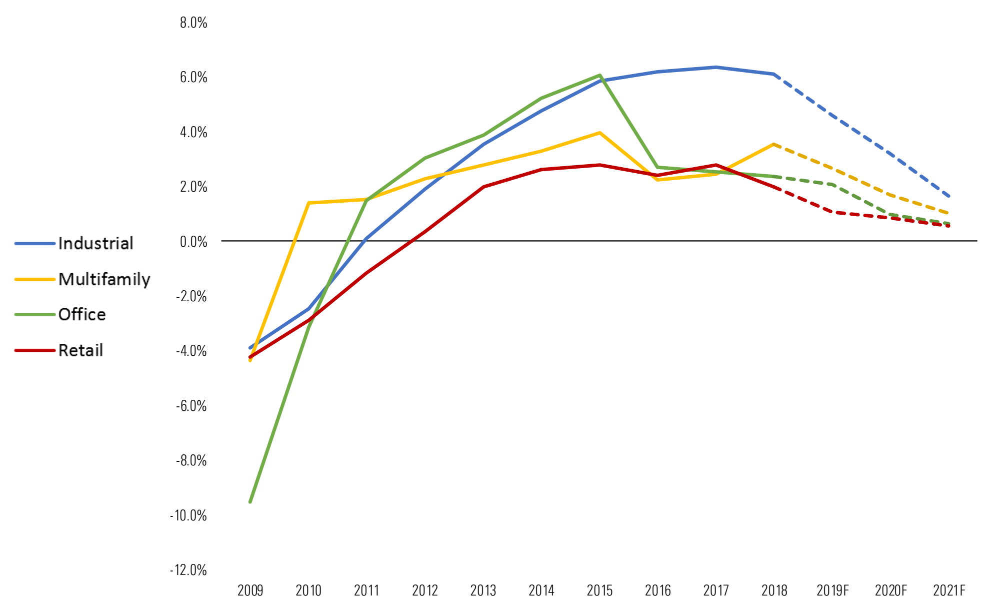


Source: CoStar.

Rental Trends

As a result of the robust fundamentals, warehouse landlords have been enjoying stronger and more consistent growth than their counterparts in other commercial real estate sectors (Exhibit 5). Since 2009, industrial rents have risen annually on average 3.6% and more than 6.0% in each of the last three years. In contrast, the annual average rent growth since 2009 was 2.6% for multifamily, 2.7% for office, and only 1.2% for the challenging retail sector.

Exhibit 5 Commercial Real Estate Rent Growth

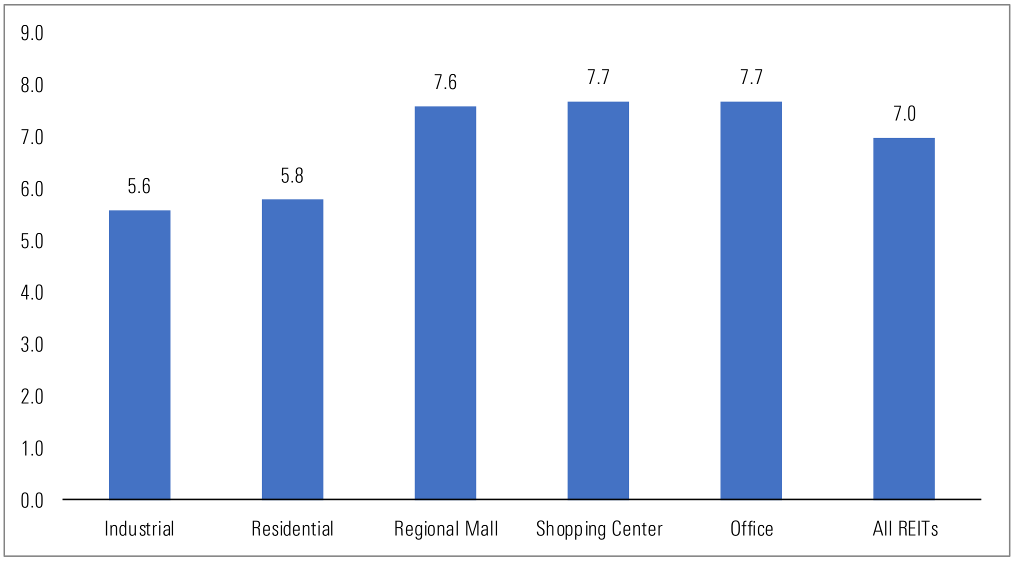


Source: CoStar.

Investor Interest

Investors have demonstrated appreciation for the industrial sector, including foreign investors who traditionally looked to purchase more trophy-like assets in central business district locations. This also includes equity market investors, as demonstrated by the lower implied capitalization rates of industrial REITs (Exhibit 6). Investor preference will result in relatively lower cost capital for owners of warehouses, industrial REITs in particular. Given heightened valuations for existing properties, we expect that the REITs will prefer to employ any newly obtained proceeds for new construction, for which most have in-house expertise and can therefore earn higher risk-adjusted returns.

Exhibit 6 Median Implied Capitalization Rates (%)

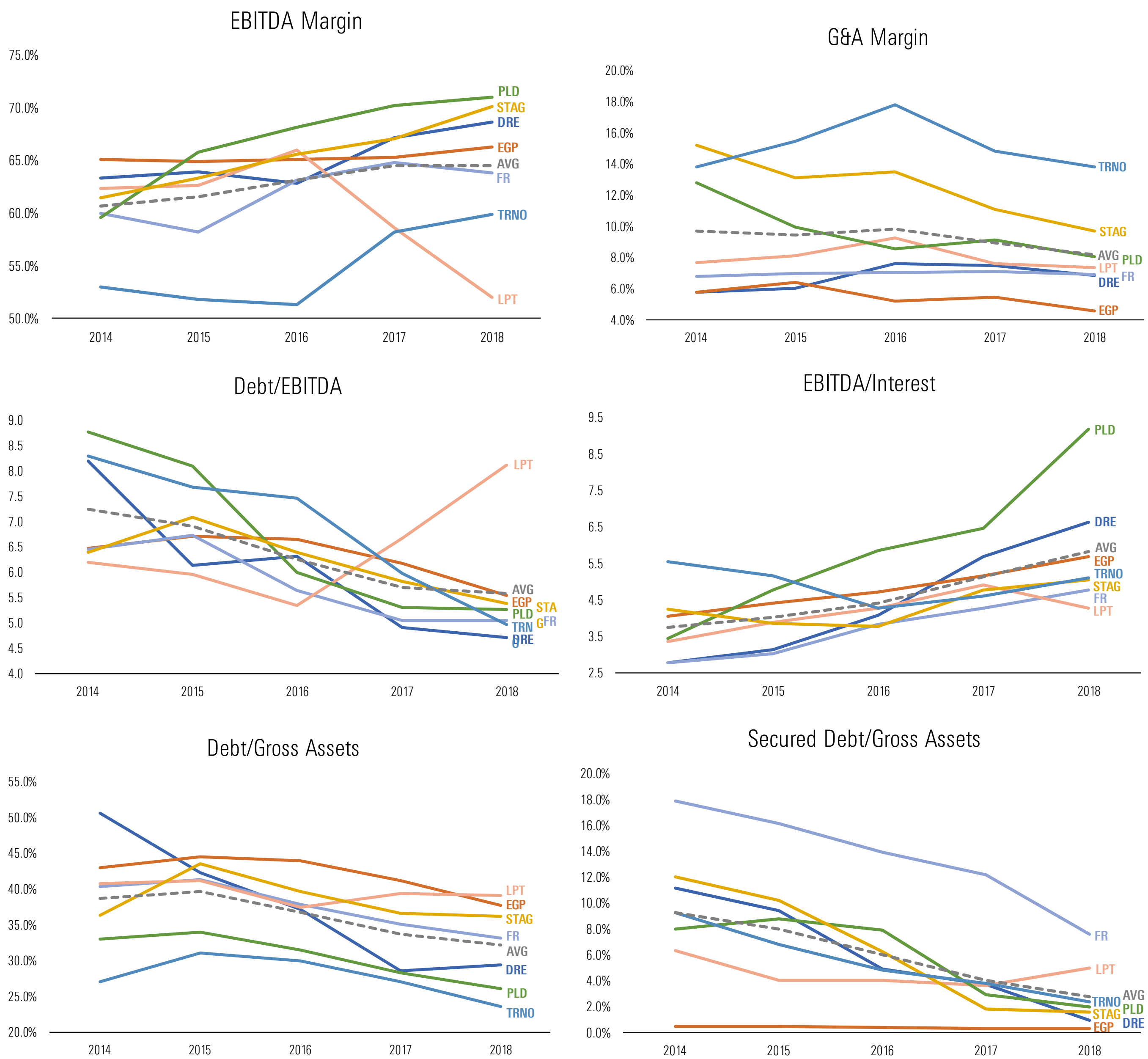


Source: SNL. Data as of May 28, 2019.

Credit Metrics

Over the past five years, industrial REITs have strengthened margins on average with EBITDA margins up to 64.5% in 2018 from 60.7% in 2014, and G&A margins have declined to 8.2% from 9.7% over the same period. Also, since 2014 average debt/EBITDA declined to 5.6 times from 7.3 times and debt/gross assets to 32.1% from 38.7%. Interest coverage improved to 5.8 times from 3.7 times, and secured debt has virtually been eliminated on most balance sheets, implying meaningful alternative liquidity by virtue of robust unencumbered assets (Exhibit 7). It is important to note that while Liberty Property Trust appears to be an outlier, we view this as a result of dispositions as it winds down its office exposure in order to focus on industrial—a credit plus, in our view—and we anticipate metrics to revert in the near to intermediate term.

Exhibit 7 Industrial REIT Historical Credit Metric Trends



Source: the REITs, SNL, Morningstar Credit Ratings, LLC.

Appendix

Exhibit 3 Industrial REIT Peer Comparison

	PLD NR	**DRE** BBB+ Stable	**LPT** BBB Positive	**FR** BBB Stable	**STAG** NR	**EGP** NR	**TRNO** NR	***Average***	***Maximum***	***Minimum***
All values (except per share amounts) in USD Thousands										
Income Statement										
Revenue	3,105,268	841,252	716,745	408,325	363,429	307,388	160,555	*843,280*	*3,105,268*	*160,555*
Property Net Operating Income	1,883,880	601,916	480,296	290,926	291,148	217,422	114,642	*554,319*	*1,883,880*	*114,642*
EBITDA	2,196,714	577,375	391,967	326,576	255,962	203,508	97,034	*578,448*	*2,196,714*	*97,034*
FFO	2,302,233	503,666	329,686	210,215	205,939	169,658	78,856	*542,893*	*2,302,233*	*78,856*
AFFO	1,895,150	439,008	276,489	172,017	188,171	110,418	78,856	*451,444*	*1,895,150*	*78,856*
Balance Sheet										
Gross Assets	43,260,723	9,253,479	7,916,985	3,976,627	3,780,324	2,992,196	2,039,321	*10,459,951*	*43,260,723*	*2,039,321*
Total Debt	11,098,480	2,871,296	3,147,531	1,338,825	1,358,624	1,132,609	443,784	*3,055,878*	*11,098,480*	*443,784*
Secured Debt	953,938	36,896	396,690	222,774	56,109	185,606	45,411	*271,061*	*953,938*	*36,896*
Net Debt + Preferred	10,916,398	2,856,001	3,050,582	1,318,403	1,425,767	1,130,778	384,034	*3,011,709*	*10,916,398*	*384,034*
Three-Year Growth (% YoY)										
Revenue	35.1%	1.0%	-11.8%	10.6%	59.8%	28.1%	63.1%	*26.6%*	*63.1%*	*-11.8%*
Property Net Operating Income	101.0%	46.9%	27.6%	59.5%	98.5%	80.7%	125.7%	*77.1%*	*125.7%*	*27.6%*
EBITDA	45.9%	7.9%	-22.6%	42.0%	79.4%	31.5%	78.8%	*37.6%*	*79.4%*	*-22.6%*
FFO	77.8%	45.9%	-15.1%	79.3%	85.7%	61.7%	158.7%	*70.6%*	*158.7%*	*-15.1%*
Profitability										
NOI Margin	60.7%	71.6%	67.0%	71.2%	80.1%	70.7%	71.4%	*70.4%*	*80.1%*	*60.7%*
G&A Margin	7.9%	6.8%	7.4%	6.5%	9.5%	4.6%	13.9%	*8.1%*	*13.9%*	*4.6%*
EBITDA Margin	70.7%	68.6%	54.7%	80.0%	70.4%	66.2%	60.4%	*67.3%*	*80.0%*	*54.7%*
Coverage / Leverage										
EBITDA / Interest Expense	12.9	8.6	4.7	6.0	5.9	6.0	7.1	*7.3*	*12.9*	*4.7*
Total Debt / EBITDA	5.1	5.0	8.0	4.1	5.3	5.6	4.6	*5.4*	*8.0*	*4.1*
Net Debt + Preferred / EBITDA	5.0	4.9	7.8	4.0	5.6	5.6	4.0	*5.3*	*7.8*	*4.0*
Total Debt / Gross Assets	25.7%	31.0%	39.8%	33.7%	35.9%	37.9%	21.8%	*32.2%*	*39.8%*	*21.8%*
Secured Debt / Gross Assets	2.2%	0.4%	5.0%	5.6%	1.5%	6.2%	2.2%	*3.3%*	*6.2%*	*0.4%*

Source: the REITs, SNL, Morningstar Credit Ratings, LLC. LTM data as of March 31, 2019.

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