Industrial Insights

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This Time Was ACTUALLY Different

By Jared Sullivan

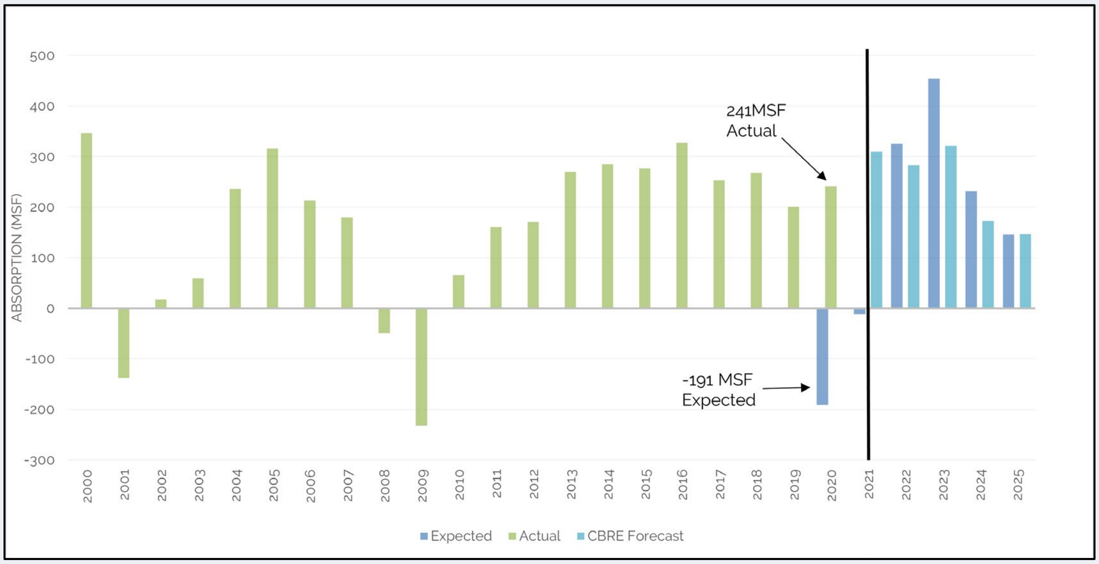
"Nothing is certain in life except death and taxes." This famous quote, attributed to Benjamin Franklin, should also include "economic cycles".

Despite the significant financial innovations and an ever-growing body of knowledge, economies do not expand forever; when the inevitable recession arrives, people lose jobs, businesses close and investments decrease in value. Historically, recessions have led to weakening or outright contracting demand for commercial real estate. As firms close offices, consumers shop less, travelers reduce hotel stays and individuals move out of apartments to save money, every sector of the industry is impacted. While there is always some market participant arguing "this time is different" – often based on the idea that a looming recession will not materialize or will not impact their specific sector – most of the time, they are wrong. When the inevitable recession hits, the market corrects, and pain is felt across the board.

The COVID-19 pandemic struck the world in late 2019, and by the second quarter of 2020, millions of people had lost their jobs, trillions of dollars in wealth had vanished as global stock markets tumbled, and people hunkered down for extended government-mandated lockdowns. Initially, the pandemic-induced recession was like nothing the United States had ever seen, including the Great Depression (which was less severe initially but grew far worse over time, stretching on for years). For the first few months, industrial production and GDP fell considerably faster than it did during the early stages of the Great Depression, while the unemployment rate increased at a faster clip. In February of 2020, over 152 million people were employed in the United States. By April of that year, it was down to just over 130 million. The loss of over 20 million jobs, decreases in stock market values, and increase in overall economic uncertainty caused consumers to quickly pull back. Retail sales plummeted, falling nearly 10% from their peak, and brick and mortar stores, many of which closed their doors at the start of the pandemic, saw sales fall nearly 30% from their pre-recession peak. The magnitude of economic disruption surely should have meant the industrial sector was going to be in for a rough patch, but this time was *actually* different.

I constructed an econometric model to forecast what would have been expected to occur given the severity (and rapid recovery) of the pandemic-

Demand for Warehouses Remained Strong Through the Recession



Source: CBRE Econometric Advisors, Bridge Industrial, 2021 Q1

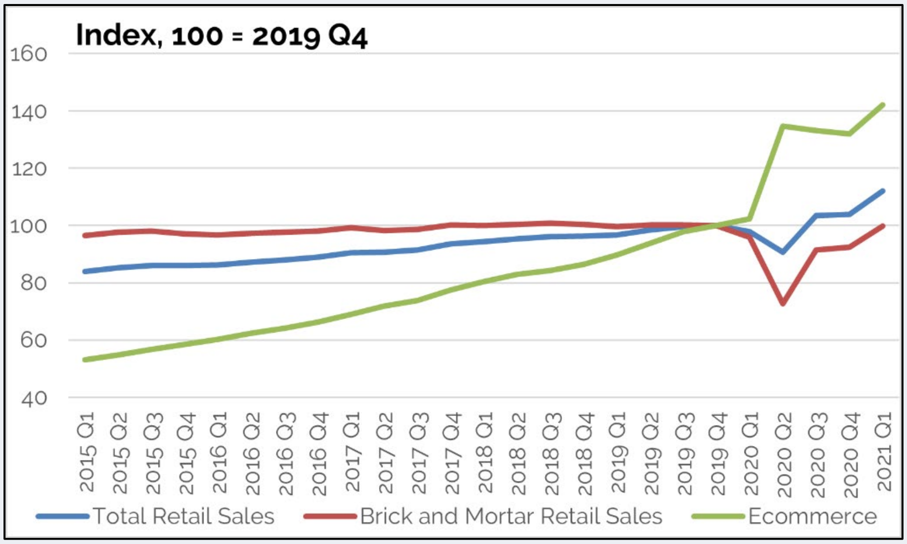
induced recession. Given the sharp drop in employment and corresponding decrease in consumer demand and industrial production, the U.S. industrial sector should have seen around 191 million square feet (MSF) of negative absorption in 2020. The contraction in demand would have spiked the availability rate causing rents to fall between 5-7% peak to trough.

The above chart highlights how this time really was different, with 241 MSF space absorbed last year, an increase from 2019. This strong year for the sector kept the availability rate stable and led to healthy national rent growth of over 3%. The strong performance during the recession stands in stark contrast to other sectors of commercial real estate and caught the eyes of capital market participants. In 2020, investors spent more on industrial real estate than on the office sector for the first time ever, driving up the value of industrial real estate by over 8% according to Real Capital Analytics. This recession clearly treated the sector differently than in past recessions, but why?

As in other recessions before, consumers decreased spending, as retail spending fell 10%. However, the difference this cycle was not whether consumers spent, but where. Ecommerce sales spiked over 30% in the first two quarters of 2020, as malls were forced to close and people, locked down in their homes, did a higher percentage of their shopping online. Ecommerce sales as a share of total retail sales jumped, from 11% at the end of 2019 to 15.7% by 2020 Q2. This rapid increase is what made this time “different”, ultimately saving the industrial sector from rapidly declining demand.

Ecommerce sales impact industrial demand through a couple of different channels. The first and most obvious channel is by shifting sales from stores to warehouses. Increased online shopping requires more warehouses to store the increased share of goods that aren’t being purchased from stores. The second channel Ecommerce impacts industrial demand is less obvious – as warehouses designed to directly serve consumers generally do not store as much product per square foot as a warehouse/distribution center designed to restock stores. Ecommerce companies employ armies of people who walk around picking and packing products to fulfill orders as they are placed online. Those people need space to walk around and quickly find what they are looking for. Rather than

Ecommerce Growth Insulated the Industrial Sector



Source: Federal Reserve Bank of St. Louis, June 2021

racks and racks of a few products stacked on pallets (the way traditional distribution centers designed to restock regional stores are designed), Ecommerce warehouses hold more products, stacked on shelves for warehouse employees to be able to pick and pack quickly. While Ecommerce companies continue to innovate their warehouse designs to store product more efficiently, a warehouse serving customers directly still requires more space per dollar than a warehouse simply restocking local stores.

The good news for the industrial sector is the Ecommerce revolution is a structural change with plenty of room to grow. As of the first quarter of 2021, Ecommerce share of retail sales stood at 13.6% (A slight drop from the recessionary peak as malls reopened). The United States has lower online shopping penetration than many other major economies, with China, South Korea, the UK, Germany, and the European Union all estimated to have higher shares of overall retail sales occurring online. Ecommerce sales will grow faster than retail sales, until the industry matures and then begins to match that of overall retail activity. Looking at current the rate of Ecommerce penetration for the United States and other countries (China has nearly 50% of sales occurring online), at current growth rates it would take over a decade for Ecommerce to mature. This structural change in our economy will continue for years to come. Maybe this will allow the next time to also be different?

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