

DISASTERS MAKE HANDY METAPHORS for the global economic crisis; by this stage in the recession, we've heard a whole range of temperatures describing our plight, from "financial meltdown" to "credit freeze." For the purpose of describing the industrial real estate sector, I've tended to characterize the crisis as "the perfect storm," and we are still at sea, riding it out. Unpredictability is the norm, and forecasting is more hope than science.

Storms do break, however, and even the gloomiest economists agree this one will too, eventually. My purpose is not to analyze weather patterns but to look at the ships that are still at sea, particularly industrial real estate. While certainly making every effort to stay afloat like the others, the industrial property sector is a big ship, equipped with the enduring market drivers, opportunities, and rewards that make it not only a seaworthy vessel but also an ideal investment vehicle for the long haul.

INDUSTRY

Big Ship for

What Makes a Big Ship Big: Industrial Sector Market Drivers

First, the tough and obvious news: Industrial real estate, specifically logistics and distribution space, is just as subject to the crashing waves of current market conditions as any other sector. First- and second-quarter results for the industrial property sector are not gladdening, but not surprising either: Occupancies have declined, and absorption is negative. Most customers simply choose to remain in their current distribution facilities, which is good; but even in doing so, they negotiate longer and harder in hopes of achieving more flexible lease terms, reflecting their own uncertainty.

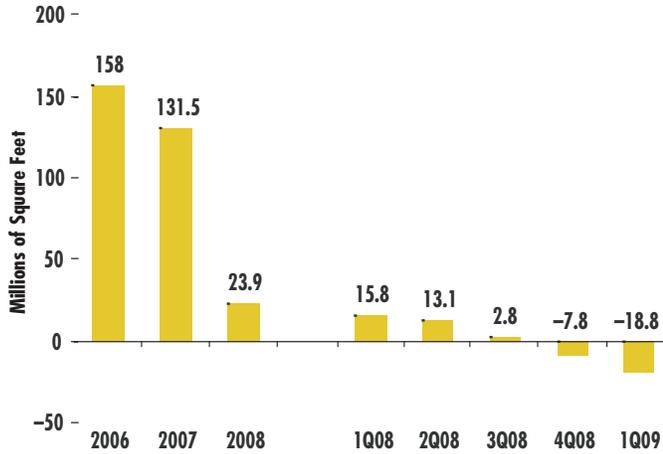


Walter C. Rakowich

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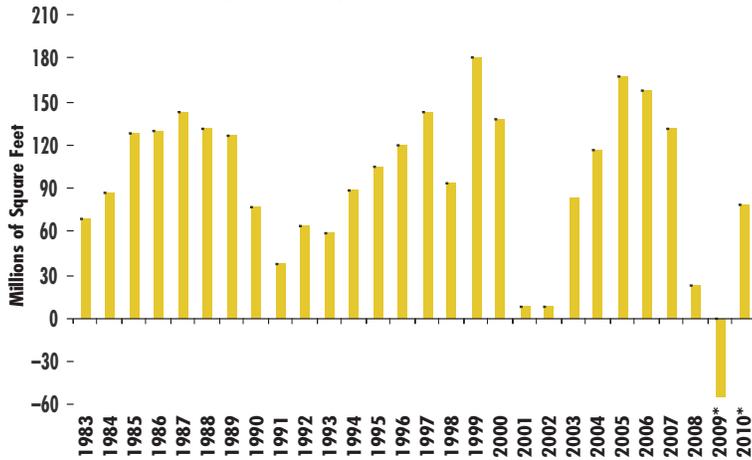


Exhibit 1: Net Bulk Industrial Absorption for the Top 30 U.S. Markets, 2006–1Q09



Source: ProLogis Research

Exhibit 2: Net Industrial Absorption for the Top 30 U.S. Markets, 1983–2008



Source: ProLogis Research

*Projected

Understandably, development has been extremely limited; this does not produce the rising bar charts we were so accustomed to year over year. Exhibit 1 portrays net bulk industrial absorption in the top 30 markets in the United States over the past three years. In terms of volume, absorption has tumbled nearly 180 million square feet in 39 months. Staggering, yes, but sustainable? Not if you trust the history portrayed in Exhibit 2. In the past 25 years, we have never had a full year of negative bulk industrial space absorption. This year may be a notorious record breaker in that regard, but it's very unlikely that the trend will continue for an extended period of time.

Why is that so? I believe it is due to the strong correlation between real GDP growth and growth in occupied warehouse space in the United States (Exhibit 3). If we go back even further, to 1950, we'll find only four periods of negative consumption growth in this country, and we are currently in the midst of one of them. But as long as population continues to grow—and projections put us at 350 million people by 2025—then gross consumption will continue to grow as well, and so will capital spending by businesses serving that growing population base.

The sheer number of consumers is not the only driver of growth of industrial real estate: There's also the proliferation of SKUs, or stock-keeping units, driven by the ever-growing number of choices consumers demand for any given product. Even in down times, competition drives proliferation and diversification, as manufacturers seek to capture market share. All of this complicates and grows the supply chain, and when that happens, that's good news for industrial real estate. In 1972, Toyota offered U.S. consumers essentially one small, economy-minded car: the Corolla. Today, as the world's number one car maker, Toyota offers six—and multiple configurations of each. And Honda is matching Toyota step for step, while Kia, Hyundai, and Daewoo make their "inroads," if you will, into the same segment. And we haven't even considered India's and China's forays, a reality that couldn't have been dreamed of in 1972. For distribution space providers, this kind of proliferation provides a steady business driver.

As long as we're talking about foreign auto manufacturing, let's look at the industrial property sector beyond the United States. In Mexico, the wealth effect



from the expanding middle class, along with the lack of existing buildings, is driving growth independent of GDP growth. The same is true for parts of central Europe, where population growth is flat but incomes are rising and adequate distribution facilities are still scarce. Returning to our automotive example: In 1990, Romanians made and drove one make and model of car: the Dacia. Not one car *company*; one *car*, with no variations. Now central and eastern Europe is the new Detroit, and competition is rising to fill this product void. And ironically, the Dacia is now available in Germany, the veritable epicenter of European automotive excellence—unthinkable even 15 years ago. Product creations and globalization of brands drive the need for distribution space, everywhere in the world. This is not a one-market phenomenon; it is a megatrend.

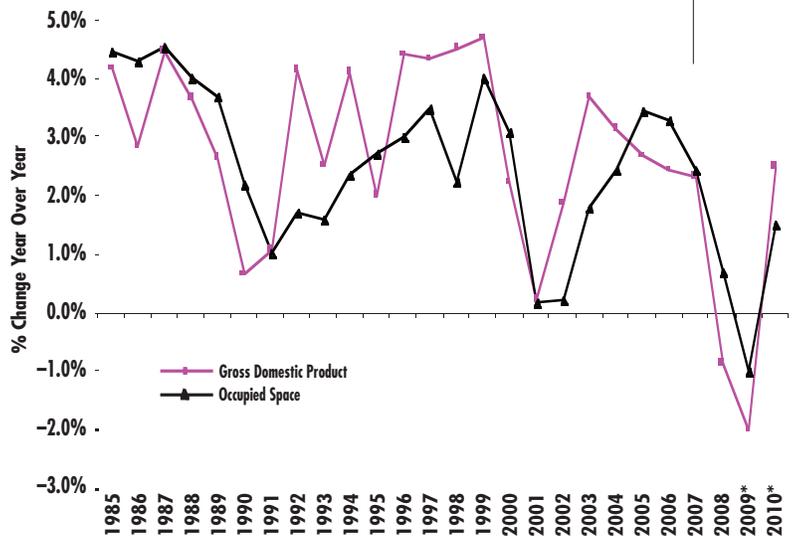
Now let's look at Japan, a country with no real GDP growth in seven years, little room for large-footprint buildings, and zero population growth. How can industrial real estate companies survive and even grow there? Two realities answer this question: The first is decline in ownership; companies are shifting to a leasing business model for their real estate needs, opting to invest their capital into their core products instead. The second reality is functional obsolescence; buildings that sufficed for the postwar boom are not adequate today, and they are gradually being replaced with new, more efficient, and more space-conscious facilities, often six and seven levels high.

These factors do not magically “create” growth in a down economy; rather, they are drivers, long-term trends that are not going away. They indicate that industrial real estate is a big enough ship to weather a passing storm, harsh though it may be.

Big Versus Small Ships: Opportunities and Challenges for Industrial Sector Recovery

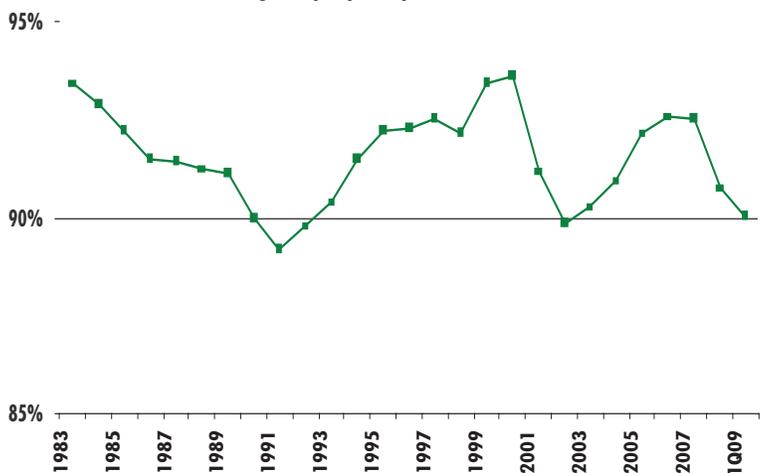
Like other property sectors, industrial must deal with the reality of declining occupancies. The top 30 U.S. markets have reflected a downward trend since mid-2007, currently sitting at approximately 90%. The good news, however, can be seen in the longer view depicted in Exhibit 4: Only twice in the last 25 years has occupancy slipped slightly below the telltale 90% line. In most other property sectors, this would be considered phenomenal. What's the industrial property sector's secret to historically high occupancy?

Exhibit 3: Correlation Between U.S. GDP and Warehouse Space Occupancy



Sources: PPR, ProLogis Research, and Bureau of Economics
*Projected

Exhibit 4: Industrial Market Average Occupancy for Top 30 U.S. Markets, 1983–1Q09



Source: ProLogis Research
*All numbers as of 12/31 except 1Q09

One key to high occupancy is a short construction cycle. With a six-month turnaround from ground breaking to move in, developers of bulk distribution facilities can react quickly to market conditions. When markets turn down, developers can turn off supply very quickly, which is exactly what has happened. Almost all industrial developers essentially halted new development as soon as the economic crisis hit full force, immediately capping supply. Now they are in the midst of leasing up their pipelines. While that negative absorption makes this a challenge, they have two assurances that the gap between supply and demand will close: the return of real GDP growth (particularly key in the United States, Canada, and the United Kingdom) and another factor I have already alluded to that works for developers while they sleep: building obsolescence.

Exhibit 5 shows the results of halting development at the end of 2008: In the first quarter of this year, only 1.6 million square feet of new building was started in the top 30 U.S. industrial markets (rounded to 2 million here). This figure will not likely exceed 10 million for 2009—a dramatically low number for the United States; we have not seen this few starts since 1983. But this is one down-stepped bar chart that should actually bring a smile to investors, once they do the math.

The U.S. marketplace has 6 to 7 billion square feet of industrial space. The current obsolescence rate is 1% to 2% per annum. That means pure obsolescence will drive annual demand of 60 to 120 million square feet of space just in the United States. There's been only one other time in recent history when deliveries have been less than 1% of stock; this creates a steeply undersupplied situation. Over time, I believe that demand will continue for the reasons I have previously stated, and when it does, growth will continue in the industrial sector.

Here's where my analogy to big ships happily breaks down. Normally, one would think that large vessels are more difficult to turn than small ones; therefore, industrial real estate developers cannot quickly respond to market conditions. But that is not actually the case. By righting the supply-demand ratios, whether actively (through market rents and economic growth) or passively

(through passage of time and building obsolescence), industrial property shows itself to be a sturdy vessel for investment.

What's in It for Big-Ship Passengers: Industrial Sector Risk and Reward

Knowing that the perfect storm will someday clear, we need to look at how today's situation provides opportunity for investors to take a relatively low level of risk now and reap substantial reward when markets recover. First, industrial real estate has a very attractive entry point for investors at the moment. Whether investing directly in industrial real estate through a trusted investment manager or in industrial companies through publicly traded equity, investors will find valuations are extremely low. As Exhibit 6 shows, spreads between capitalization rates and the ten-year Treasury bill are at historic highs. In addition, cap rate increases in the last 18 to 24 months have been dramatic, as seen in Exhibit 7. While there is disagreement as to how much, or indeed whether, cap rates will rise further, most pundits agree that industrial properties are valued at significant discounts relative to their underlying replacement costs. Not only is industrial property a big ship, but right now the boarding passes are at bargain prices.

A few other factors make the bulk industrial property sector attractive to investors. Unlike the other commercial property sectors, distribution facilities have high tenant retention, with only 4% to 5% in annual turnover. And when buildings do change customers, the relatively small amount of interior finish (5% to 7%) means lower costs in preparing the space for new tenants, as well as low ongoing capital maintenance costs. Furthermore, most industrial properties have triple-net leases, which means that the vast majority of increases in taxes, utilities, and insurance are passed on to customers. All these factors combined contribute to a higher level of certainty and consistency of cash flow as compared to other property sectors.

Finally, there's one more rise I expect in the industrial property sector: the return of rising rental rates. This may seem to be a surprising expectation during a current market of depressed rent levels, but I see more than just demand eventually



driving lease rates higher; it's also a market force I'll call "development reluctance." In response to soft market conditions, developers are on the sidelines today. But when demand returns, there will be a sizable gap between current market rents and the projected rents needed to achieve a level of return high enough to exceed today's cap rates and generate a profit. Either construction costs will need to substantially decline, or rents will need to rise before developers will again take development risk. I think a combination of both will occur. Eventually, obsolescence and demand will create enough pressure for this to happen over the long term.

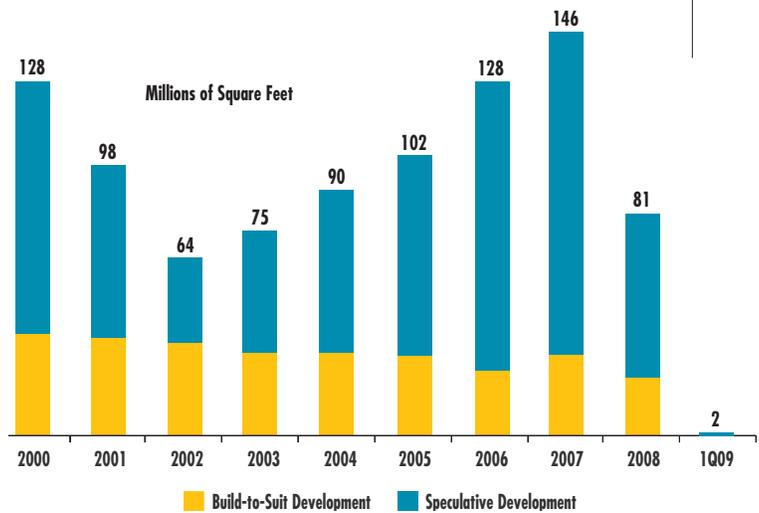
Storm-Tested and Seaworthy

In conclusion, I'd like to focus on why big ships cross daunting oceans every day. If we spoke with the captains of these vessels, I'm sure they could tell us stories of storms that would make our hair stand on end. They consider storms on the high seas part of the job, and practically all those ships make it to their destinations time after time. Why? Precisely because they *are* big ships, with large payloads designed for long voyages with no frills. The captains of these ships don't have to worry about scenery or comfort; their only goal is delivery, on time and on target. Little else matters.

That's precisely how I view industrial real estate as an investment vehicle. In my mind, it is one of the safest places to invest large sums destined for a specific goal. Of course, no one can rule out cap-sizing, but if you had to size up the likelihood of a successful transatlantic voyage, I'd put my money on a freighter every time. This is what they do. And by analogy, this is what industrial real estate does, cycle after cycle. It's built on stable global demand drivers, and it can respond to market conditions surprisingly quickly. It is straightforward, comprehensible, and relatively predictable. And for those who invest in industrial real estate companies that are globally positioned to take advantage of market activity in any geography or industry, the rewards will be there in the long term, when the ship makes port. ■

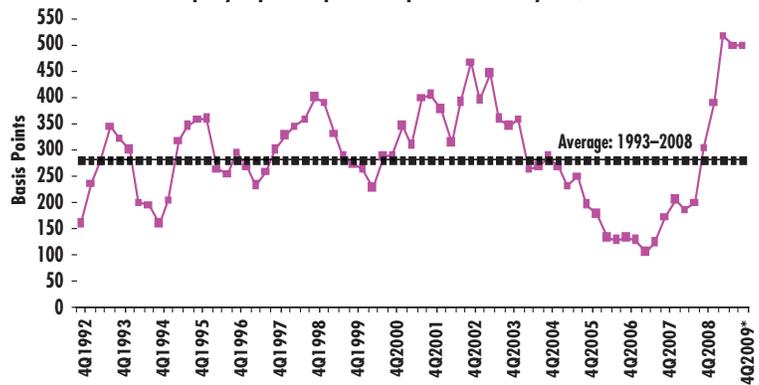
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Exhibit 5: New Bulk Industrial Starts in the Top 30 U.S. Markets, 2000–1Q09



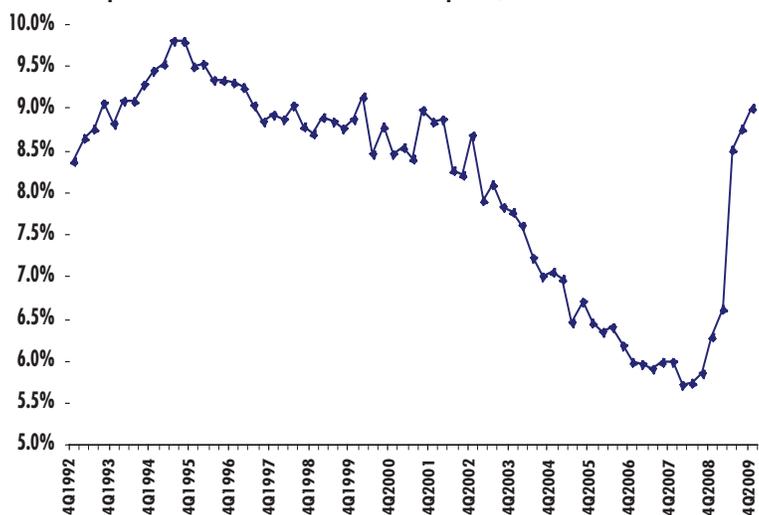
Source: ProLogis Research

Exhibit 6: Industrial Property Cap Rate Spread Compared to Treasury Bills, 1992–2009



Source: ProLogis Research
*Projected

Exhibit 7: Cap Rate for Institutional-Grade Industrial Properties, 1992–2009



Sources: NCREIF and ProLogis Research
Note: Cap rates for 2Q09, 3Q09, and 4Q09 are projections.