BGO Strategic Capital Partners

Real Estate Market Reflections

Global Opportunity Spotlight: Light Industrial

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In recent quarters, light industrial has begun surfacing on investors' radar screens as a complement to big box warehouse exposure. BGO SCP has been investing in this industrial sub-sector since 2016, and we believe light industrial is a great way to access well-located, infill real estate with a diversified tenant base whose small businesses are the backbone of so many global economies. We're buying at a valuation / basis that we believe is more attractive than highly competitive big box distribution centers and continue to believe that structural and cyclical opportunities abound for light industrial. This is an area where we think we can access institutional, infill real estate where historic default rates are below average across all sectors (e.g., our largest light industrial manager has a portfolio default rate consistently below 1%) and where we think we can often exit below replacement cost.

We continue to believe that structural and cyclical opportunities abound for light industrial

What is Light Industrial?

Light industrial buildings typically fall below 100,000sf and provide mission-critical real estate solutions for tenants that prioritize infill locations with high population density. Tenant suite sizes typically range from 2,000sf–50,000sf. Our definition of the light industrial sector includes the following sub-sectors:

- **Small Bay Business Parks**: Assets typically consist of multiple flexibly configured, smaller warehouses demised into smaller units that cater to various industries, including light manufacturing, logistics and service-based businesses.
- **Last Mile Logistics**: The final step in the supply chain process, where goods are transported from a transportation hub to their final destination, typically the customer's doorstep.
- **Light Manufacturing**: Structures specifically designed to produce goods that require less intensive industrial processes. These buildings typically support activities such as assembly, fabrication and the light processing of materials.
- **IOS (Industrial Outdoor Storage)**: Designated rentable areas where businesses can store large equipment, materials or products outside of a building, typically in an industrial or commercial setting. This type of storage is often used for items such as machinery, vehicles, construction materials and bulk inventory.

With building sizes smaller than the bulk distribution sector (assets 500,000sf or greater) where vacancy rates are higher, light industrial assets target a significantly different tenant profile. These are often multi-tenant buildings with a tenant base that includes local builders, small, advanced manufacturers, last mile third party logistics firms and sometimes, tenants run retail operations from their leased space, although retail is usually a small portion of operating income. Small bay space was designed to allow expansion by adding bays to an existing tenant's unit or moving a tenant into a different size unit in the property, optimizing occupancy. Flexibility is the key. Manufacturing is typically limited to light manufacturing and / or assembly. Light industrial assets are ubiquitous in dense markets.

Why is it attractive?

Strong demand / high occupancy: Demand for all industrial sectors exploded with the growth of e-commerce, reshoring and the post-pandemic increase in inventories. As a result, market rent for U.S. industrial product has grown 55% since 2017 and national vacancy remains in the single digits, despite 14% aggregate inventory growth over the same period (CoStar, October 2024). Light industrial demand drivers have proven resilient through both the pandemic and the GFC. Especially for light manufacturing and small tenants, their leased space is often "mission critical" to their businesses. In other words, even in the event of bankruptcy, we believe the tenant will not reject their lease in their most important facility, an asset that is integral to the ongoing operation of the tenant's business. Landlords' ability to negotiate well above CPI rent growth lease terms (as much as 4.5% per CWK transaction data as of Q4 2023) is more evidence of the favorable position in which light industrial landlords find themselves today. According to a small bay industrial market study published by Commercial Observer in September 2024, the post-COVID growth of startups, especially in technology, has produced a corresponding increase in demand for light industrial buildings. 3D printing businesses, biotechnology, robotics and highly specialized small scale manufacturing businesses also need light industrial space. Additionally, consumers' increasing demand for shorter delivery times has driven demand for infill / last mile buildings that are closer to consumers. Continued urbanization also drives light industrial demand.

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Hard to recreate in-fill land: Light industrial's historically high occupancy has also been due, in part, to the limited development of small bay space which CoStar estimates accounts for just 12% of U.S. construction activity, despite being 36% of existing inventory. Not only is current availability limited, but future development is severely limited due to barriers to entry. There is little new supply since the highest and best use for infill industrial land is usually distribution that has higher land coverage area and therefore, more rentable square feet. Accordingly, the stock of U.S. industrial properties under 100,000sf has grown by approximately 2% over the past 5 years, while the stock of properties larger than 100,000sf has grown by approximately 16% (CoStar, February 2024). It is also hard to find infill parcels that are large enough to build an institutional size asset. NIMBYism and highly scrutinized entitlements are additional barriers (Newmark, May 2024).

"Mom & Pops": Light industrial ownership is quite fragmented with approximately 75% of the market in non-institutional hands (JLL, February 2021). Typically, there is built-in upside buying from non-institutional owners, many of whom are not local and hire third party leasing and management in a sector with high operating requirements.

Tenant diversification: Similar to multifamily, a light industrial portfolio provides access to many tenants across many industries, and can add geographic diversification. Having a large rent roll also smooths out property cashflow with no single tenant typically putting property net income at material risk.

High barriers to entry: The barriers to entry for light industrial include the physical impediments to building in locations with little vacant land. However, particularly in multi-tenant small bay business parks, there are also operational impediments to success. Owners need to be vertically integrated, including leasing. Owners need to know their tenants, since a renewal is almost always cheaper for the landlord than having to find a new tenant due to downtime and higher leasing and buildout costs for new tenants. Asset management technology, including leasing and construction systems is an important part of the formula.

Medium-term Leases: Three-to-five-year leases allow mark-to-market opportunities on leases, particularly for those assets which have been under-managed by "Mom & Pop" owners. Conversely, these leases are long enough for institutional buyers.

Valuation: Historically, the light industrial sector enjoyed more attractive rental yields (higher cap rates) given the perceived risk around this asset class (Newmark, May 2024). While this valuation premium eroded in more developed markets in the U.S., on a global basis, attractive opportunities exist where the industrial trend lags the U.S.

Macro: Due to the imbalance in light industrial's supply / demand characteristics in favor of landlords, institutional ownership of light industrial is growing. In the U.S. alone, trailing twelve-month transaction volume was $30B and the average transaction cap rate is 6.6% compared to pre-COVID averages (Q1 2014 – Q4 2019) of $21.7B and 6.9% for light industrial assets (RCA Data, October 2024). BGO SCP is of the view that we are in the early stages of the "institutionalization" of light industrial.

Risks

- **Management-Intensive**: Having lots of tenants necessitates having the associated tenant management skills. Additionally, this is a very local business, requiring experience and a willingness to commit resources to understand micro-markets.
- **Credit Risk**: Typically there is more exposure to less-than-investment-grade tenants. However, as noted previously, default risk is lower than expected due to the mission critical nature of these units for their tenants.
- **Deferred Capital Expenses**: Light industrial assets tend to be older, increasing the chances of required capital work. Roofs are an area of particular risk for capital needs.

Opportunities

United States

While some institutional investors are gradually shifting their attention toward light industrial, given the challenges in sourcing and scaling, most major players have remained invested solely in large bulk assets. With major industrial markets in the U.S. seeing rental growth of 41%-73% from 2021-2023 (Greenstreet, October 2024), there is a significant opportunity to re-gear the leases of these small tenant properties. Converting obsolete retail spaces into light industrial properties is gaining traction, particularly in urban markets. The aggregation of smaller assets to create an institutional size portfolio typically provides a premium. (i.e., the whole is worth more than the sum of the parts.)

With the exception of Japan, global country / regional level GDP is forecasted to increase from the recent cyclical low. According to the IMF, advanced economies' GDP growth is forecast to increase from 1.6% in 2023 to 1.7% in 2024 and 1.8% in 2025. U.S. GDP is forecasted to grow from 2.5% in 2023 to 2.7% in 2024 and 1.9% in 2025. Continental Europe's GDP growth is more modest, but still positive (International Monetary Fund, April 2024).

Europe

The European light industrial market has been resilient and compelling amid economic challenges. Last mile logistics (also called urban logistics) assets, typically located close to city centers, are in high demand due to stringent European planning regimes that limit new supply. Urban logistics rents have grown at a 2-year CAGR of 11.6% in the EU, compared to 5.7% for big box logistics assets (CBRE Erix Data, Q4 2023).

The closest form to U.S. small bay in Europe and developed UK is multi-let industrial (MLI) assets which cater to smaller tenants, like online retailers, technology, high-tech manufacturing and B2C industries. MLI tenants are often less price-sensitive, as rent typically accounts for less than 4% of their annual gross income (Representative Tenant Operating Costs, Cushman & Wakefield).

Finally, in Europe, and the UK in particular, the industrial outdoor storage (IOS) sector is in an emerging stage of its institutionalization and has increasingly become an investable sub-segment of the broader Industrial market. The yield difference between IOS and overall logistics assets is slowly decreasing, and some argue they will converge in the medium term. In our view, investors drawn to portfolio aggregation strategies in Europe for industrial assets in the 5,000-50,000sf range (whether Last Mile logistics, MLI, or IOS) can unlock value through economies of scale and potential portfolio premiums upon exit. For example, in Spain, only one modern, institutional portfolio has come to market in the past three years, highlighting the scarcity of well-constructed portfolios (NW1, Oct. 2024). Lastly, the light industrial sector in Europe is increasingly incorporating sustainability requirements of investing.

- United Kingdom: The UK market offers ample opportunities to pursue an urban logistics strategy in the South East (London and M25 metros), the Golden Triangle and other key nodes. We particularly favor an IOS strategy in Greater London and around Manchester / Birmingham, while MLI assets can be attractive in consolidated urban areas of the UK's major cities.

- Spain: The Spanish logistics and light industrial market, focusing on urban and mid-box assets, presents attractive opportunities due to high barriers to entry and scarcity of modern, high-quality assets. Key hubs include Madrid, Barcelona, and Valencia, with significant demand from 3PLs and e-commerce operators. (Barcelona vacancy continues to be sub-2%) (BNP Paribas, Q2 2024). Land scarcity and challenges in acquiring sites from private land-owning families make sourcing capabilities crucial for investors. The market favors portfolio aggregation strategies with potential for achieving a portfolio premium upon exit.

- Nordics: The Nordic light industrial market, particularly in Sweden and Finland, offers strong fundamentals and attractive investment opportunities driven by advanced digital infrastructure and a growing e-commerce sector. Urban logistics facilities are in high demand, especially in major cities like Stockholm, Helsinki and Copenhagen. Strong rental growth potential, with industrial stock per capita in Europe more than 5x lower than in the U.S., further enhance the sector's appeal (CBRE Data, February 2024). Investors are particularly drawn to portfolio aggregation strategies in key logistics corridors with a strong emphasis on ESG considerations.

Asia Pacific

With the industrial sector only emerging as an institutional asset class in the past ten years, investor focus has been squarely on the development and acquisition of large, bulk industrial warehouses. While the global arbitrage on Asian large industrial warehouses has largely been realized, the valuation gap still exists for light industrial which has not received a similarly impactful flow of capital. However, barriers to entry are incredibly high, given the extremely fragmented nature of ownership of light industrial and the general lack of specialization among the managers.

- Australia: Arguably, Australia has the most developed light industrial market in Asia Pacific.

- Japan: Despite being one of the most industrialized countries in the world, the industrial real estate market has historically been characterized by a patchwork of small, family-owned warehouses, particularly in in-fill locations around Tokyo. Despite the growth in large warehouses over the past decade, more than 50% of the sector still consists of smaller, multi-tenant properties (CBRE and Mitsui & Co. Logistics Partners Data, Q3 2020). We expect opportunities to acquire existing in-fill warehouses and buildings appropriate for adaptive re-use as new demand drivers evolve (e.g., more electric vehicles driving the re-purposing of gas stations).

- Hong Kong: Over the past several decades, industrial has increasingly been crowded out of the prime urban areas of Hong Kong. While select opportunities still exist, the bulk of any future light industrial in Hong Kong is likely to be in the brownfield and strata-title sub-sectors.

Case Studies

Project Tukwila (U.S. Small Bay Industrial)

BGO SCP made its first light industrial investment more than eight years ago, purchasing a small bay industrial park near Seattle's Sea-Tac Airport, Seattle Exchange (Project Tukwila). The 661,000sf asset consisted of 324 tenants and 45 buildings. With average three-year lease terms, we were typically signing two leases every week.

We purchased the asset from a large global owner of industrial assets who was using third parties to lease and manage Seattle Exchange. The catalyst for them selling was that the asset was too operationally demanding and didn't fit their global bulk distribution strategy.

Due to the neglect of previous owners, there was "low hanging fruit" in our asset improvement plan, including painting the buildings, installing better signage and putting in low maintenance and drought resistant landscaping. However, the greatest value creation came from increasing occupancy from 79% to 94% and growing in-place rent from $1.01/sf/month to $1.56/sf/month at exit. We grew NOI by 2.2x over five years, creating a stabilized yield on cost of 12.1% and sold the asset to an institutional buyer at a 5.2% cap rate, resulting in an attractive return. Note that even with the substantive value that we created, we still sold at a price below replacement cost.

Project Crumpet (UK IOS)

BGO SCP invested in a strategic partnership with a specialist UK logistics manager who was an early mover in aggregating IOS sites around the UK. The portfolio is currently 60% specified and is tracking our acquisition underwriting.

IOS sites usually have a very low (or zero) coverage area since outdoor storage is the primary tenant benefit. Capex as a percentage of project costs is usually limited (generally less than 5% of all-in costs) and often involves installing a draining system, paving, fencing, adding lighting, improving security and demolition of existing structures. This, coupled with embedded rental growth from the start of ownership, results in attractive yields on cost in the 7.5%-8.0% range, depending on the location.

Besides the return benefit of aggregating assets for a portfolio sale with low capital expenses, IOS has the benefits of infill locations, "sticky" tenants who have a high renewal probability, a diverse tenant base and barriers to entry due to their infill locations. Unlike small bay industrial, IOS sites are typically leased to a single tenant on a long-term lease (e.g., 5-10 years). Additionally, IOS tenants typically have better credit than small bay asset tenants.

Project Tree (UK Light Industrial)

Our most recent acquisition has not yet closed. Project Tree is a structured secondary investment comprising (i) the recapitalization of seven cash-flowing last mile urban logistics assets in key UK regions at the GP's initial cost and ~13% below 1Q24 valuations; and (ii) an equity commitment (subject to our approval) towards four to six additional urban logistics projects from an extensive deal pipeline. In addition to purchasing assets below replacement cost with in-place cash-flow, the business plan targets investments with mark-to-market rental opportunities and limited capital requirements. While it isn't in our underwriting, there is upside in aggregating an institutional size portfolio of these assets.

In Conclusion

As the light industrial sector continues to institutionalize (lower cap rates), rents continue to grow above CPI, barriers to new supply remain and exit values remain below replacement cost, light industrial remains one of BGO SCP's favorite sectors. However, more than most sectors, the importance of exceptional leasing and management cannot be understated.

Please contact our team at bgoscpinvestorrelations@bgo.com with any questions or comments.

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