



BKM Capital Partners

MULTI-TENANT LIGHT INDUSTRIAL

RECESSION RESILIENCY



BKM INTEL | THOUGHT LEADERSHIP SERIES

Introduction

The outlook for the multi-tenant light industrial real estate sector remains bright, despite the changing macroeconomic environment, which has been characterized by higher inflation, rising interest rates, and quantitative tightening. As the Fed attempts to rein in inflation through dampening demand, the question turns to whether that has already led to or will induce an economic recession. **While we will not attempt to answer that question, this white paper will explore the multi-tenant light industrial real estate sector through BKM's expertise and assess how the property type might perform in a recessionary environment.**



Macro Environment

HIGH INFLATION

U.S. CPI rose to an annualized 8.3% in August, down from 8.5% in July and 9.1% in June, which marked the highest level in more than 40 years. Per the New York Fed's *Survey of Consumer Expectations*¹ report for August 2022, median one and three-year-ahead inflation expectations both declined in August, from 6.2% and 3.2% in July to 5.7% and 2.8%. Conversely, TIPS (Treasury Inflation-Protected Securities) breakeven rates², which represent inflation rates expected by market participants, for one, three, and five-years, are 2.3%, 2.6%, and 1.8%, respectively.

Due to the recent drop in energy prices, it appears that short-term inflation expectations may be moderating. However, food prices and stickier CPI elements like rents continue to rise. For capital market participants, inflation continues to be an area of focus.

RISING INTEREST RATES & QUANTITATIVE TIGHTENING

In September, the FOMC raised the Fed Funds Rate by 75 bps to a range of 3.00% - 3.25%. As of September, the FOMC's median fed funds rate projection for 2022 was 4.375%, implying a range of 4.25% - 4.50% by year-end or 125 bps of additional fed funds rate hikes.

Accompanied by rising interest rates is the Fed's quantitative tightening plan (a monetary policy tool that reduces the Fed's balance sheet) which was announced in May, calling for \$30 billion in US Treasuries and \$17.5 billion in mortgage-backed securities to roll off the balance sheet in June, July, and August, totaling \$47.5 billion per month. In September, the Fed increased the pace up to \$95 billion per month, amplifying the pace of liquidity reduction from the capital markets.

RECESSION DEBATE

U.S. real GDP (nominal GDP less inflation) contracted at a 0.9% annualized rate in the second quarter, following a 1.6% contraction in the first quarter, which satisfied the technical definition of a recession. However, with a low unemployment rate of 3.5% as reported in the September jobs report, it is unclear if the U.S. is in a recession or not.

Furthermore, the 2-to-10-year segment of the yield curve inverted in March for the first time since 2019 and remains inverted today. Anu Gaggar, Global Investment Strategist for Commonwealth Financial Network, found that the 2/10 spread has inverted 28 times since 1900. In 22 of these instances, a recession followed (i.e., 79% of the time). For the last six recessions (i.e., 100% of the time), a recession on average began six to 36 months after the 2/10 curve inverted.³

This highly uncertain macro environment has caused investors to reevaluate their portfolios and asset allocations..

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Multi-Tenant Light Industrial Real Estate

WHAT IS MULTI-TENANT LIGHT INDUSTRIAL?

Multi-tenant light industrial is a vital sub-sector of industrial real estate, with leases under 100,000 square feet representing over 90% of all industrial asset class leasing activity (based upon the number of leases).⁴ Given the number of tenants in a typical multi-tenant light industrial business park, these assets tend to be operationally intensive and require a strong local market presence, asset management expertise, and scalable technology.

Therefore, we've defined the product type characteristics to include the following:



- Business Parks with less than **200,000 square feet**
- **4-10 buildings** in a single asset
- **20-200 industrial units/tenants**
- **70-75% warehouse**, assembly, or manufacturing space
- **25-30% office space**
- **Shorter Weighted Average Lease Terms (WALT)** typically in the three-to-four-year range
- **Ability for tenants to grow within the business park** (BKM's average tenant stays in the park for eight years)
- **On-site property management**
- **Infill locations close to city centers**, 3-10 miles from consumers, businesses, and key infrastructures
- **Flexible zoning** (light industrial zoning) to allow a range of uses

STRONG REAL ESTATE FUNDAMENTALS

Multi-tenant light industrial has emerged as one of the latest darlings in real estate. In contrast to bulk industrial with long-term leases, which are often considered to be similar to fixed income investments, investors are drawn to multi-tenant light industrial for two primary reasons: 1) Strong supply and demand fundamentals; and 2) Short-term structural aspects of the leases. With persistently high inflation and rising interest rates, investors have sought out properties with shorter term leases and robust fundamentals to mark-to-market rents more frequently.

Inherent in the multi-tenant light industrial sector are the following property attributes that institutional investors find attractive:

Secular demand tailwinds

Limited inventory and high barriers to entry

Historically low vacancy

Strong rent growth

Downside protection from infill locations

Inflation hedge with favorable mark-to-market leasing spreads compared to the broader industrial property sector⁵

Tenant diversification advantage

Historically low credit losses

During the last two recessionary periods, the Great Financial Crisis (GFC) and Covid-19 Pandemic, multi-tenant light industrial proved its resiliency and stability in the face of vast economic uncertainty. Within the sector, occupancy remained stable, and rent collections were in the top quartile relative to other property types. Although the capital market environments differed significantly during each recession, multi-tenant light industrial resulted in exceptional risk-adjusted returns for investors over the medium to long-term in both instances.



SECULAR CHANGES CONTRIBUTING TO MULTI-TENANT LIGHT INDUSTRIAL DEMAND

A new tenant base has emerged in multi-tenant light industrial, bringing higher quality tenants with larger profit margins, focused on the following business segments:



E-Commerce

- E-commerce has grown 44.5% year-over-year⁶ and is projected to grow to \$1.8 trillion by 2030 (39% of total retail sales)⁷
- Well-located and highly functional light industrial warehouses or properties reduce transportation costs and meet customer demand
- Shortest delivery times to end user identified as critical to the modern e-commerce supply chain



Technology/Innovation

- Advancement of the chip in robotics, autonomous vehicles, smart sensors, and IOT generate exponential demand for light industrial space to design and test new technology
- Significant growth of life science and technology companies creates additional demand for available industrial space to accommodate the growing need for R&D and the onshoring of advanced biomanufacturing
- 3D printing eliminates need for large manufacturing – movement toward smaller facilities



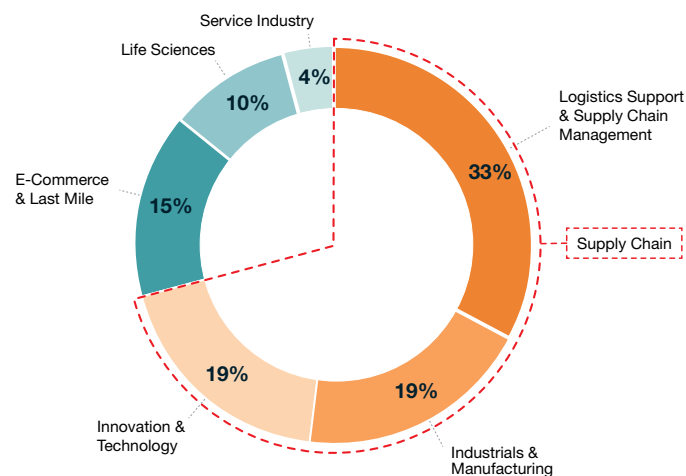
Manufacturing

- Flexible zoning and functionality required to accommodate multiple uses - of assembly, warehouse, and manufacturing
- Small and medium-sized manufacturers focus on product development and can seamlessly outsource logistics through e-commerce platforms
- Onshoring of manufacturing to ensure a stable supply chain to meet consumer demand

As evidenced in the graphic below, most of BKM's tenants are integral to the supply chain and are highlighted in the U.S. as mission critical due to recent events such as the Covid-19 pandemic and the Russia-Ukraine war.

ID	Description	No. of Tenants	SF Occupied	% Sq. Ft. Occupied
	Logistics Support & Supply Chain Management	24	1,073,850	33%
	Industrials & Manufacturing	22	637,058	19%
	Innovation & Technology	14	620,017	19%
	E-Commerce & Last Mile	17	479,200	15%
	Life Sciences	7	332,087	10%
	Service Industry	7	153,814	4%
Total		91	3,296,026	100%

BKM Portfolio data as of March 31, 2024



Urbanization & The “Halo Effect”

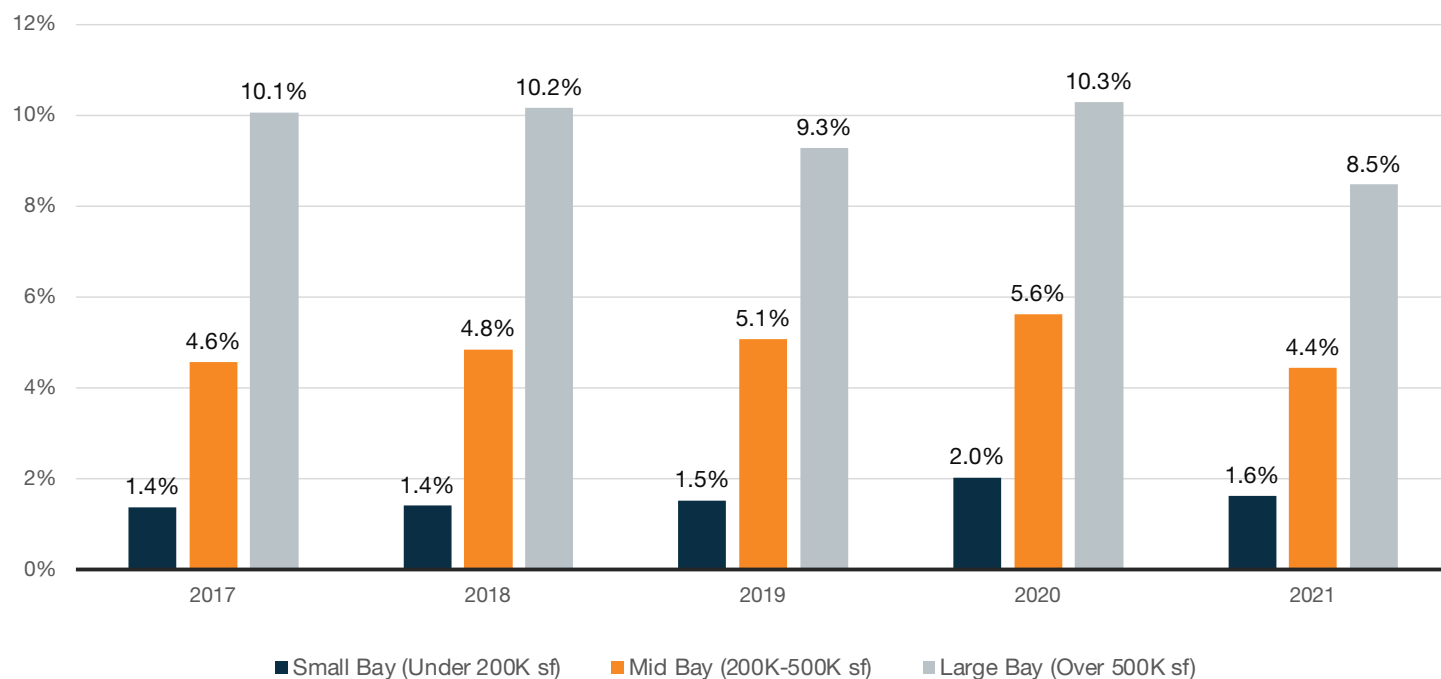
Decades ago, many of today's existing multi-tenant light industrial buildings were constructed on the periphery of urban populations. With the drastic acceleration in urbanization over recent decades, many of these assets are now engulfed by population centers, making them ideal candidates for infill supply-chain networks.

Given the limited availability of land and high barriers to entry in infill markets, we've noticed the “Halo Effect” trend accelerate. This is a trend whereby secondary markets benefit from the construction of large distribution centers and advanced manufacturing facilities, which drives growth and demand from downstream companies servicing these hubs, creating jobs, population growth, and strong real estate fundamentals. BKM actively targets and invests in these markets to capitalize on this powerful trend.

MULTI-TENANT LIGHT INDUSTRIAL SUPPLY

Historically, over-supply has been one of the catalysts for real estate recessions. Since 2007, the total industrial inventory within the United States has grown by roughly 3.0 billion square feet.⁸ However, recent deliveries have been highly concentrated in the market's large bay (i.e., bulk industrial) sub-sector.

Warehouse Space Delivered by Building Size (% of Existing Stock)⁹



- Over the five years through 2021, new supply in the small bay category (under 200K sf) totals a relatively mild 8.2% of the existing stock
- New supply among mid bay buildings (200K-500K sf) totaled 27% of existing stock
- Deliveries of the largest buildings (over 500K sf) totaled 58% of existing stock

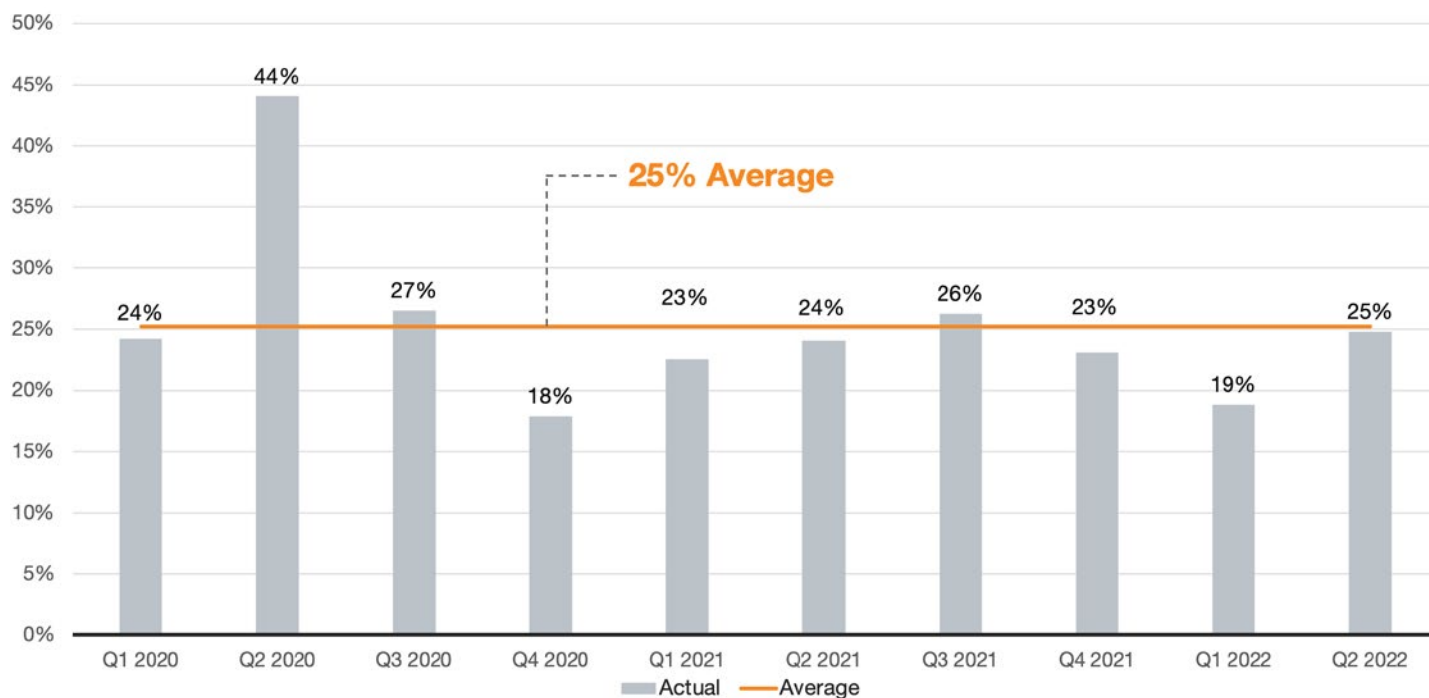
The lack of new supply has resulted in particularly tight market conditions for multi-tenant industrial. Late last year, demand for industrial real estate exceeded supply by over 40 million square feet, driving vacancy rates to record low levels, hovering in the mid-three percent range and as low as one percent in major cities.⁹ In BKM's portfolio, vacancy rates have dropped roughly 600-bps since early 2020.

RENT GROWTH

Per CBRE's Q2 2022 U.S. Industrial & Logistics report, average asking rents increased by 14.9% year-over-year.¹⁰ Gateway locations recorded the highest growth, like California's Inland Empire at a 28.4% increase in average asking rent.¹¹ Markets near major consumption centers – where units are larger, more available, and relatively less expensive – posted some of the highest rent growth rates in 2021. We expect that strong demand will buoy rents in these markets, although the addition of some new supply in outlying submarkets could slow the pace of growth in 2H 2022 or beyond.

Since Q1 2020, BKM's portfolio has experienced an average of 25% mark-to-market leasing spreads:

BKM PORTFOLIO LEASING SPREADS



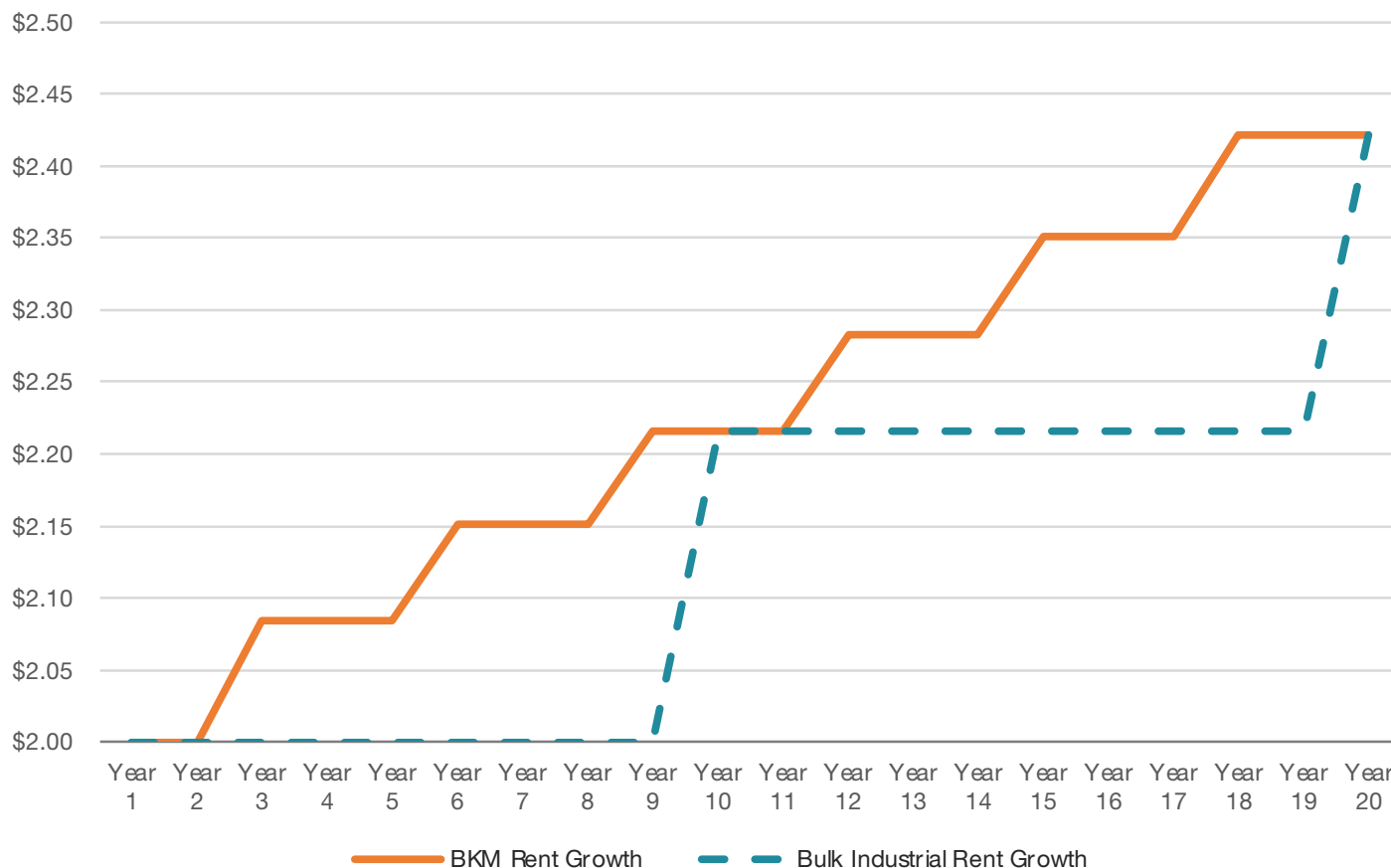
Multi-Tenant Light Industrial Structural Characteristics

As mentioned in the introduction, multi-tenant light industrial has unique structural characteristics relative to bulk industrial, which we believe will be favorable in the current macroeconomic environment.

INFLATION PROTECTION DERIVED FROM SHORT-TERM LEASES

In an inflationary environment, multi-tenant light industrial's shorter duration leases are advantageous given the ability to mark-to-market rents more rapidly, thus acting as a natural inflation hedge. For example, BKM's portfolio has a WALT (weighted average lease term) of roughly three years, allowing for the capture of higher rents every three years as leases come up for renewal or roll-to-market. Compared to the typical bulk industrial lease with a WALT of 10 years, the result is higher revenue growth¹² and capture, as seen in the graphic below, all else equal.

20-YEAR RENT GROWTH (\$2.00/SF RENT)¹²



HIGHLY DIVERSIFIED TENANT BASE

Investors recognize the value of tenant diversification, which is why single-tenant net lease warehouses, which lack tenant diversification, are so heavily scrutinized by investors looking for cash flow growth. Multi-tenant light industrial falls on the opposite end of the spectrum, providing a highly diversified tenant base and rent roll. This diversification minimizes the impact of any one tenant on the performance of the property. During times of heightened uncertainty and volatility, diversification is a widely desired attribute given its downside protection benefits.

The highly diversified tenant base inherent in the multi-tenant light industrial sector is a function of:

1

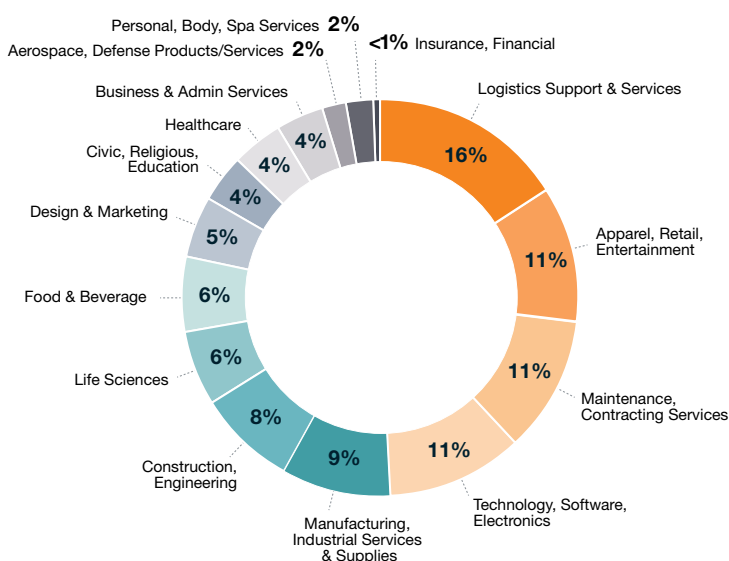
Smaller suites sizes, resulting in a larger volume of tenants (i.e., revenue security) at each property

2

Highly versatile spaces, which maximize utility for a wide variety of business industries

This is best exemplified in BKM's portfolio tenant composition noted below:

ID	Description	No. of Leases	% Sq. Ft. Occupied
	Logistics Support & Services	171	16%
	Apparel, Retail, Entertainment	188	11%
	Maintenance, Contracting Services	288	11%
	Technology, Software, Electronics	153	11%
	Manufacturing, Industrial Services & Supplies	161	9%
	Construction, Engineering	180	8%
	Life Sciences	73	6%
	Food & Beverage	84	6%
	Design and Marketing	112	5%
	Civic, Religious, Education	59	4%
	Healthcare	79	4%
	Business & Admin Services	117	4%
	Aerospace, Defense Products/Services	17	2%
	Personal, Body, Spa Services	67	2%
	Insurance, Financial	17	<1%
Total		1,766	100%



BKM Portfolio data as of June 30, 2024

BKM portfolio limited to max exposure of 12% in any one industry category

LOW HISTORICAL CREDIT LOSSES

A large majority of BKM's tenant base contains small and medium-sized businesses, whereby the health and function of the businesses largely depend on the leasing and use of suitable space. By nature, these businesses are an extension of the owner's livelihoods and often represent many years of hard work, grit, and discipline, resulting in a "do whatever it takes" mentality to pay rent to keep the business running. Further, many tenants provide personal guarantees as a condition of their leases.

Since BKM's inception, the firm's portfolio has had a credit loss of 0.82% as a percentage of revenue. In 2020, credit losses represented 0.35% of revenue. Low credit losses are a byproduct of tenant diversification, BKM's vertically integrated platform, and strong on-site presence at the properties, where potential tenant issues are avoided and addressed before they become significant.

INSTITUTIONAL MANAGEMENT YIELDS DOWNSIDE RISK PROTECTION

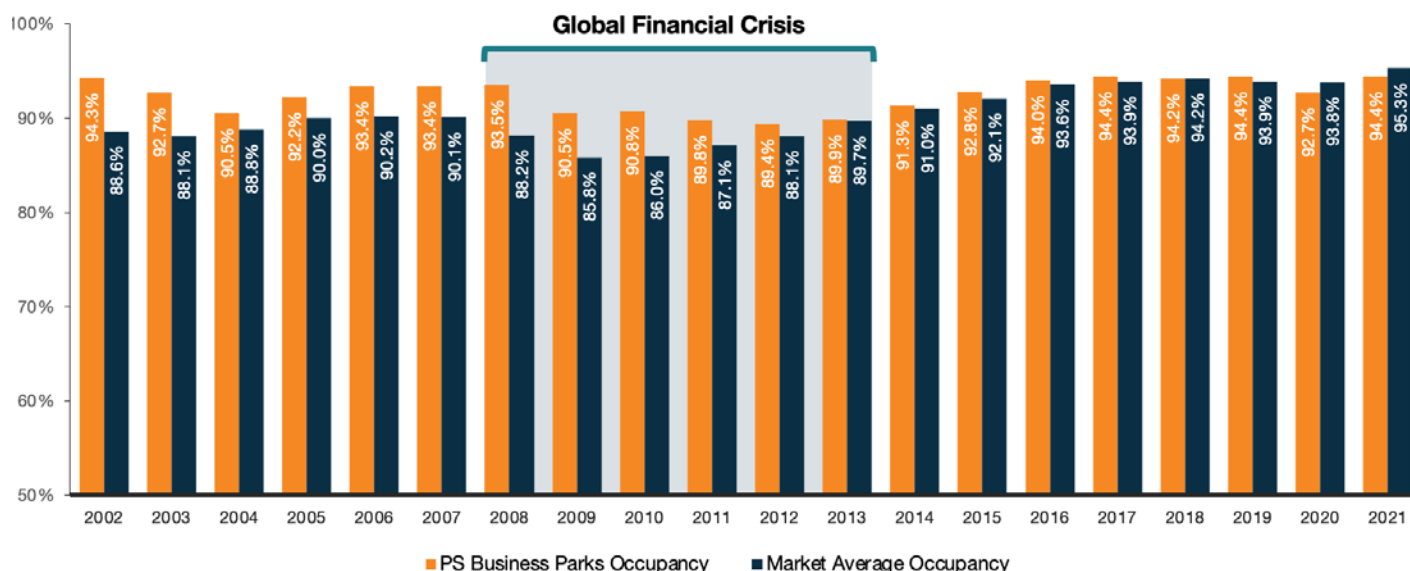
Broadly speaking, active and vertically integrated institutional managers in the multi-tenant light industrial space, like BKM, have outperformed relative to their peers since the pre-GFC era. Small private owners have dominated the sector with a preference to maintain cash flow via the delay of capital expenditures and a bias towards maintaining occupancy at the expense of achieving market rents. The differentiation provided by sophisticated, institutional on-site management (i.e., BKM's approach) is critical to the performance of multi-tenant light industrial properties and their ability to perform through market cycles.



Resiliency During Times of Economic Weakness

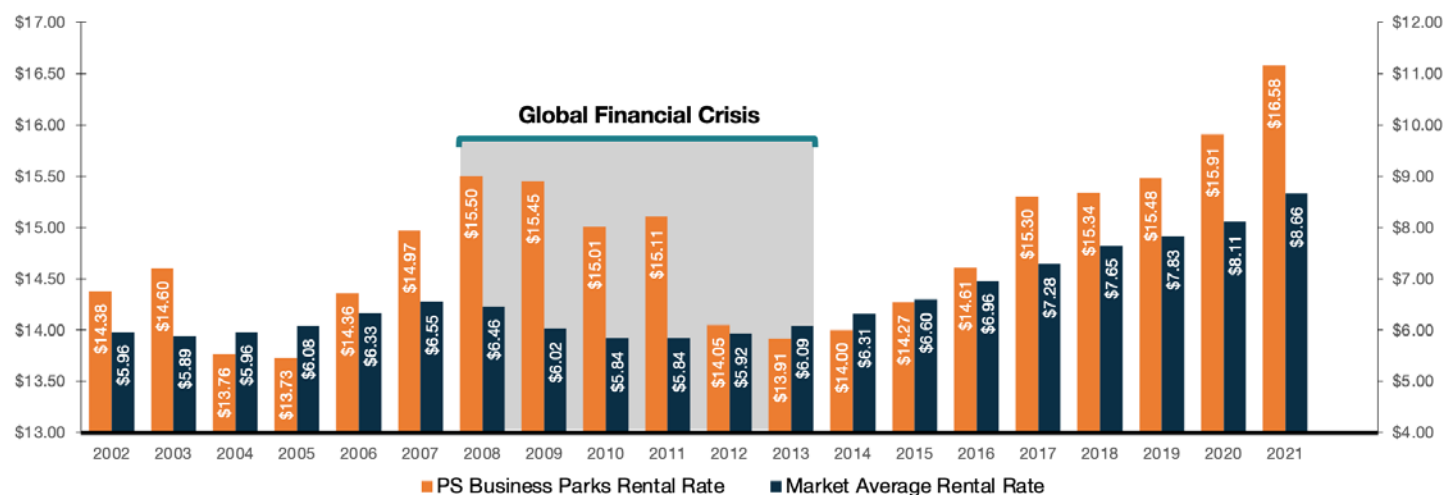
The characteristics highlighted above produce a resiliency demonstrated in the two most recent recessionary periods. PS Business Parks, recently acquired by Blackstone and formerly the largest public REIT focused on the multi-tenant light industrial sector, represents an excellent public data set for evaluating the performance of multi-tenant light industrial over time. During the GFC, PS Business Parks significantly outperformed the broader market¹³, in terms of rent and occupancy, as seen below:

AVERAGE OCCUPANCY



As seen in 2010, PS Business Parks' vacancy rate of 9.2% was 48% lower than the average market vacancy rate of 13.7%. Additionally, during the GFC recession, market rental rates experienced a 15.0% drop, while PS Business Parks saw a 9.7% drop in rates. **This outperformance resulted from PS Business Parks' diversified tenant base, vertically integrated platform, and short-term lease structures.**

AVERAGE RENTS



PERFORMANCE DURING THE COVID-19 PANDEMIC

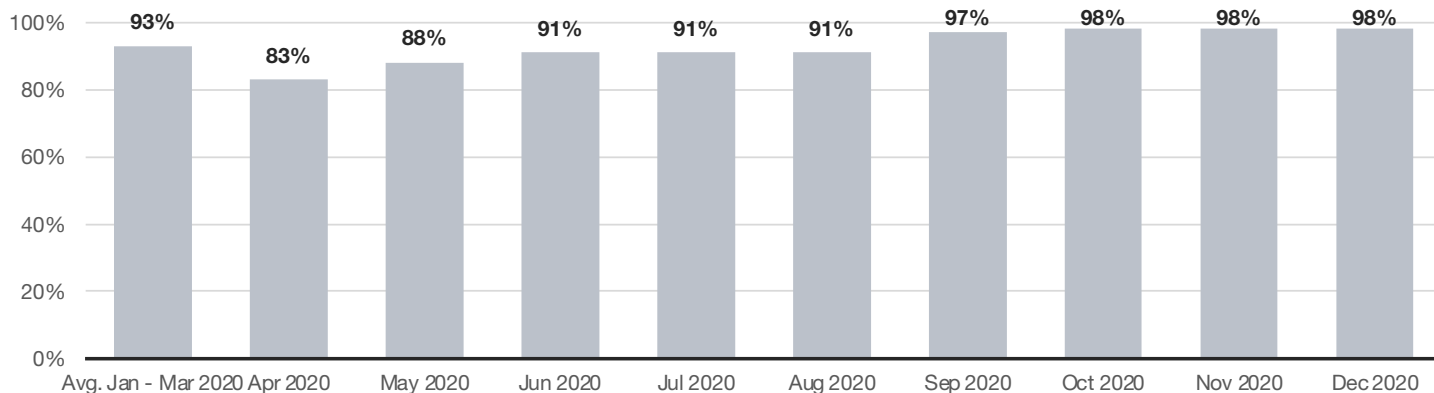
More recently, the COVID-19 pandemic created challenges for real estate owners across the country. **BKM was able to track the performance of its portfolio of 49 properties, consisting of 8.6 million square feet and over 1,400 tenants located in seven states**, over this period. When examining BKM's portfolio performance during the Covid-19 Pandemic recession, rent collections and occupancy remained very strong, even at the height of the pandemic during the April 2020 – June 2020 period.

As described previously, multi-tenant light industrial real estate is mission critical, with many small businesses representing an extension of the owner's livelihoods and relying on a single site, all of which are structural attributes that aided in a strong performance during Covid-19. A key reason for BKM's strong portfolio performance was due to BKM's vertically integrated platform, including in-house asset management, construction, leasing, and on-site property management functions. Being in close contact with tenants and addressing issues before they became problems proved to be a valuable advantage during the pandemic. BKM worked together with tenants, many of whom are small businesses, to provide rent assistance and resources through government programs, community support, or direct rent relief.

If a tenant needed to expand or change suites, BKM's in-house teams were ready to mobilize. BKM's construction team proactively built out vacant space with product-market fit space configurations, enabling tenants to tour units, sign a lease on a Friday, move in over the weekend, and begin operating the following Monday.

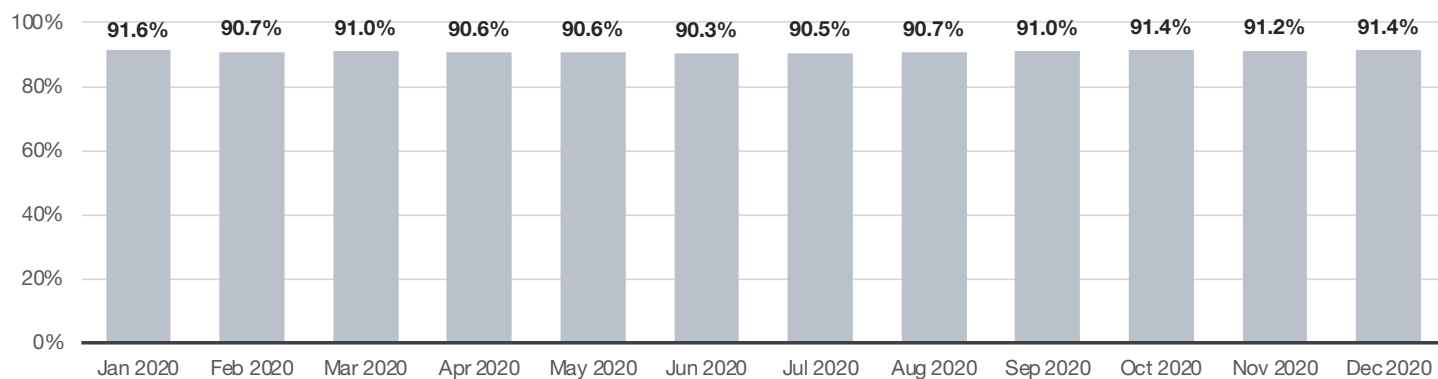


BKM PORTFOLIO 2020 RENT COLLECTIONS (COVID-19 PANDEMIC)



BKM was also able to avoid huge swings in occupancy and revenue throughout the Covid-19 pandemic due to the staggered expiry of short-term leases, further aiding in BKM's negotiating power.

BKM PORTFOLIO OCCUPANCY 2020 (COVID-19 PANDEMIC)



Looking Forward

Multi-tenant light industrial continues to have strong supply and demand fundamentals that produce robust rent growth. The sector also possesses structural characteristics that can mitigate significant challenges in today's economic landscape, such as inflation. Although multi-tenant light industrial has proven its resiliency during the last two recessions, we acknowledge that all recessions are not created equally.

It is unclear whether the United States economy will fall into a material recession. However, if it does, recent history suggests that institutionally managed multi-tenant light industrial is expected to perform well on a relative basis.



Sources

¹<https://www.newyorkfed.org/microeconomics/sce#/>

²As of market close on September 26th, 2022

³<https://www.reuters.com/markets/us/us-yield-curve-inverts-again-what-is-it-telling-us-2022-07-05/>

⁴JLL Research | U.S. Industrial Outlook | Q3 2021

⁵Spread of market rent compared to expiry in-place rent

⁶CBRE Research & U.S. Census Bureau 2020. Second Quarter 2019 to Second Quarter 2020

⁷CBRE US MarketFlash, Post-Coronavirus Industrial Real Estate, March 2020.

⁸JLL Multi-Use Logistics Rediscovered, February 2021

⁹CBRE-EA, CBRE Research Q122

¹⁰CBRE U.S. Industrial & Logistics | Q2 2022

¹¹NAI Capital Q2 2022 Industrial Market Outlook – Inland Empire

¹²Based on West Coast CBRE Q421 Industrial Rent Growth forecast, three-year WALT for BKM, 10-year WALT for Bulk Industrial, no annual rent steps, and equal market rents between bulk and multi-tenant light industrial

¹³Market average occupancy and rental rates sourced from CBRE, CoStar Group & Moody's Economy.com and represent single and multi-tenant buildings less than 120,000 SF across the U.S. PS Business Parks data comprises a mix of industrial, flex, and office space.



ABOUT THE AUTHOR

BKM Capital Partners was founded in 2013. Headquartered in Newport Beach, California, BKM Capital Partners is a leading real estate operator and fund manager specializing in the acquisition and improvement of value-add light industrial multi-tenant properties in major markets across the Western U.S. The firm has 13 offices and over 85 employees and continues to produce top quartile performance for its investors.

Please visit our website below for more information.

bkmcp.com

Contact us

949.566.8800
investorrelations@bkmcp.com

Headquarters

1701 Quail Street, Suite 100
Newport Beach, CA 92660