The ElmTree Edge

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The Only Certainty: Uncertainty

Amidst ongoing economic uncertainty, investors and developers must overcome the challenges of a volatile economy and a newly fragile supply chain to consistently create value

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With virtually every objective analyst and economist forecasting some level of a recessionary slowdown in 2023, commercial real estate developers and investors are keeping a sharp eye out for signs of a market pullback. With lingering fault lines and vulnerabilities in the wake of pandemic-driven global supply chain disruptions and ongoing labor challenges, it makes sense to think—and plan—for what's next.

The good news is that industry fundamentals remain strong—and the enduring resilience of industrial properties continues to make this one of the safest and smartest commercial real estate investments in what we believe is traditionally a "recession-proof" sector. With uncertainty on the horizon, how will industrial development and investment strategies adapt? With the prospect of economic uncertainty, what will be the impact on not just pipelines and timelines, but priorities and opportunities?

Continued uncertainty

While precise economic forecasts are often little more than educated guesswork and projecting the timing of any true recessionary cycle is next to impossible, it is safe to say that the odds are high that uncertainty will be a recurring theme throughout 2023. When seemingly the only certainty is uncertainty, considering how industrial markets will shift—and how developers and investors will respond—takes on new urgency.

Conservative underwriting

One inevitable outcome of elevated economic uncertainty is more conservative underwriting. It wasn't long ago when it seemed as if everyone was building on a speculative basis, as investors were confident in the depth of the buyer pool. It felt like everyone had plenty of capital and everyone wanted to get into the industrial space. In a higher interest rate environment or when lending markets get tougher, banks become much more selective and relationship-driven—with a sharper focus on creditworthiness. In that context, the need to clearly define underwriting processes in terms of mission criticality and strategic importance is heightened. In active markets like Savannah or Charleston, things are still moving forward with little to no change in momentum. But what we are already starting to see in some markets today is that prospective projects are getting reviewed with a keener and more critical eye. If Q3 and Q4 of 2023 see interest rates up around 7 or 8 percent, there are several marginal deals that simply can't make the numbers work and subsequently will not transact.

Proof and predictability

Experience, strong credit, and a demonstrated track record based on extensive relationships, proven processes, and proven results are always desirable. In leaner times, however, that certainty—or at least that predictability—carries higher value. Private equity real estate professionals with a sound strategy, robust portfolio, and a long list of established relationships with Fortune 100 clients will be in a more favorable position than newcomers and competitors operating on the margins. More than ever, investment-grade net lease industrial assets will bubble to the top, and strong credit will be more highly valued. Strong developer relationships also matter more when the economy experiences a downturn. Developers are generally only willing to go so far when their capital is at risk and some larger regional players are already hesitating about deploying too much capital and potentially having $30 or $40 million dollars tied up.

Timelines and pipelines

How does the onset of a recession impact those projects already in the development pipeline? A tighter lending environment will obviously slow things down—to a point. The biggest adverse impact will be on smaller operators trying to capitalize on a market with plenty of liquidity. More established private equity operators may find themselves with two or three projects in the pipeline instead of the five or six that might be more typical in a stronger economy. Quality opportunities will still be there, and favorable cap rates will continue to drive potential deals. It's also important to recognize that industrial tenant growth may be correlated to different economic metrics than those driving development cycles. Inflation can spur increased profitability and growth for many brands, and it's not hard to see why some sectors of corporate America feel optimistic about future growth based on their performance in recent quarters.

Opportunities and hot spots

Even—and sometimes especially—in a downturn, there are always emerging opportunities and areas of higher activity. Regardless of macroeconomic developments, the Southwest U.S. will likely remain a significant area of growth. The region is seeing both an influx of overseas investors buying production facilities and additional growth from U.S.-based brands reshoring their operations. Automation will be a significant point of emphasis for industrial tenants, but it remains to be seen if banks will fund costlier buildouts. Tenants may be on the hook for that higher price tag, and some simply won't be able to afford the potentially significant investment required for automated systems and infrastructure. The as-yet-unresolved question is the extent to which industrial tenants will pause and wait for cheaper capital, and how much will they invest and push forward. In an

industry landscape where tech is increasingly seen as essential, not optional, it will prompt some hard decision-making and more complex cost-benefit analysis. Just one more way in which uncertainty will be the theme in 2023 and beyond.

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