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The CenterCap Group
media@centercapgroup.com
212-620-2655

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CCG PERSPECTIVES

How Hot is Cold Storage?

By Ian Jeddy and Deborah Smith

Previously given little attention by the institutional investment community, cold storage is now on a strong growth streak – will it last?

Cold Storage is the infrastructure of mid-to-large refrigerated warehouses, a subsector of the Industrial and Logistics real estate space. The hallmark of cold storage warehouses is to keep fresh food fresh or frozen food frozen, but cold storage serves other purposes too – like storing vaccines that need to be preserved at cold to extremely cold temperatures. The trade partners are typically food producers, food wholesalers and retailers such as grocers, restaurants, other bulk buyers, as well as medical/pharmaceutical firms.

Cold storage development, operation and management is very different and far more complex than dry storage warehousing, with high barriers to entry. Cold storage facilities are designed, engineered and constructed with a high degree of customization and are normally built to suit specific customer needs. Their operation requires significant management skill and technical knowledge. Not surprisingly, the cost to build can be two to three times that of traditional dry warehousing and take as much as five months longer to complete. Construction materials are similarly customized – including specialized insulated metal panels, premium concrete slabs, under-floor heating and different refrigeration and mechanical equipment to manage temperature ranges from -25 to 55 degrees. Then, there is the regulation. Facility managers of these buildings must comply with Federal and local regulations such as USDA, EPA, OSHA, and FDA (for pharmaceutical products) standards; fire protection and local building codes; height restrictions and water supply requirements. All this translates into increased complexity and cost in running these facilities, and hence present a deterrent compared to traditional dry warehouse storage which is much cheaper and simpler to build, operate and manage—which is why many investors have stayed away from it. As a result, cold storage hasn't received a whole lot of attention or recognition as an established asset class. Until (maybe) now…

Take a look at the demand trends. Firstly, cold storage has proven to be a resilient asset class that has consistently performed even during times of economic distress. During the GFC of 2008 – 2009, revenues for the third-party logistics (3PL) sector fell by nearly 7% in aggregate, while food & beverage (F&B) revenues fell by just one-tenth of one percent, as noted by Armstrong & Associates. And during the current COVID-19 crisis, F&B sales significantly outperformed with growth of approximately 26% in March 2020, compared to an 8.7% decline for retail in aggregate, Prologis analysis revealed. Secondly, population growth and consumer behavior changes driven by evolving demographic trends in both suburban areas and urban metropolises led to an explosion of e-commerce. These shifts generated increased online purchases of not just traditional retail products but fresh and frozen foods and produce. As consumers demand more "farm to fork" product to be delivered just in time and fresh, expanded and more complex cold storage options have become necessities. This trend has been accelerated by the global pandemic where consumers, "shuttered" in their homes, required and demanded more online e-grocery product. Its observation is quite obvious today: walk into a Whole Foods grocery store and it's very likely you will find more Whole Foods employees busy bustling about stuffing bags with groceries and food items for online orders than you will see actual customers buying food items. As estimated by CBRE, online grocery shopping driven by COVID-19 has created greater need for infill temperature-controlled facilities in proximity to consumers. And they expect the e-grocery sector, currently 3% of sales, to grow to 25% in 2025. Thirdly, current cold storage inventory is outdated. According to Jones Lang LaSalle, the average age of cold storage buildings in the U.S. is 42 years, with 78% built before 2000. Hence, there is a drive to replace old, outdated facilities with newly built product that incorporates greater automation and energy efficiency. There is also a need to meet the storage requirements of pharmaceutical medicines and vaccines, some of which need to be stored at -70 degrees, for which new facilities with new technology and more energy efficient cooling will be best suited to address. All of these factors have amplified the demand for cold storage assets.

The demand-supply imbalance is mirrored in the rise of merger and acquisition activity in the sector over the past decade, with heightened consolidation occurring in just the recent few years. The two largest sector players control a whopping ~59% of market share today. Lineage Logistics, the market leader with 1.9 billion cubic feet of temperature-controlled capacity, raised $1.6 billion in September 2020 from private equity and institutional investors to continue its acquisition program. In October 2020, Americold announced the acquisition of AGRO Merchants Group, the world's fourth-largest temperature-controlled operator, for $1.74 billion from Oaktree Capital Management. In December 2020, Cerberus

Capital Management announced a joint venture partnership with Provender Partners to build a multibillion-dollar portfolio of cold-storage facilities. Further, in addition to existing cold storage asset consolidation, there is scarcity of cold storage assets in key markets, especially to facilitate last mile delivery. With product harder to come by, there has been an uptick in speculative build. Industrial warehouses, including cold storage facilities, are among the best-performing categories of commercial real estate while malls, offices and hotels face uncertain futures in the wake of the coronavirus pandemic. Demand for new industrial space is expected to exceed 1 billion square feet (worth $900 billion) by 2025, as estimated by Jones Lang LaSalle. All of these factors are attracting institutional capital and private equity interest, which historically has seen low-level participation in this sector.

So, are we at a peak or will the trend continue? We think the latter. First, the rise of e-commerce and changing consumption patterns with greater use of online grocery shopping, especially with younger consumers, will continue as they adopt the convenience as part of their normal lifestyle. Second, reshoring of product and need for "safety stocks" with manufacturers and distributors will perpetuate the demand for cold storage. Third, the growing importance of servicing last mile delivery with just-in-time fresh produce will drive the development of facilities closer to urban and growing population centers. Fourth, new build in strategically placed locations will command a premium to old, outdated energy inefficient facilities. And lastly, and importantly, we expect to see robust institutional investor interest in the cold storage sector in the near future.

In addition to real estate and private equity investors, who are we watching closely to step up in the sector? Infrastructure investment firms and managers who traditionally have not considered this asset class. The shoe fits for two prominent reasons: (i) large infrastructure firms have raised significant amounts of capital, for which investing in their traditional sectors (railroads, bridges, toll roads, oil and gas assets, airports, sea ports, etc.) is a crowded field with too many firms chasing the same assets, lowering their ability to achieve their return targets, (ii) there is greater focus on sustainability, impact investing and ESG investments from institutional capital allocators (sovereign wealth funds, public pension plans, etc.) that are demanding cleaner more sustainable, environmentally friendly investments. Norway (the world's largest SWF by AUM), Sweden and other Nordic/European countries have already mandated that their institutional investment managers focus on renewable, sustainable resources and environmentally friendly investments. Other countries, from Australia to Japan, Canada and the U.S. are also facing pressure from their constituents to adopt similar investment guidelines. In the face of such a changing investment landscape, it could make it challenging for an investment manager to plonk down billions of dollars on an environmentally unfriendly asset (say a midstream oil & gas pipeline) and hold it for some duration without running afoul of these investor criteria. And given the rise of renewable, clean energy, and environmentally friendly alternatives, these managers run the risk of being stuck in an asset that might be obsolete or highly unattractive, which could diminish investor returns – and that's without factoring in any remedial costs associated with decommissioning, if necessary. To be clear, it's not like investment in fossil fuel assets is about to dry up anytime soon, but given the complexity – both expected and unexpected – managers will need to take into consideration, other cleaner environmentally friendly alternative investment options will very likely take priority.

If you believe that making an investment in the preservation of the global food chain is consistent with impact investment and broader sustainability objectives, and/or if you believe cold storage is an important supply chain cog for the preservation of health and safety of future generations, then we all should anticipate a lot more private equity dollars will make their way into this previously overlooked niche sector in the years to come.