REPORT

INDIA'S WAREHOUSING POTENTIAL: BEYOND THE METROS

GRI CLUB MEMBERS SHARE INSIGHTS ON OPPORTUNITIES IN TIER 2 AND 3 CITIES

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SUMMARY

INTRODUCTION

For more than 25 years, GRI Club's exclusive networking events have been providing unique opportunities for the industry's decision makers to exchange valuable insights and experiences, igniting deal flow and potential using the real estate market.

GRI Club reports provide the key takeaways from these events, including the most valuable insights, the most ardent discussions, and the most intriguing strategies.

This report was compiled following the conversations that took place at the online meeting **Beyond the Metros: Unlocking Warehousing Potential in Tier 2 and Tier 3 Cities**, covering crucial topics including emerging locations, advantages and challenges, regulatory complexities, and tenant preferences.

SECTORAL CLUB PARTNERS

EXPANDING WAREHOUSING HORIZONS

The discussion surrounding opportunities beyond metropolitan areas extends far beyond the realm of warehousing, resonating with the strategies employed by consumer companies seeking market penetration in tier 2 and tier 3 cities.

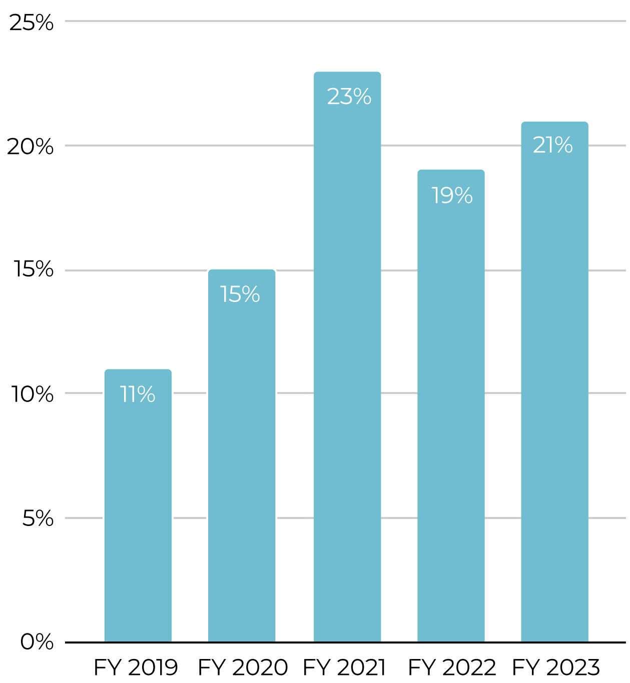
These companies have effectively crafted distribution models not only to reach these cities but also to tap into rural markets where the sale of goods necessitates storage facilities.

India's landscape boasts over 35 to 40 cities with populations exceeding one million, presenting a substantial market opportunity comparable to European or US cities. Tier 2 cities are emerging as significant players, with approximately 12 to 15 million square feet of warehouse space utilised in recent years.

In terms of location specifics, warehousing micro-markets in tier 1 cities typically span 45 to 50 kilometres, whereas tier 2 cities witness development hubs emerging within a 25 to 30 kilometre radius from city centres.

The share of secondary markets in the total transactions recorded in the country has grown consistently from just 11% in FY 2019 to 21% in FY 2023. Secondary markets accounted for 1.3 mn sq m (13.7 mn sq ft) of warehousing transactions during the year.

Share of Secondary Markets



Source: Knight Frank Research, 2023.
Note: The secondary market basket comprises 13 markets: Lucknow, Bhubaneshwar, Coimbatore, Ambala-Rajpura Belt, Guwahati, Indore, Jaipur, Ludhiana, Patna, Visakhapatnam, Vadodara, Surat and Vapi.

Cities like Lucknow, Indore, Nagpur, Coimbatore, Jaipur, Guwahati, Hosur, Patna, and Bhubaneswar emerge as prime tier 2 locations, offering substantial potential from a warehousing and industrial perspective.

Breaking down the numbers, there's an even split between Grade A and Grade B, up from the previous 30-40%. To attain Grade A status, cities should boast between half a million and a million square feet, reflecting the evolving landscape of commercial real estate.

Ahmedabad's transformation from tier 2 to tier 1 status underscores the shifting dynamics, driven by substantial manufacturing numbers and the presence of e-commerce and 3PLs.

Baroda's manufacturing prowess attracts units from diverse industries, including aeronautics, while cities like Vapi and Surat contribute significantly to Gujarat's development landscape. These cities collectively witness substantial growth, with Ahmedabad leading the charge.

Annual warehousing transactions

City	FY 2023 in mn sq m (mn sq ft)	% Change FY 2023 YoY	CAGR FY 2017-23
Mumbai	**0.88 (9.5)**	10%	35%
NCR	**0.8 (8.6)**	-5%	20%
Bangalore	**0.69 (7.4)**	25%	34%
Pune	**0.69 (7.4)**	-2%	24%
Kolkata	**0.47 (5.1)**	18%	25%
Hyderabad	**0.47 (5.1)**	-7%	27%
Chennai	**0.42 (4.5)**	-11%	16%
Ahmedabad	**0.35 (3.8)**	-29%	14%
Total	**4.77 (51.3)**	0%	24%

Source: Knight Frank Research

From an infrastructure standpoint, the focus is on transitioning toward a modernised distribution system, with institutionalised warehousing and service providers playing pivotal roles.

Looking ahead, the digitisation trend has untethered people from specific locations, allowing them to live anywhere while maintaining their consumption habits. This shift, accelerated by remote work options and online shopping convenience, has blurred the boundaries between urban and rural areas, driving demand for housing and infrastructure development in non-traditional locations.

Additionally, the transformation of consumption patterns is spurring the need for efficient logistics and warehousing facilities in tier 2 and 3 cities, as they serve as strategic hubs for reaching dispersed consumer bases efficiently. This trend presents both opportunities and challenges for businesses to adapt to the evolving needs of a digitally connected and geographically dispersed population.

(Image: aleksandarlittlewolf | Freepik)

OVERCOMING OBSTACLES

Regardless of whether it's in tier 1, tier 2, or any other segment, the business of warehousing is inherently challenging. Rent levels remain stagnant, construction and land costs are on the rise, and approval and capital costs are escalating. Under these circumstances, generating returns may become increasingly difficult.

Consequently, many institutional investors, including sovereign wealth funds, pension funds, and top-tier private equity firms, hesitate to venture into these cities due to the complexities involved, especially during the exit phase.

◆ Navigating Approval Processes

When evaluating tier 2 markets, challenges arise concerning land availability and regulatory approvals. Acquiring contiguous land in areas with diverse existing developments and ensuring access to skilled labour and connectivity from specific areas remain crucial aspects.

In tier 2 markets where penetration remains limited, zoning and approval entitlements are governed by state jurisdiction, a status unlikely to change. Obtaining large parcels of land suitable for warehousing often necessitates relocation to areas 20 to 25 kilometres away from the city centre.

Warehousing, with its typically horizontal structure and simpler classification under a lower Floor Space Index (FSI), may encounter fewer approval hurdles. However, obtaining planning and design approvals stamped by relevant authorities remains imperative.

In several tier 2 and tier 3 cities, these approvals can be challenging, often due to the absence of a central regulator overseeing the process, as it falls outside the jurisdiction of the Directorate of Town & Country Planning (DTCP). Typically, approvals are granted by local authorities such as the Gram Panchayat for planning purposes.

Each location exhibits its own dynamics in approval processes, with variations evident in regions such as the National Capital Region (NCR), where the absence of property taxes can influence project viability.

Sector-specific government reforms:

National Logistics Policy (NLP) launched in **Sep/2022**	Infrastructure status to the logistics industry with **100% FDI**
Aim to improve ranking in the Logistics Performance Index to **25th place***	Initiatives to reduce logistics costs to global benchmark within the next **5 years**

*Position in 2023: 38th.

Source: "Evolving landscape of warehousing and logistics in India: A road to becoming third-largest economy by 2027." Grant Thornton, 2023.

Critical to the development of tier 2 cities are significant infrastructure enhancements, including the establishment of new airports, dedicated freight corridors, and expanded highways. These developments can facilitate land acquisition, positioning them as pivotal drivers for growth.

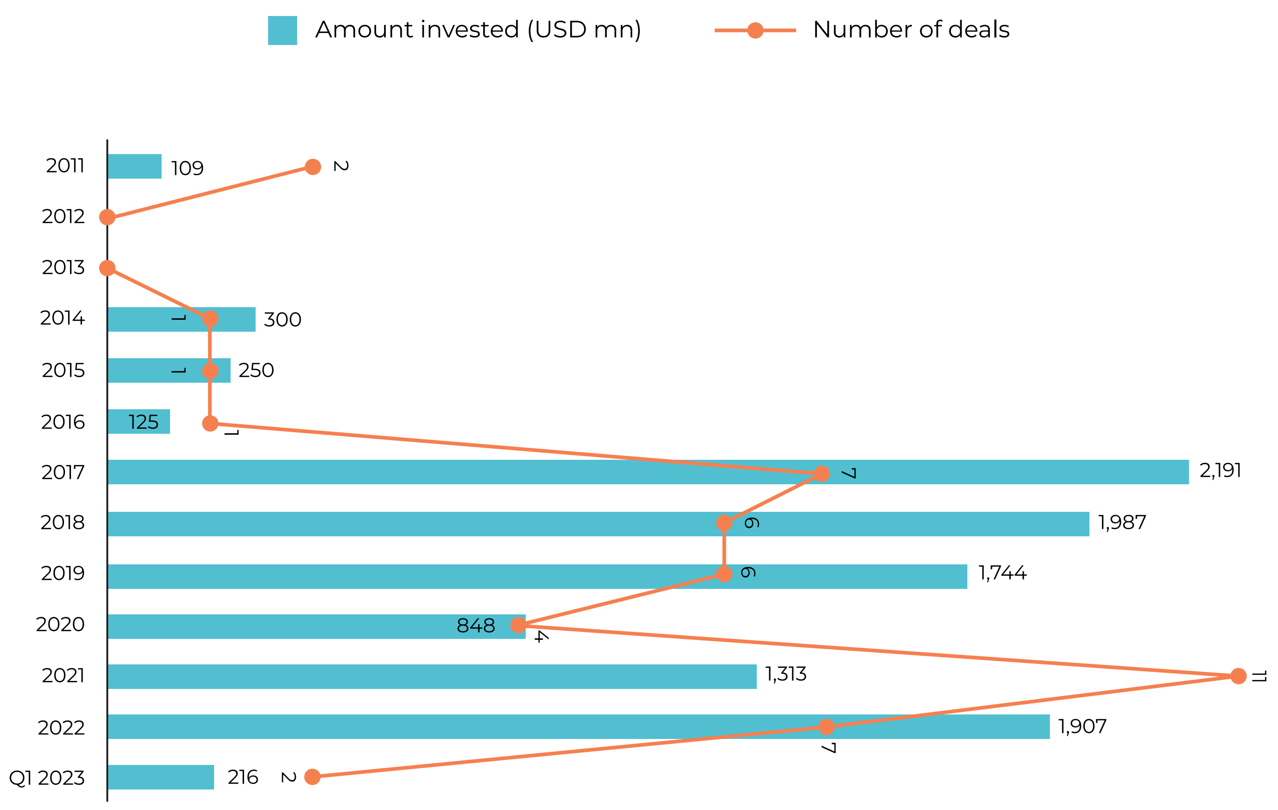
Despite similarities in land challenges between tier 1 and tier 2 cities, entering tier 2 locales is generally perceived as relatively easier. This perception persists despite the fragmentation of land holdings, which can pose significant challenges in consolidating plots for projects.

◆ Unlocking Investment Dynamics

In the realm of investment, tier 2 cities present a unique landscape. While larger funds hesitate to venture into these areas, it's not due to a lack of recognition of their potential. Rather, the scale of opportunities in tier 2 and tier 3 cities isn't as vast as in tier 1 urban centres.

Nevertheless, despite the cautious approach of bigger investors, the allure of tier 2 cities is evident. The absorption of a million square feet on average in some of these cities attracts multiple players, each aiming to secure their market share. However, due to the size of these opportunities, investors tend to be highly selective in their approach.

Private Equity Investments in Warehousing



Source: Knight Frank Research, Venture Intelligence
Investments considered until Q1 2023

An intriguing observation is the partial leasing of many warehouses in these areas. This phenomenon suggests that embarking on new projects may be futile if existing supply remains underutilised.

Quality specifications also pose a challenge in tier 2 cities, mirroring concerns in tier 1 counterparts. While there may be flexibility in certain amenities or height requirements, tenants and consumers consistently prioritise high-quality, large-scale warehouses, regardless of location or industry.

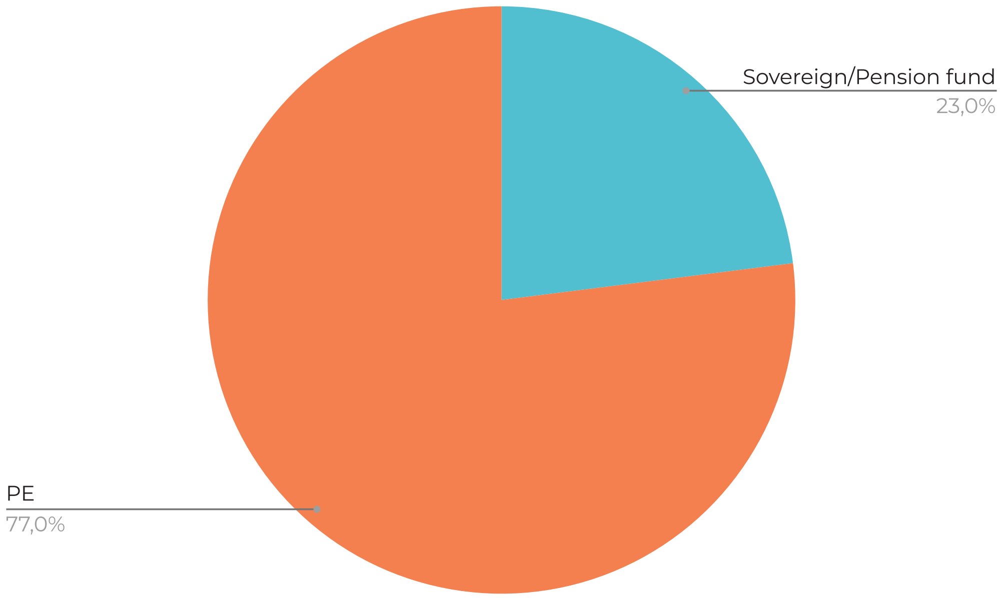
Moreover, the scale of operations in tier 2 markets often doesn't support the establishment of sizable portfolios. As such, opportunities for cost-saving on the construction front are limited. Although development costs might be lower, exit valuations, indicated by higher cap rates, are also lower. This dynamic impacts return expectations significantly.

From an investor's standpoint, while there may be slight differences in cap rates or development yields between tier 1 and tier 2 assets, the challenge lies in realising these projected returns.

Despite serving as potential diversification tools, tier 2 investments may not always offer more attractive returns, regardless of the allure of lower land costs. Development deals in those markets typically yield 25-50 basis points lower returns than those in tier 1 cities, varying from city to city.

PE and long-term capital providers alike actively participate in creating new Warehousing assets

Share of investments: 2011 - Q1 2023



Source: Knight Frank Research

◆ Exploring Rental Realities

Despite an increase in warehouse facility sizes, rental rates across India have remained stagnant, awaiting an eventual uptick in the future. However, in tier 2 markets, rental rates often fail to align with institutional return expectations, particularly when coupled with land prices.

Rental rates in tier 2 cities frequently hover below the 20, 19, or even 18, 17 range, prompting questions about the suitability of asset types for these markets. While cities like Lucknow and Guwahati command higher rents, they pose execution challenges. In contrast, tier 2 cities like Indore, Nagpur, Surat, Ahmedabad, and Hyderabad typically offer lower rents, presenting a challenge for investors seeking higher yields.

In some tier 2 markets, land prices in prominent corridors exceed those in tier 1 cities, creating uncertainty about achieving full-scale lease-out. Despite facing temporary oversupply issues, tier 1 markets like Mumbai, Delhi, Bangalore, and Chennai offer greater scalability with lower rents.

While some areas experience exceptionally high rents due to supply scarcity and high demand, this may not be sustainable. Over time, as supply increases, a decline in rentals is expected, similar to trends observed in certain markets relative to tier 1 cities.

Warehousing stock and vacancy

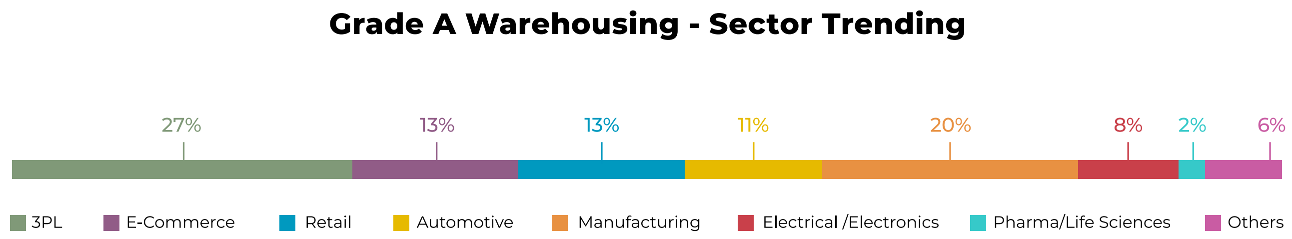
Market	Existing Stock mn sq m (mn sq ft)	Vacancy FY 2022	Vacancy FY 2023
Mumbai	13 (139)	14.0%	10.3%
NCR	7 (75)	13.8%	9.7%
Chennai	3.8 (41)	14.1%	16.7%
Bangalore	3.4 (37)	10.4%	15.8%
Kolkata	3.2 (34)	14.1%	19.9%
Ahmedabad	3.2 (34)	15.9%	10.8%
Pune	2.8 (30)	15.9%	11.6%
Hyderabad	2 (22)	15.6%	18.1%
Total	**38.3 (412)**	**15.6%**	**12.2%**

Source: Knight Frank Research

Local competition significantly contributes to lower rentals in tier 2 cities. Traditionally, real estate investments in warehousing were pursued by traditional investors for land acquisition and leasing. Unfortunately, many local developers lack the construction quality associated with Grade A properties, hindering investment in larger projects.

However, the shift towards larger sizes and Grade A requirements from 3PL companies and manufacturers indicates changing demand dynamics. Adding the increasing demand for Grade A properties and larger sizes in tier 2 cities, the investment landscape has evolved.

Elevating projects to Grade A status may alleviate the situation, but this presents a substantial challenge given the disparity in investment priorities between local and institutional players.



Source: CRE Matrix | Grade A India Warehousing Quarterly Report - Q4 CY'23

The preference for units within organised parks over isolated locations further underscores the need for high-quality parks in tier 2 and 3 cities. Meeting the demand for Grade A properties in these locations holds potential for achieving higher rental yields despite local competition.

Additionally, cold storage facilities (both integrated and stand-alone) remain largely underdeveloped from the perspective of large institutional developers, presenting a challenge even in tier 1 markets. The prospects for cold storage in tier 2 markets are even more distant and are expected to materialise much later.

Enhancing services to add value for customers could prove advantageous. However, it's crucial to recognize that most rental markets are unlikely to experience significant improvements in the next 12 to 24 months. Therefore, developers must innovate and demonstrate entrepreneurship to remain ahead of the curve, reducing costs and increasing value to ensure satisfactory returns.

(Image: aleksandarlittlewolf | Freepik)

MAXIMISING OPPORTUNITIES

While execution in tier 2 cities poses additional hurdles, particularly for investors based outside the region, having a reliable local partner with a deep understanding of the market dynamics and strong relationships can mitigate some of these challenges.

For institutional investors, adopting a more fund-like approach rather than a developer-centric strategy is advisable in tier 2 markets. While it may be tempting to engage in integrated development activities, focusing on providing capital and leveraging local expertise can be more beneficial in the long run.

When considering innovative financing models for warehousing infrastructure projects in tier 2 and tier 3 cities, simplicity often reigns supreme. Developers and partners typically prefer straightforward equity structures, as they prioritise execution over complex financial arrangements.

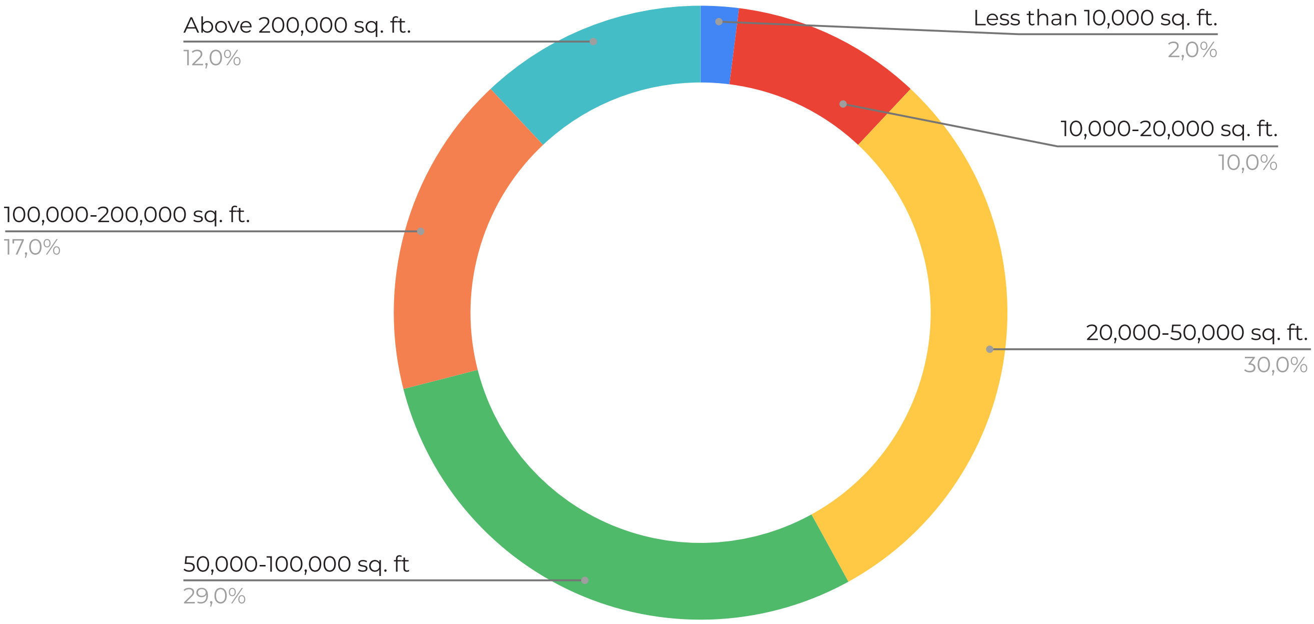
This is primarily due to the nature of warehousing investments, which are characterised by stable, volume-driven returns and relatively predictable rental incomes. Unlike other asset classes, warehousing investments tend to be long-term and less influenced by market cycles.

The focus should remain on building sustainable, long-term returns rather than relying on financial engineering strategies that may introduce unnecessary risk to warehousing projects.

By prioritising joint ventures or collaborations with experienced local partners, investors can effectively navigate the complexities of tier 2 markets while maintaining a contingency plan for unforeseen challenges. Exploring opportunities in tier 2 markets can prove promising with the right parcel of land and a trustworthy partner.

Regarding the question of when institutional players will enter en masse, it primarily boils down to scale. Currently, logistic parks in markets like Jaipur are around 10-25 acres in size. However, once projects of 40-50 acres or larger start emerging, with absorption rates doubling to 2 million square feet or more, institutional interest will likely follow suit.

Segmentation of transaction activity as per transaction size in FY23



Source: CBRE Research, Q4 2023

Cities like Coimbatore, Nagpur, Indore, and Lucknow are also showing promise, with established players and institutional presence. Additionally, markets like Rajpura already have institutional representation. Therefore, it's only a matter of time before tier 2 cities gain more traction.

For institutional investors, considering tier 2 cities as part of a portfolio that includes both tier 1 and tier 2 assets may be easier. This combined approach may provide a smoother entry into tier 2 markets.

However, identifying single large parcels of land for individual development projects, like a 20-25 acre plot for a 500,000-600,000 square foot development, presents more challenges. While aspiring to participate in such ventures, scalability remains key to success.

In terms of development, big box format developments are observed in tier 1 cities, with sizes ranging from 3 lakh to 6 lakh square feet. However, in tier 2 cities, the approach may differ. Instead of solely focusing on speculative development, a mixed strategy is advisable.

To ensure success, it's crucial to begin with robust infrastructure, including Grade A facilities, and meticulous planning of the site layout. While a few units can be developed speculatively, the majority should be built-to-suit (BTS) or pre-leased developments.

Regarding size, the range can be between 1 lakh to 3 lakhs square feet, catering to the demand and scale of operations in tier 2 cities. This balanced approach ensures both flexibility and stability in the development process.

Overall, the current potential in cities like Lucknow, Coimbatore, Guwahati, Jaipur, and others ranges from 0.5 to 1 million square feet annually. For institutions to enter these markets, a joint venture with local players seems viable, allowing control over cost aspects related to land, construction, and licensing.

Addressing the yields in these markets, they are either on par with tier 1 cities or lower. To make operations feasible, the focus is on cost reduction and enhancing services to attract Grade A+ clients.

Another positive aspect lies in the opportunities available for entrepreneurs based in tier 2 cities. With the right mindset and strategic approach, entrepreneurs can leverage the existing demand, sectoral growth, and available capital to create meaningful partnerships and deals.

By understanding the dynamics of both funds and their own limitations, entrepreneurs can tap into the vast potential of tier 2 markets and experience significant growth. It's essential not to view transactions solely as asset-based deals but rather as opportunities to cultivate long-term relationships and develop portfolios within regional tier 2 markets.

It's not merely a matter of the presence or activity level of tier 2 markets; rather, it's about institutional investors finding the right formula, matrix, or approach and dedicating time to it. This approach aligns with the perspective of institutional investors, who are interested in investments that can evolve into scalable portfolios rather than isolated assets.

Funds will always follow potential, and they are also eager to explore opportunities in tier 2 and 3 cities. As a proof of the success of this kind of approach, there are institutional and pan-Indian developers already active in tier 2 locations, indicating ongoing activities.

For instance, Blackstone has successfully found a reliable partner and is thriving in a tier 2 city. Similarly, IndoSpace has made strides in Coimbatore by collaborating with a local partner, indicating a viable model for success.

HIGHLIGHTING LOCAL LEADERSHIPS

While the discussion often revolves around institutional warehousing, it's crucial to acknowledge the significant role played by local and regional players in these markets.

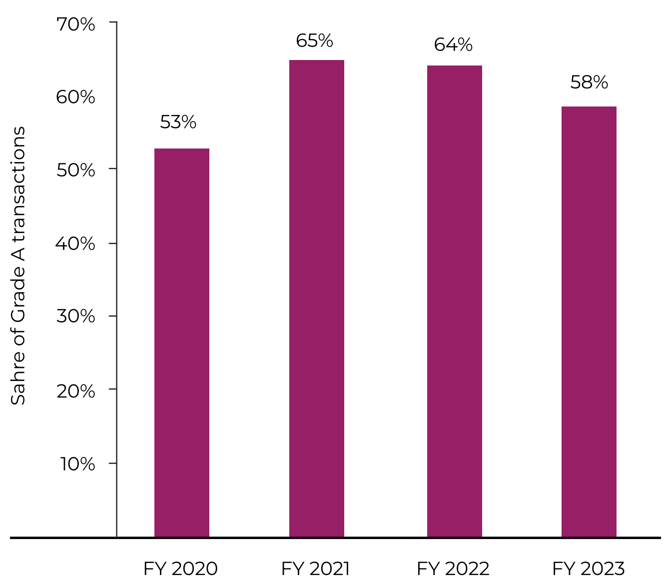
Tier 2 markets are ideally suited for regional players and emerging or established developers aiming to forge resilient portfolios while meticulously managing costs. Additionally, they provide opportunities for offering phased developments to key clients, including e-commerce giants or industrial enterprises.

The burgeoning e-commerce sales in tier 2 and tier 3 cities, along with the extensive coverage of PIN (Postal Index Number) codes by logistics companies, further underscore the breadth of potential. Cities like Lucknow, Coimbatore, and Jaipur present possibilities for developers to capitalise on existing demand and build significant portfolios.

The demand for quality real estate persists in these markets, offering promising prospects for developers willing to navigate the unique challenges and capitalise on emerging opportunities. Furthermore, for institutional players, there may be a chance to leverage transactions driven by cap rates or yield-to-cost considerations.

This approach becomes particularly relevant when local players develop Grade A facilities. By observing successful developments of a million square feet in various locations, institutional investors may find it viable to enter the market gradually and scale up over time. This approach holds potential for institutional players eyeing entry into these markets in the future.

Annual share of Grade A transactions



Source: Knight Frank Research

ANALYSING TENANT TRENDS

When assessing the tenant mix in tier 2 locations, participants addressed how it compares to tier 1 in terms of expected demand.

Analysing data from the previous year, it's evident that 3PL companies dominate the market, comprising nearly 30 to 35% of the total occupancy, as reported by an IPC study.

Manufacturing, encompassing sectors like automotive, pharmaceuticals, and electronics, follows closely behind, occupying approximately 20% of the available space, accounting for around 3 million square feet out of the total 5 million square feet in tier 2 and tier 3 markets.

The next significant segment consists of consumption-related industries such as retail, e-commerce, FMCG (fast-moving consumer goods), and FMCD (fast-moving consumer durables). Despite e-commerce's slight decrease in presence over the last two years due to overcapacity during the lockdown period, it remains a significant player in the market.

Sector-wise share of transactions

Sector	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
3PL	15%	35%	36%	35%	31%	29%	39%
Other Sectors	30%	21%	21%	23%	23%	28%	30%
Retail	10%	12%	11%	8%	4%	11%	13%
E-commerce	18%	14%	24%	23%	31%	23%	7%
Miscellaneous	4%	4%	1%	3%	1%	4%	5%
FMCD	14%	6%	3%	4%	5%	3%	4%
FMCG	10%	7%	4%	4%	5%	2%	3%

Source: Knight Frank Research

Notes:

Warehousing demand data includes light manufacturing/assembling.

Other Sectors include all manufacturing sectors (automobile, electronics, pharmaceutical, etc.) except FMCG and FMCD.

Miscellaneous category includes services such as telecom, real estate, document management, agricultural warehousing and publishing.

This shift in tenant composition underscores the evolving landscape from 2021 to 2023, transitioning from a predominance of e-commerce to a more diversified mix of 3PL, manufacturing, and consumption-related industries.

Founded in 1998 in London, GRI Club currently brings together more than 16,000 senior executives spread across 100+ countries, operating in both real estate and infrastructure markets.

GRI Club's innovative discussion model allows free participation of all executives, encouraging the exchange of experiences and knowledge, networking, and business generation.

GRI Club Members also have access to our exclusive online platform to learn more about other members and their companies, correspond, schedule meetings, and receive unrestricted access to all GRI Club content.

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