

Replacement Costs as a Catalyst for Value Growth

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Factors Shaping the Trajectory of the Market

Industrial real estate, fueled by the rise of eCommerce, was the standout real estate property sector over the last decade. This outperformance was accelerated during COVID as supply chain bottlenecks further accelerated eCommerce sales and led to just-in-case inventory management.

Over the last couple of years, as a result of higher rents and labor costs, tenants have consolidated their requirements, especially in the expensive coastal markets. As a result, market rents have declined by nearly 7% nationally from peak levels, and by over 40% in the Inland Empire.¹ At the same time, construction costs have increased (hard costs, labor, financing). The confluence of lower rents and higher construction costs (together with wider yields) have led to a pullback in new supply.

The dramatic decline in new supply (down by nearly -60% nationally and by more than -75% in certain major target markets) should help support a recovery in real estate fundamentals and values. Furthermore, we expect new construction to continue to be depressed given market rents sit 20%+ below replacement cost rents on a national basis—for the first time since the Great Financial Crisis (GFC). The substantial discount between market rents and replacement cost rents should provide the opportunity for rents and values to increase before the supply-side response kicks in—a bullish indicator for this cyclical recovery.

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¹ Greenstreet, November 2025

Why does replacement cost matter?

Replacement cost represents the estimated all-in expense required to construct a comparable building, including land. In practical terms, the replacement cost rental rate is the minimum rent necessary to justify new development and achieve a standard development profit. While market rental rates fluctuate with economic cycles and the balance of supply and demand, replacement costs remain relatively stable over time and typically rise at a modest premium to inflation. Moreover, prices for construction materials and labor rarely decline as sharply as rental rates during periods of economic stress. Replacement cost for industrial (and virtually all) real estate has increased meaningfully in recent years, propelled by supply chain disruptions during the Covid-era, tariffs, labor constraints and the advent of more technologically advanced buildings required to meet evolving occupier preferences.

Land is scarce

Construction costs are driven by market demand for construction labor and materials, commodity prices and supply chain disruptions. Land value is theoretically a derivative of value (rents + yields) and construction costs. In simplest terms, it can be approximated as the total value of the finished product less the cost to build and developer profit margin. However, in practical and empirical terms, land values are stickier than what theoretical value may suggest. Given commercial land is generally controlled by well capitalized institutions and individuals, typically few industrial land sites trade at the depressed pricing levels implied

by residual (theoretical) land valuations. Land has become even scarcer over the past 15 years as 4.5 billion square feet of industrial product has been delivered, removing more than 250,000 acres of buildable industrial land. For example, industrial land pricing at Exit 7A in New Jersey increased from \$20 per buildable square foot in 2013 to \$40 per square foot in 2020. Land prices surged during Covid and by 2023 exceeded \$125 per square foot in New Jersey. As such, replacement costs today are approximately \$300 per square foot in Central New Jersey, and approximately 15% above today's market rental rate.² This upward trend in land cost—especially in infill locations best positioned to efficiently serve dense, affluent populations—is expected to contribute to higher replacement costs going forward.

Replacement Cost Impact on Rents and Values

As with all assets, rents and values ultimately reflect supply and demand. Market rents (what price a landlord can command for space) are a function of various cyclical and structural forces. Supply, in turn, reacts to that demand. As rents rise, developers add new supply, which absorbs excess demand, bringing rents down. New supply however depends on the cost to build. Replacement cost determines the financial feasibility of building new supply and therefore provides strong indications of the trajectory of supply. When the cost and barriers to build are low, new supply can react quickly, eroding excess rental growth thereby creating a ceiling on value appreciation. When the cost to build is high, new supply is more limited, providing a runway for rents and values to grow.

Building and locational quality matter most

Replacement cost provides a guidepost for future value growth only in markets where demand is sufficient to justify development. At one end of the spectrum, a market like Cleveland has experienced annual effective rental growth of 80 basis points³ between 2001 to 2020 (underperforming the Tier 1 markets by more than 250 bps), despite replacement cost rents remaining consistently above market rents over that time period. Weak demand and demographics held back rental rate growth, notwithstanding limited new supply. In contrast, a market like Miami, with robust demand driven by strong population growth and rising ecommerce penetration, experienced market rental growth of 3.2% over that time period. Market rents in Miami stayed in-line with replacement cost rents and quickly rebounded at points in time where there was a discount. This bifurcation in market performance is likely to widen as structural demand drivers (such as the adoption of automation and AI technology and supply chain shifts) diverge across markets and product types. In markets with resilient demand, replacement cost and development economics will largely determine value appreciation in that subset of “winning” assets and locations.

Current and Future Replacement Costs

While industrial rents are stabilizing at a cyclical low, replacement costs are expected to keep increasing (albeit at a slower pace). According to the Turner Building Cost Index (which includes materials and labor), year-to-date build costs increased by 3.5% as of Q3 2025 and are 15% above 2022 levels. Steel

² MSREI Strategy

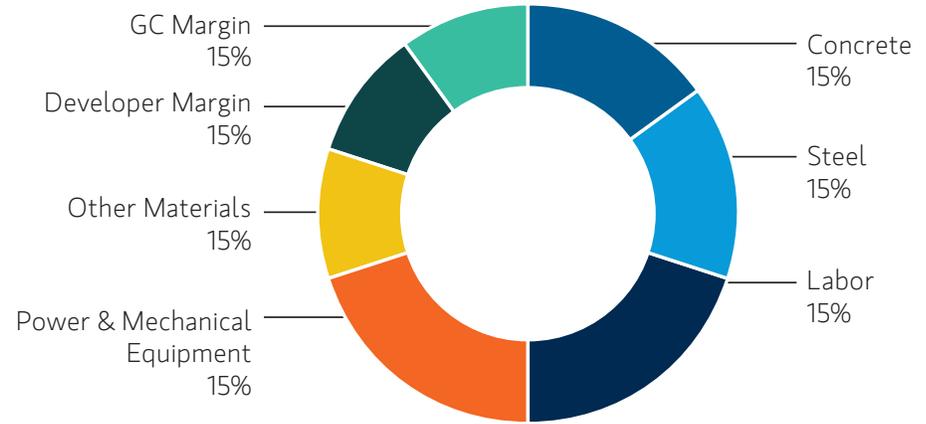
³ Greenstreet, November 2025

prices are up 12.4% y/y, cement increased by 4.6% y/y, and construction wages increased 4.0-6.0% y/y depending on skill, according to ENR (as of November).

Beyond the factors driving up basic construction costs, adoption of automation technology by industrial tenants to reduce operating expenses has further increased costs for modern industrial facilities. Power and mechanical equipment now represent 20% of total construction costs (excluding land), a threefold increase compared to a decade ago. While this seismic shift in tenant demand preferences raises overall build costs, those developers and property owners who can provide the enhanced power infrastructure required to support these automated systems should gain an outsized share of tenant demand.

Looking forward, construction costs are expected to remain elevated in the industrial sector, primarily due to the added complexity of newer buildings, while they may moderate in the residential sector, due to lower margins, which is helping to offset still elevated input costs (from tariffs) and wage costs (from immigration curbs).

Component Share of Total Industrial Property Build Costs



Source: MSREI Strategy

Spread between Replacement Cost and Market Rent is Similar to Post-GFC Dynamic

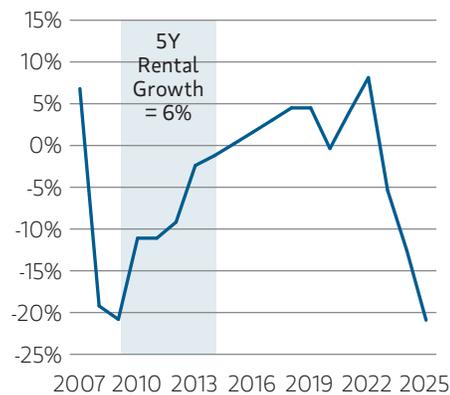
In the wake of the Global Financial Crisis, peak-to-trough market rents fell by approximately 30% across the main industrial markets in the United States. By contrast, replacement cost rents were more durable. Construction labor and commodity prices (e.g., concrete and steel) were relatively stable and overall build costs fell by only 12%⁴ through 2010. This was primarily driven by a pullback in general contractor (GC)

margins, as many GC's chose to build at lower margins to stay employed. In addition, while theoretical residual land valuations declined materially during the GFC, *actual* land value did not. Following the GFC, the gap between market rent and replacement cost rent converged within approximately five years (as depicted by the first chart). Additionally, there is a strong correlation (approximately 70%) between industrial value appreciation and the spread between industrial market rents and replacement cost rents.

DISPLAY 1

Rental Growth Upside

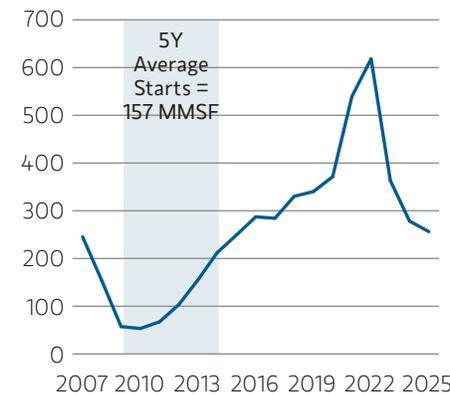
% , Market Rental Rate versus Replacement Cost Rent



Source: MSREI Strategy

Development Starts Likely to Stay Low

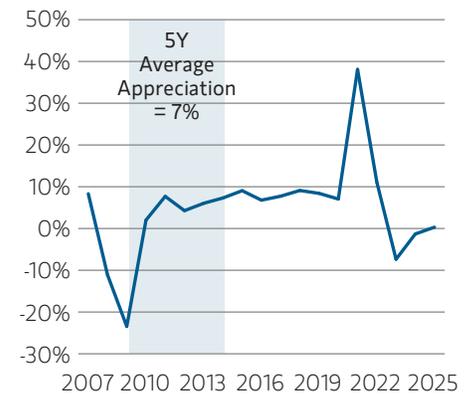
MM SF, Main US Market Starts



Source: CoStar, MSREI Strategy

Values Expected to Grow

% , Value Appreciation



Source: NCREIF

⁴ Turner Building Cost Index

Comparing the rent dynamic of the GFC period to today, current market rents are nearly 20% below replacement cost rents on a national basis. Replacement costs have increased by ~70% since 2020, while market rents have increased by ~50%, even after adjusting for the recent pullback over the last 18 months. Over the same period of time, market cap rates have expanded by nearly 100 basis points. The combination of higher costs and lower sale prices have

challenged developer economics, leading to a significant pullback in construction starts (down 70% from peak levels in 2023). This lower supply should help bring market rents up and more in-line with replacement cost rents over time.

Conclusion

The U.S. industrial market is approaching an inflection point. Vacancies appear to be peaking, demand is gradually improving, and new supply

has slowed across major markets. Importantly, the gap between market rent and replacement cost rent is nearly 20%. In the absence of cap rate expansion (which we view as unlikely relative to today's elevated yields), this wide disconnect between market and replacement cost rents—coupled with an expectation that replacement costs remain sticky or rise further—suggest strong potential for future outsized rental and value growth.

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