PGIM REAL ESTATE

JULY 2025 | INVESTMENT RESEARCH

Mexico Value-Add Industrial: Cyclical Opportunity, Structural Growth

Executive Summary

Despite ongoing market volatility, we believe the case for value-add industrial real estate investment in Mexico makes sense today due to three key factors.

1. Today's lower liquidity market environment, in conjunction with a constructive long-term outlook for property fundamentals, may offer an attractive entry point.
2. Supply pipelines are thinning rapidly as rising vacancy rates curtail construction starts.
3. The base of institutional capital with an appetite for core assets is growing.

Three Key Themes Supporting Value-Add Investing in Mexico Industrial Today

1 — Attractive Entry Point

Need for recapitalizations despite favorable structural demand drivers

2 — Supply Slowdown

Lease-up periods will decline due to less competition from new construction

3 — Deepening Capital Base

Public companies provide liquidity for assets that have been stabilized

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Part 1: Why Does Mexico Industrial Value-Add Make Sense Today?

We identify three factors that are among the most important in determining the nature and scale of the opportunity in Mexico industrial value-add today.

1 Attractive Entry Point

Vacancy is leveling out as demand drivers strengthen

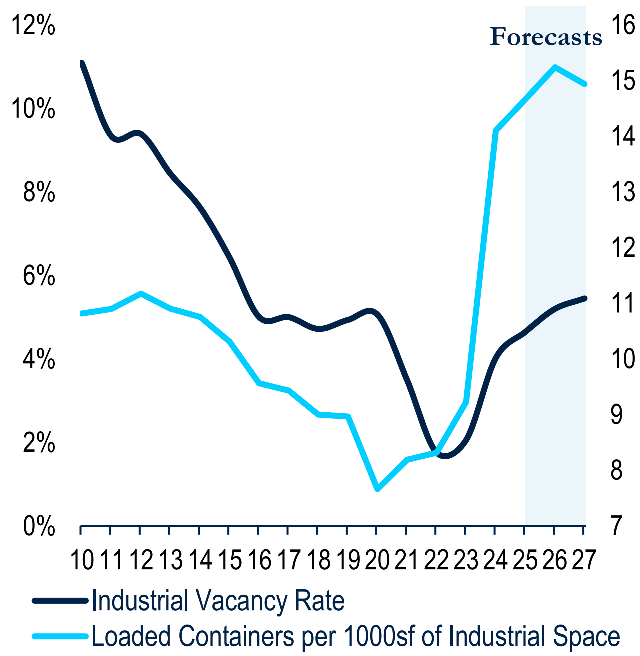
Since bottoming out below 2% in 2022, Mexico's industrial vacancy rate has been climbing (**Exhibit 1**). Tenant demand remained positive in most quarters since then, but rising rents incentivized even more construction. That leaves Mexico's industrial market with vacancies now in line with the 2016-2020 period.

Yet the rapid growth in shipments to the United States portends further demand expansion. As recently as 2020, eight loaded containers entered the United States from Mexico per 1,000 square feet of space. Now that ratio is over 14. Exporters are operating at higher capacity now, and we expect they will need additional space to accommodate additional demand.

That makes today's entry point attractive. While vacancies have risen, they are still low by historic standards. Further, additional U.S. consumer demand growth will require exporters to ramp up production and, in many cases, lease space in newly developed or existing properties.

Exhibit 1: Vacancies Normalize as Demand Queues Up

Industrial Vacancy Rate (% of stock) vs. Exports from Mexico to United States



Sources: CBRE, INEGI, US Census Bureau, PGIM Real Estate.
As of July 2025.
Forecasts are not guaranteed and may not be a reliable indicator of future results.

Defining Value-Add Real Estate

While style definitions in real estate are not set in stone, in contrast to income-driven, buy-and-hold core investments, a value-add portfolio will typically seek to generate capital value growth-driven returns over a limited period of time, based on most or all of the following factors:

- Improving the level, quality and durability of cash flows by active asset management, capex and development activities.
- Achieving a positive valuation effect by growing the income stream on a portfolio, improving its quality and risk profile to capture favorable yield shift and capturing upside from mispricing or market momentum.
- Taking on leasing risk and having exposure to non-income producing assets, via both developments and non-stabilized acquisitions.

2 Supply Slowdown

Construction is decelerating from recent peaks, reducing competition in 2026+

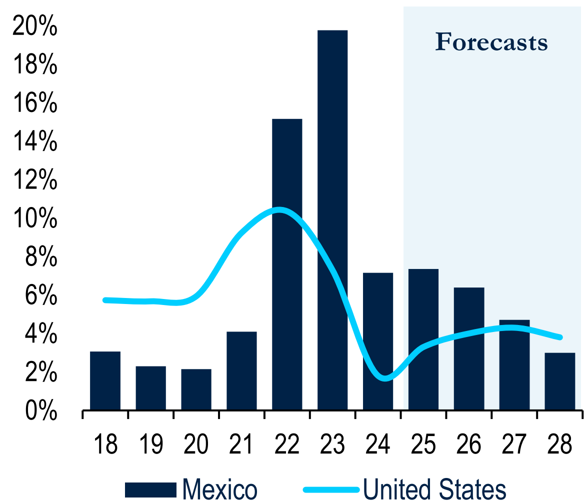
Rents grew rapidly after 2020, as tenants scrambled to find available space for expansions and new operations (**Exhibit 2**). Rent growth in Mexico even bested the United States during that period.

Higher rents induced a strong development response in Mexico's largest markets, with supply growing by as much as 12% of stock (**Exhibit 3**). With rent growth sharply decelerating, supply pipelines have already started to thin out.

Properties in need of lease-up over the next few years will face less competition from newly built buildings. The full supply pipeline overstates overcapacity, since a significant share of supply is pre-leased, generally to expanding rather than relocating tenants. Additionally, some properties under construction lack electrical or other infrastructure permits.

Exhibit 2: Rent Growth Decelerating, but Strong

Annual Industrial Rental Growth (%)



Sources: CBRE, Costar, PGIM Real Estate. As of July 2025.

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Exhibit 3: The Supply Wave Is Ending

1Q25 Construction Pipeline (% of Stock)

1Q25 Construction Pipeline by Leased Status (% of Stock)

Sources: CBRE, PGIM Real Estate. As of July 2025.

3 Deepening Capital Base
Expect growing demand for stabilized assets

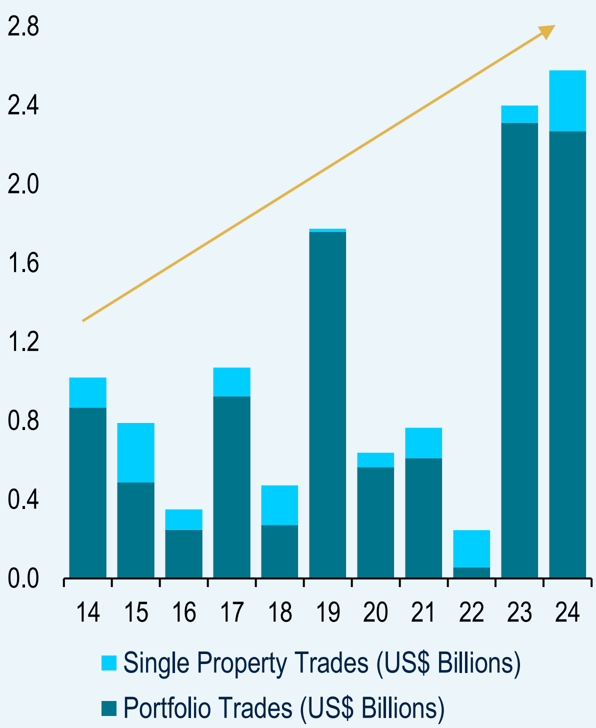
Liquidity in Mexico's industrial capital markets has waxed and waned, with some boom years in the late-2010s interrupted by pullbacks, including a prolonged one after 2019 (**Exhibit 4**).

Part of the explanation is the thinness in the core institutional buyer base. While many domestic and international institutional investors set up funds to invest in industrial properties, they were mostly targeting value-add and opportunistic returns. When it came time to sell, there were not always core institutional investors there to buy.

The growth in FIBRAs (Mexico's publicly traded real estate companies) should provide a more permanent source of core capital in the future (**Exhibit 5**). The FIBRAs have come out of the post-2020 period of volatility with solid balance sheets, consistent access to debt and equity capital and increased ownership by foreign investors. Their structures incentivize acquisition of stabilized properties, not value-add or opportunistic investments, making them likely buyers of newly built or repositioned properties.

Exhibit 4: Transactions Volumes Have Picked Up . . .

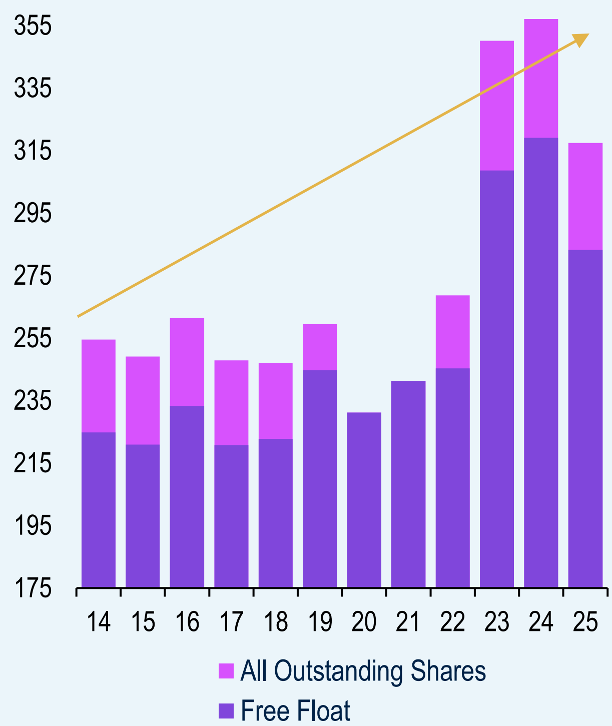
Annual Industrial Transaction Volume (US$ Billions)



Sources: MSCI Real Capital Analytics, PGIM Real Estate. As of July 2025.

Exhibit 5: . . . Coinciding with Growth in Public Companies

Market Capitalization of FIBRAs (MXN$ Billions)



Sources: S&P Global, PGIM Real Estate. As of July 2025.

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Part 2: Recognizing the Challenges

Aside from the typical risks value-add investors face – such as pricing, fluctuations in occupier demand and exposure to external shocks – we identify two challenges that are specific to today's investment environment.

Challenge #1

The United States' trade policy remains unsettled

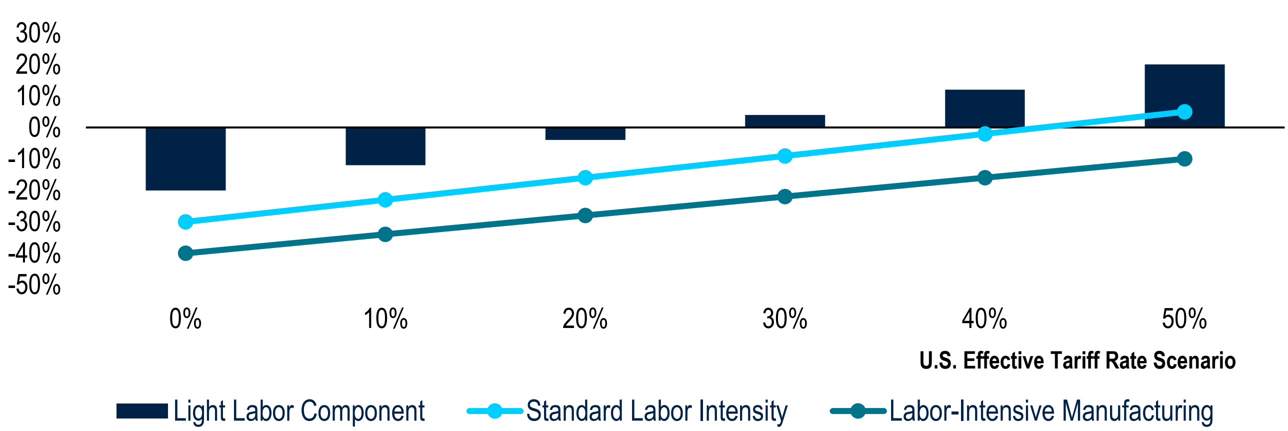
The United States imposed a 10% tariff on goods manufactured in Mexico in February, only to remove it days later. The tariffs imposed on most countries on May 3rd exempted Mexican-made goods produced under the United States-Mexico-Canada Agreement (USMCA), which benefited Mexico's exporters. However, the threat of more or higher tariffs remains.

WHAT THIS MEANS

Goods sold in the United States are less expensive to manufacture under many different tariff scenarios (**Exhibit 6**), particularly those that are labor intensive to make. Further, any tariffs imposed on Mexico are likely to be the same or lower than other countries, maintaining Mexico's relative cost advantage and maintaining its status as a preferred manufacturing location. Policy uncertainty is the more immediate concern, with some tenants delaying investment until trade rules are reestablished, likely after the 2026 re-ratification of the USMCA.

Exhibit 6: Manufacturing Is Still Less Expensive in Mexico Under Most Tariffs

U.S. Landed Cost Savings of Mexico-Manufactured Goods



Sources: Tetawaki, PGIM Real Estate. As of July 2025.

Challenge #2

Pockets of near-term supply overhang need to be absorbed

A significant amount of construction in recent years has pushed vacancies higher than their long-term average across many metros (**Exhibit 7**).

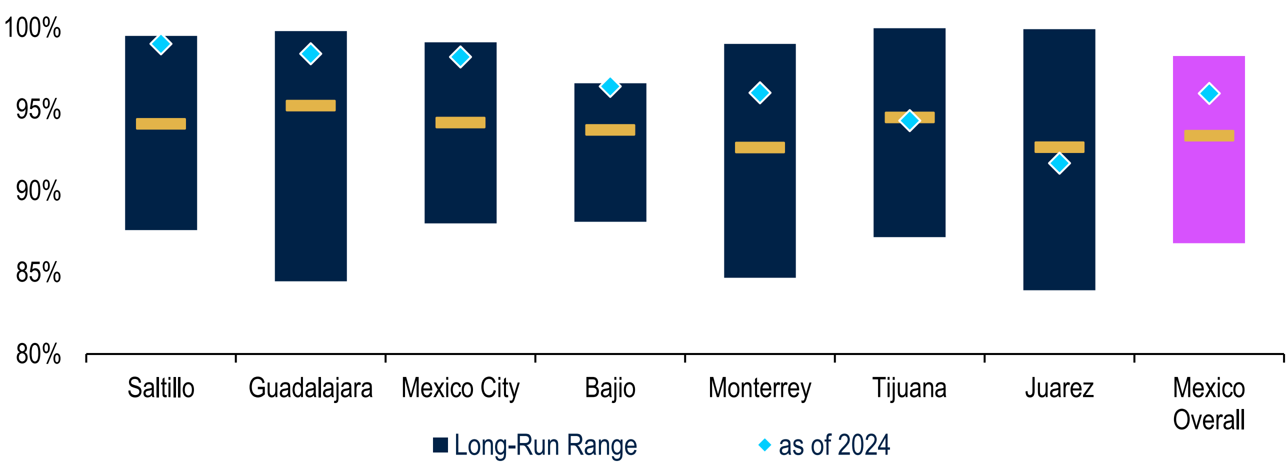
WHAT THIS MEANS

The slowdown in new supply may not generate strong rental growth immediately in some locations owing to elevated vacancies in certain markets and submarkets.

Additionally, even as vacancies and face rents improve, investors will need to be realistic about lease-up periods.

Exhibit 7: Some Markets Have Supply to Work Through, but Pullback in Construction Will Help

Industrial Occupancy by Market (%)



Sources: CBRE, PGIM Real Estate. As of July 2025.

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Part 3: Building a Value-Add Portfolio for the Next Cycle

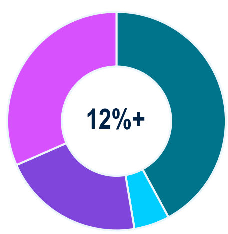
In **Exhibit 8** we illustrate the different approaches to value-add investments:

- Some areas in which **mispricing** is likely to be found include:
  1. Developers that have equity tied up in projects and are willing to sell or partner prior to completion or lease-up;
  2. Properties that have been slow to lease-up, or are facing imminent lease expirations; and
  3. Properties that lack sufficient power or other infrastructure, where a buyer can add capacity and attract better tenants.
- **Active asset management** is effectively a key feature of all value-add investing. Yet with supply set to decelerate rapidly, investors have a unique opportunity to identify the best locations in currently oversupplied markets and assume leasing risk (to capture the rebound in occupancies expected in the coming years).
- **Development** strategies combine build-to-suit and speculative construction, depending on local market conditions and tenant preferences.

Exhibit 8: Stylistic Target Return Range and Breakdown for Different Value-Add Investment Approaches

Mispricing

Opportunities linked to mispricing in the market, for example due to low liquidity or stressed capital structures.

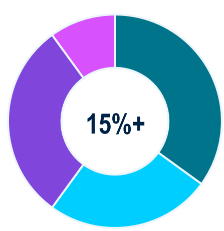


Key return driver(s): market performance plus yield shift.

Risk Level: Low-Medium

Active Asset Management

Taking on risk in under-managed or under-performing assets likely with vacancy or a challenging lease expiry profile.

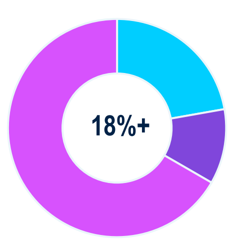


Key return driver(s): income growth via re-leasing and ERV reversion.

Risk Level: Low-Medium

Development

Ground-up development of assets in market environment with declining construction activity.



Key return driver(s): valuation uplift and development profit.

Risk Level: High

Income Return | Net Income Growth | ERV Growth | Valuation Effect

Note: Net Income Growth reflects the gain from asset management activity while ERV growth reflects the general boost to values from rising benchmark rents. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.
Source: PGIM Real Estate. As of July 2025.

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