AXA IM – Real Assets

Europe entering the sweet spot of logistics rental growth

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The consumer has taken power in the retail industry, which has put retailers on the backfoot and caused a fundamental rethink of the traditional business model. Omnichannel retail[1] has emerged as the likely winning model. It requires a seamless supply chain that integrates warehouse and store stock through advanced inventory management to deliver goods as and when consumers demand them — which is what they have come to expect. Industrial and logistics real estate is the key beneficiary, with unprecedented demand levels requiring significant new supply.

Logistics: The key beneficiary of the omnichannel retail world

In the omnichannel retail model, the supply chain becomes a key determinant of whether customers have a good or bad experience — whether they get their goods on time, in a location of their choosing, in a suitable condition and at the right price. With the supply chain integral to success, many retailers and logistics operators are reconfiguring their distribution networks and investing in logistics stock that is able to support the omnichannel retail model. Consequently, there has been a significant expansion in occupier demand for high-quality, modern logistics space, especially for units in densely populated urban areas.

Omnichannel retailer models, which integrate traditional warehouse space with modern technology-driven, supply-chain solutions, have resulted in a surge in demand for logistics space. There have been a number of different supply-chain responses to the growth of e-commerce and the emergence of omnichannel retail, but the reconfiguration of supply chains has typically meant that retailers and their logistics operators require both large warehouse/e-fulfillment centers and urban/last-mile logistics units. Increasingly critical to location decisions is access to labor and the end-consumer base, along with transport infrastructure.

Omnichannel retail is more established in some markets, such as the United States, the United Kingdom and Germany, than others, such as Italy, Spain and Russia.[2] This is reflected in considerable differences in the volume of modern warehousing and distribution stock. With e-commerce penetration expected to rise further, we believe there is pent-up demand for stock that can support the omnichannel retail model. Development and lease up is our preferred strategy, as it can offer a higher yield on cost than standing core investments, as well as access to well-let, modern stock.

Industrial market characteristics

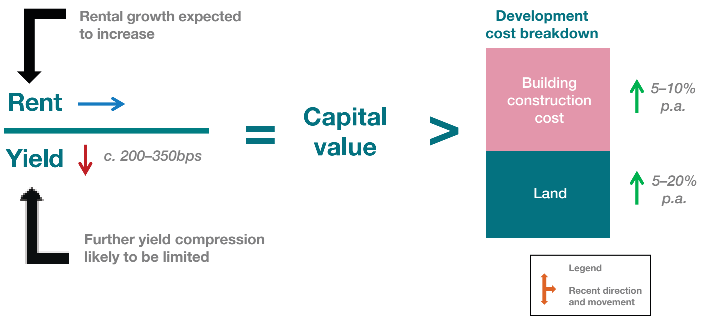
There are considerable differences between countries in terms of their volume of warehousing and distribution stock. In comparison to the United States and many key developed Asian markets, most European markets look undersupplied. Thus, despite rising development, we expect strong occupier demand to continue to outpace supply in the short term. With construction costs and land prices also rising and — given current record-low levels — further yield compression expected to be modest, we forecast above-inflation prime logistics rental growth in most major European markets over the short term. A key downside risk to our rental growth forecasts is that a significant increase in development activity may lead to oversupply. Hence, our preference is for urban and city-fringe locations in land-constrained markets that serve large population centers — these locations are a key focus of occupier demand, but it can be difficult to build new supply. An increase in the development of multi-story logistics units may provide an answer to pressure on land and space needs, constraining rental growth potential. However, as these units are more difficult, more expensive and less efficient to build and occupy, they are only likely to be developed in areas with high population density, strong e-commerce penetration and high land prices.

With e-commerce penetration rates expected to rise significantly higher, we expect retailers and logistics operators to respond by continuing to expand and modernize their logistics property portfolios. While this structural increase in demand for logistics space is expected to remain strong for the foreseeable future, the current pace of expansion is, we believe, clearly unsustainable over the long term, so we expect a moderation to occur.

Differences in the way land is made available by local authorities for industrial use, along with variations in the extent to which rental values adjusted in the previous cycle, have led to differing trends in rental value growth in the United States, the United Kingdom and continental Europe. Coming out of the GFC, the United States and the United Kingdom had a significant speculative-supply overhang, which caused a drastic rental adjustment whilst the vacant space was absorbed. In combination with an e-commerce-driven surge in demand, a more market-driven approach to making land available for industrial use has since led to a robust rental recovery.

In continental Europe, by contrast, significant volumes of land are owned by local authorities who are more concerned about employment growth than profits when releasing land for development. This is because most of their tax revenue is generated through employment rather than real estate tax. This dynamic has kept land prices relatively stable, which when combined with the ever-falling property yields, limited the pressure on rental value growth. However, with limited further yield compression expected, we think the upward pressure on rents will increase as the supply of land for logistics is becoming scarce and prices have started to increase significantly, particularly close to the major urban populations that are a key focus of demand.

Rents need to rise to keep the developer equation in balance



Sources: Various; AXA IM – Real Assets, data as of first quarter 2019

Rental growth is a key performance driver

Something is going to have to give to keep the developer equation in balance (see chart), and we think that something will be rents. Moreover, as real estate costs are a limited proportion of the overall cost of supply chains, we think above-inflation rental growth will be achievable in Europe as occupiers increasingly focus on speedy access to their end consumers and the more important elements of access to labor and managing transport costs that represent a larger proportion of their supply-chain cost base.

We think this increased pressure on rental rates will continue to see the logistics sector outperform other types of commercial real estate, despite our expectation that further yield compression is likely to be fairly limited. Ultimately, we see this as an attractive late-cycle investment strategy, underpinned by a structural shift in demand that should result in a level of resilience even if a wider economic slowdown materializes. That said, the amount of capital targeting the asset class is significant and stock selection will remain critical to long-term performance, with assets proximate to key population centers and in land-constrained areas expected to have the strongest return prospects.

Due to evolving demand from omnichannel users, warehouse facilities are facing growing concerns regarding obsolescence risk. We argue the quantum of users requiring the absolute latest in supply-chain solutions remains rather small and that obsolescence risk can be minimized by investing in assets that have appropriate clear heights, suitable bay depth/widths and sufficient parking, and which are in good locations with access to a sufficient supply of suitable labor. Returns may be enhanced and protected by investing in units in land-constrained edge-of-city and urban locations that are near to critical inner-city delivery points, and ultimately the end consumer. Strong occupier demand for a scarce supply of suitable stock is likely to support above-inflation rental growth in the short term, and the constrained supply of urban land means there is likely to be demand for redevelopment for alternative, higher value uses over the medium to longer term.

At the portfolio level, we believe obsolescence risk may be mitigated by investing in a large, diversified portfolio of industrial and logistics assets in land-constrained locations close to key population centers. Managing obsolescence also requires regular management of the timing of sales and renewing the portfolio to ensure a diversified base of assets in the most attractive markets. Development and lease up is our preferred strategy, as it offers access to well-let, modern stock as well as a higher yield on cost than standing core investments.

Summary

We think the increased upward pressure on rents will continue to see the logistics sector outperform, despite our expectation that further yield compression is likely to be fairly limited. Ultimately, we see this as an attractive late-cycle investment strategy, underpinned by a structural shift in occupier demand. However, the amount of capital targeting the asset class is significant and stock selection will remain critical to long-term performance. With some warehouses as young as a few decades old not necessarily capable of catering to this modern demand, there is increasing obsolescence concern regarding logistics investment. However, we argue that the quantum of users requiring the absolute latest in supply-chain solutions remains rather small, and further that obsolescence risk can be mitigated by investing in a large, diversified portfolio of industrial and logistics assets in land-constrained locations close to key population centers.

[1] Omnichannel retail combines physical and online commerce, but also increasingly involves social media as a new trading channel.
[2] Euromonitor/CBRE, sourced in CBRE, "CBRE EMEA Logistics 4Q 2018"

CORPORATE PROFILE

AXA IM – Real Assets is the real assets arm of AXA Investment Managers, an active, long-term, global, multi-asset asset manager, which is part of the AXA Group.

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Operating across equity and debt, private and listed, infrastructure and real estate, we have a distinctive 360° approach to real assets investing. This provides us with a thorough understanding of relative value in real asset markets, a focus on optimizing the management of cycles, agility and flexibility in asset allocation, and an unrivaled understanding of balance sheet capital structure. Leveraging on our worldwide capabilities, we offer every one of our clients a wide range of real assets investment solutions to meet their specific needs.

[1] IPE Real Estate Top 100 Investment Management Survey, Nov./Dec. 2018.
[2] INREV Fund Manager Survey, May 2019. Rankings based on non-listed direct real estate assets under management.

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