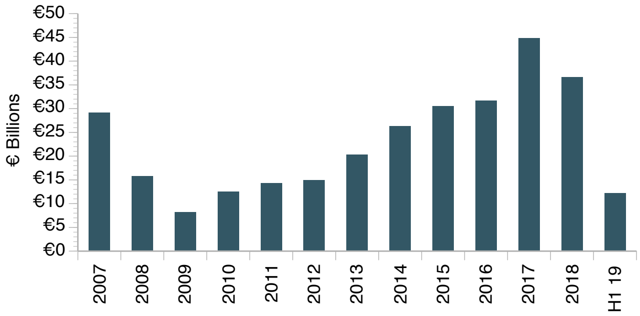
USAA Real Estate

Finding value in European logistics

Where does the potential lie?

Investment in Europe's logistics real estate market has gained momentum in recent years, with the sector undergoing a significant transformation. Core yields have compressed to record lows and are now universally below 2007 levels. In keeping, investment volumes on a relative basis have been staggering. 2018 investment in European industrial and logistics reached €36.6 billion, a remarkable 54 percent increase on the 10-year average. For institutional investors, getting access to the sector is the biggest challenge. A 2019 ULI survey found that the number one issue impacting investors was the availability of suitable assets or land for acquisition and development. Although access to logistics stock is restricted, there are still opportunities for investors to participate in the sector's growth. But, where does the potential lie? Investors are increasingly turning their attention to development, with robust fundamentals supporting a value-creation strategy.

European industrial & logistics investment volumes



Source: Real Capital Analytics, 2019

Fierce competition for core

The reconfiguration of supply chains, growth of e-commerce and changing consumer preferences are causing a secular trend to the benefit of the growth of the logistics sector. The share of logistics in total European investment has risen from about 9 percent in 2012 to between 12 and 14 percent in recent years. The institutionalisation of the sector, along with increased liquidity, has compressed core yields to record lows. Core European logistics yields were in the region of +/-5 percent as at 1Q2019, compared to a 10-year high of 8 percent. This poses a challenge for investors targeting logistics, as competition tightens and finding value becomes more difficult.

Admittedly, pricing on core looks very tight in a historic context, but occupier markets are fundamentally healthy, and the sector looks interesting on a relative basis. The risk premium relative to office and retail has been partially eroded but is still around 150 basis points. Spreads between logistics yields and government or corporate bonds are also elevated compared with long-run averages. Logistics continues to see strong flows of capital targeting core assets; however, fierce competition is shifting the focus towards development to secure stock and drive returns. Pursuing development is an attractive way to acquire assets compared with competing against core investors for limited opportunities. Development provides an enhanced yield opportunity when compared against core acquisition strategies. But, outside of the financial equation, allocating capital to development makes sense for several other reasons.

Fundamentals support a value-creation strategy

Supply and demand imbalances in both capital and occupier markets support the need for logistics development. There is substantial, pent up demand for European logistics investment, but relatively few options to access investments on a truly Pan-European basis. Many funds offering Pan-European logistics exposure have substantial queues that investors must wait through before they can make an investment. The supply of investible assets is further constrained by core owners holding assets, and development pipelines are increasingly tied to capital sources.

Occupier markets are also experiencing robust demand against a backdrop of very low vacancies. Although completions are increasing, development has been very disciplined. Speculative development is picking up, particularly in the UK, but is still measured. According to JLL, the level of new supply across the UK at mid-2019 was still 41 percent below the last pre-recession peak. Given robust demand, the relatively low amount of speculative development and low vacancies in Europe, the fundamentals remain supportive of development.

Development mitigates obsolescence

Obsolescence has been an important driver of demand and represents a significant opportunity for development in Europe. Occupier demand is acutely focused on quality modern space, as users seek to reconfigure and modernise supply chains. JLL estimates 84 percent of UK logistics take-up in H1 2019 comprised new floorspace. However, much of the current logistics stock is functionally obsolete for modern users. It is estimated that just 20 percent of the logistics stock in Europe is suitable to meet the demands of prospective tenants.

Not only is there very substantial appetite for modern buildings, but approaching the market through development is an effective way to mitigate physical obsolescence. Developing modern buildings that are flexible in terms of specification, so that they are easier to re-let and comply with the most recent standards, can help to future-proof assets. Of course, obsolescence also poses risks, particularly in the face of technological transformation. But, in the current market, obsolescence is less of an issue for new development, given robust levels of demand, constraints on land, and restrictions in place regarding zoning and planning consent.

Development builds resilience

The fact that core logistics yields are already historically low places greater emphasis on income as a driver of future performance. Structural change in consumer behaviour, such as the growth in e-commerce, means the logistics sector is seen as a sound source of long-term income. At this stage of the cycle, investing in an income-producing product that is backed by structural tailwinds is attractive.

Although there are important distinctions in lease lengths, the logistics sector has sought longer leases in recent years in line with the development of modern facilities. The development of larger, better-quality facilities has allowed investors to target higher-quality tenants that provide more resilient income streams. E-commerce tenants are making substantial commitments in lease terms but are also investing significant amounts in terms of the technology that goes inside their buildings. This is likely to encourage occupiers to remain in place for greater lengths of time. For that reason, the quantum of investment coming from end-users is perhaps just as relevant, if not more so, than the length of the lease.

Value-creation strategies

The logistics sector offers many attractions. But, in light of record pricing and heightened competition for core assets, investors are turning their attention to development, with market fundamentals supporting a value-creation strategy.

Since 2014, USAA Real Estate has invested in European logistics in a venture with Mountpark, largely through development. The Mountpark team has a proven track record in delivering successful and complex logistics development projects throughout the UK and Europe. Development currently spans seven countries, providing access to a strategically located network of logistics properties across Europe's major supply-chain corridors.

Development is expected to be the best route into building a first-class investment portfolio with attractive returns at a spread over core yields. But, developing any old "big box" won't suffice. An understanding of the sector dynamics, and shifts in logistics networks and labour markets, is vital for building the right facilities in the right locations. Investors need to pay close attention to where tenants want to be if they are going to build and capitalise logistics facilities that will remain attractive to future users.

There are substantial opportunities for investors that are strategically positioned. However, in the context of rising land values, the ability to control a portfolio of assets, consented land for development and a significant, strategic land bank is critical to success. Sites that are flexible and ready to develop allow investors to respond rapidly to occupier demand and increase the probability of success.

It will also be important for investors to focus on locations where there is currently sufficient quality and quantity of labour within a reasonable drive or transit time. Investors can add value to a development by conducting substantial labour studies on potential sites to ensure the project will be suitable for potential occupiers now and into the future.

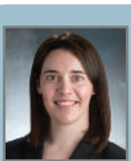
In response to labour concerns, it is also important for investors to work with occupiers to ensure developments provide best-in-class work environments that support talent attraction and retention. Modern, forward-looking warehouses include improvements to both internal and external designs to make buildings more attractive to employees and labour-hungry occupiers.

Sustainability is another area where investors can add value to their investments. Designing and developing buildings to meet recognised certifications, is key to delivering best-in-class projects that enable more-efficient customer operations. Beyond initial certification, it is important to work with building managers and occupiers to drive sustainable improvements through operational efficiency, including how to continually manage the operation of the building effectively.

Conclusions

Investors are looking to orient portfolios toward assets that could benefit from longer-term trends. E-commerce and the reconfiguration of European supply chains means there is significant development potential for modern, efficient logistics facilities across the region. Supply and demand imbalances in both capital and occupier markets further support this need. State-of-the-art logistics facilities that meet occupier requirements, including higher clear heights, deeper truck courts, better site maneuverability, and a greater focus on sustainability and worker welfare, will have characteristics that improve renewal and re-letting probability.

Adopting and maintaining a robust value-creation strategy is an attractive way to deliver superior-quality buildings at an enhanced yield when compared with core acquisition strategies. If investors choose development, it will be important for them to have a significant consented land bank, an established team with a proven track record, and long-term relationships with occupiers. The ability to leverage deep relationships and expertise in development operations, construction and asset management supports a continued focus on value creation throughout the asset life cycle.



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CORPORATE OVERVIEW

USAA Real Estate provides co-investment, acquisition, build-to-suit and development services for corporate and institutional investors, and arranges commercial mortgage loans on behalf of affiliates. USAA Real Estate is a subsidiary of USAA, a leading financial services company, serving military families since 1922. The Amsterdam-based operation is actively engaged in developing, acquiring and managing institutional-quality real estate investments, primarily through its Pan-European logistics venture, Mountpark Logistics EU.