USAA Real Estate

Why investors are looking to logistics for resilience

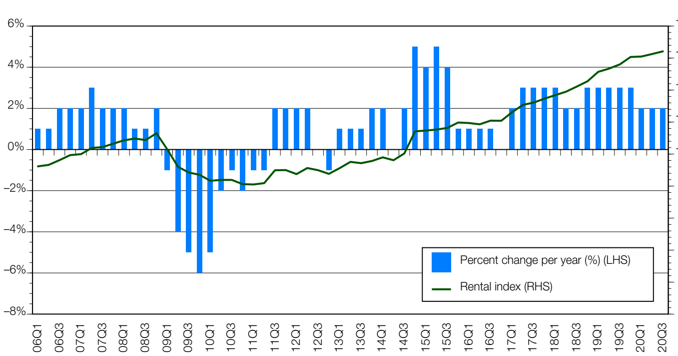
The COVID-19 pandemic continues to dominate the outlook for the economy and commercial real estate market (CRE). In the direct real estate market, the full extent of any value adjustment that might result from the crisis is still emerging. Yet the listed market has already seen a significant correction. Between mid-February and mid-March, the FTSE EPRA/NAREIT Developed Europe Index lost more than 40 percent of its value. Since then, the index has begun to recover some lost ground, but there are significant differences by sector, with industrial/logistics down by 2 percent since the peak, and retail down by more than 25 percent.[1] In this article, we evaluate the resilience of the logistics sector and consider why it is likely to outperform versus other sectors and asset types, going forward.

E-commerce propels logistics demand

Evolving consumer habits, coupled with the COVID-19 pandemic, are resulting in a boost to online sales and, with it, an increase in the demand for logistics space. Across the EU, e-commerce sales in April 2020 increased by 30 percent, compared with April 2019, while total retail sales diminished by 17.9 percent.[2] Although not all this growth may be permanent, much could be, as new online adopters are now familiar with e-commerce and the convenience it provides. The UK, Europe's largest e-commerce market, saw the proportion of online spending peak during lockdown in May at 33.4 percent. This is compared with a pre-pandemic level of 20.1 percent in February. Despite some contraction from the sharp rate of increase in this sector, UK consumers are still carrying out much of their shopping online, with the proportion of online sales at 27.5 percent in September.[3]

Logistics is one of the few sectors that has seen tenant demand increase in the short term. Leasing activity across European logistics markets increased during the first nine months of 2020, when compared with the same period in 2019. Some markets have proved particularly robust. The third quarter of 2020 set a record for leasing activity in the UK, such that take-up in the first nine months of 2020 exceeded the full-year total for 2019.[4]

Europe logistics rent index (2016Q1 = 100)



Source: CBRE

Additional positive influences

The pandemic is accelerating structural changes, such as the growth of e-commerce, but there are additional positive influences, which are expected to fuel demand for logistics space. The need for more resilient and flexible supply chains has emerged as a key theme. During the height of the pandemic, companies with lean supply chains and low inventory levels found that their networks were more vulnerable. Many businesses may subsequently choose to hold higher inventory levels to provide them with more security — which could translate into greater demand for logistics space.

Over the long term, we also expect businesses to reassess manufacturing, distribution and warehouse networks, with a view to achieving security of supply. So far, the discussion has focused on reducing over-reliance on individual countries or suppliers and the potential to accelerate the creation of localised supply chains for on- and near-shoring. It will take time for businesses to evaluate the impact on their supply chains and transition to a new normal. However, there appears to be a shift under way whereby companies are beginning to value being close to the end consumer and making sure they can have confidence in their distribution networks. According to the Institute for Supply Management's (ISM) July survey, 20 percent of firms are planning or have already begun to re-shore or near-shore some operations. While this will not lead to a wholescale reindustrialisation of Europe, it will certainly drive demand for much greater logistics stock.

Significant investment in logistics required

It is clear that e-commerce growth alone will require substantial logistics development. Even before the pandemic, baseline forecasts project a significant requirement for logistics real estate. Despite sustained demand, the availability of new space, particularly larger facilities, is constrained. Although completions have increased, development has been very disciplined. In the UK, development rose to its highest level on record in the third quarter of 2020, but because 84 percent consists of built-to-suit units, there is actually a potential supply shortage for companies looking to grow. The relatively low amount of inventory development translates into an average European vacancy rate of 4.7 percent.[5] In Poland, for example, of the 1.6 million square metres of development under construction, 70 percent is already pre-let.[6] The imbalance between logistics demand and supply close to major population centres could present significant opportunities for real estate developers and investors.

The availability of investable logistics product is likely to constrain investment in the sector, although development provides an attractive route into building a first-class investment portfolio. We see significant opportunity in the development of logistics parks near large population clusters that can accommodate occupier demand in a range of sizes. There are substantial opportunities for investors that are strategically positioned to take advantage of the growth of the logistics market. Europe has only one-third as much warehouse space per capita as the United States, and much of the stock is obsolete or unable to serve the needs of today's tenants.

Strong relative performance

Relative to other real estate sectors, logistics has brought above-trend returns in most European markets. As of June, one-year rolling returns in retail had slumped to –9.3 percent, while offices had fallen to 6.53 percent, compared with 9.15 percent in the logistics sector.[7] Figures such as these have moved investors to focus even more intently on the logistics sector during the crisis.

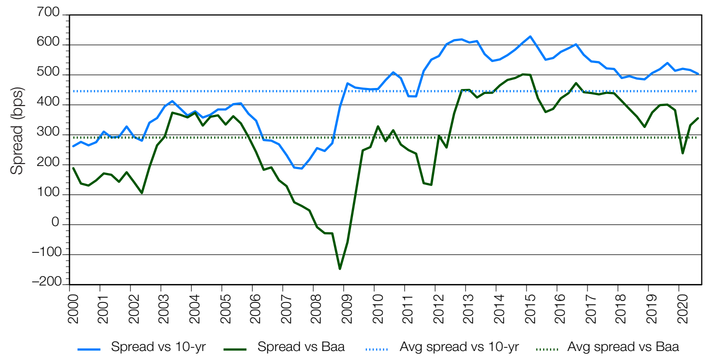
This has been reflected in pricing across CRE markets. The hotel and retail sectors have been the most severely impacted, with yields for prime shopping centres and hotels (leased) softening in the region of 25 basis points to 75 basis points since the end of 2019. In the office sector, prime yields, which were compressing in the lead up to the pandemic, have changed course, either by remaining stable or marginally softening. Logistics yields have, overall, been stable at already cyclically low levels. Although in some markets, we have seen further compression, such as prime logistics in Spain, where yields have compressed by a further 35 basis points since the end of 2019.[8]

While pricing for logistics has compressed relative to historic norms, the sector remains even more attractive today on a relative basis, given the softness in bond yields and what many deem as an overpriced stock market. Given current uncertainties and the flight-to-safety in the market, several countries have seen bonds move into negative territory. Corporate bonds have also set record new lows in recent months, with investors clamouring to lend to blue-chip companies amidst unprecedented monetary support. The spread between European logistics and 10-year government bonds is roughly 500 basis points, still above the average of 445 basis points. Spreads over Baa corporate bonds are also elevated, with a spread of 355 basis points compared with a post-2000 average of 290 basis points. With government and corporate bond yields so low, this should help to reinforce pricing for the very best logistics assets. As a result, we expect to see pricing for quality, long-let logistics assets remain robust, with yields showing no evidence of softening.

Performance to drive investment

Robust tenant demand is generating strong investor appetite for logistics, with some groups looking to increase their exposure and others seeking to enter the sector for the first time. Logistics is the only major property type to register higher deal activity so far this year than in 2019. European industrial and logistics investment increased 1.4 percent year-over-year in the first nine months of 2020

Europe logistics yield spreads



Sources: Oxford Economics, Bloomberg, CBRE

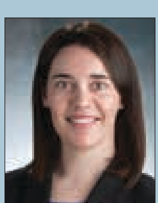
to reach €23.5 billion. The sector continued to outperform the wider CRE market, which fell 18.7 percent for the year to date.[9]

We expect the logistics sector to be one of the best performers through this crisis, more resilient to the downturn and well positioned to gain from accelerating structural drivers. The demand and supply dynamics are highly favourable, as they are likely to maintain a high level of rents and could ultimately lead to rent growth. CBRE recorded annualised rent growth of 1.8 percent across EMEA industrial and logistics in the third quarter. In certain markets, where the availability of land is constrained and land values are high, we have seen significantly stronger growth. The UK and France stand out, with annualised rent growth of plus or minus 4 percent in some regions. This is impressive for a sector that has historically seen relatively muted rent growth.[10]

The inevitable pressure for investors to put capital to work, combined with the anti-cyclical nature of logistics, is expected to continue to fuel demand for assets. Rapid growth in e-commerce and efforts to reinforce domestic supply chains will provide a solid foundation for growth. We believe, therefore, that logistics is set to become an increasingly larger part of the European investable universe, as investors look to evaluate their allocations in favour of the sector.

[1] Bloomberg. Note: Comparison as of 26 Oct. 2020 versus the 52-week peak; [2] OECD. Includes sales via mail order or the Internet; [3] Office for National Statistics; [4] CBRE Ltd.; [5] CBRE Ltd.; [6] CBRE Ltd.; [7] INREV Quarterly Index Q2 2020; [8] CBRE Ltd.; [9] Real Capital Analytics; [10] CBRE Ltd.

CONTRIBUTOR



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CORPORATE OVERVIEW

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