URBAN INDUSTRIAL IN EUROPE

Lower risks, higher returns

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by
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INSIGHTS

- Demand for last-mile space is increasing due to rising ecommerce market share and consumers expecting faster delivery times.
- Supply of logistics space is much tighter in urban areas than in traditional locations.
- Urban logistics locations are underpinned by a higher land value, and have the potential for redevelopment to higher uses. Infill planning restrictions are tight, creating barriers to entry for non-specialists.
- Favourable infill locations attract a wider tenant pool, and therefore portfolios typically have higher tenant diversification. Due to small asset sizes, individual covenant risk is also lower. Both these factors lead to lower overall risk.
- Portfolios of urban logistics assets that were previously deemed too small to warrant attention are now providing downside risk and strong return potential.

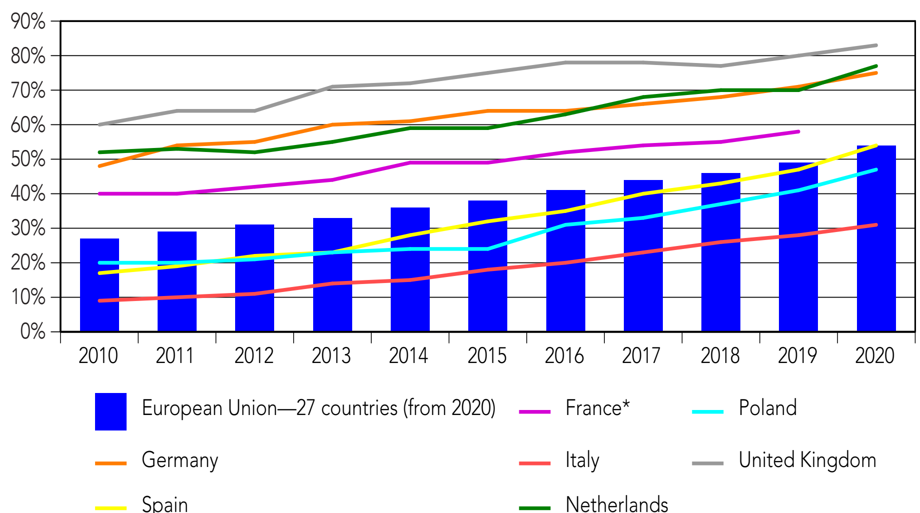
EXECUTIVE SUMMARY

As industrial real estate has become one of the most sought-after segments of the commercial property market over the last decade, the “urban logistics” subcategory has in itself risen to a position amongst the most appealing investment opportunities with outsized returns and limited risk relative to its big-box peers.

The story of massive shifts in consumer purchasing behaviour is one those in the commercial real estate space are all too familiar with. As COVID-19 has catalysed the irreversible rise of ecommerce, consumers have become exceedingly demanding over shortened delivery times. This shift has resulted in a huge drive from traditional retailers, third-party logistics providers (3PLs) and online retailers to acquire space that affords proximity and rapid access to urban populations. Savills estimated that pan-European take-up for urban logistics space has increased strongly from 15 million square metres in 2012 to in excess of 30 million square metres last year. Consumers want their purchases faster than ever before and the spotlight has been directed to the infill urban logistics facilities that offer this last-mile distribution.

Historically, the inconsequential scale of investment for urban logistics assets has kept “last mile” off the table for institutional investors. The assets in this subsector are smaller format warehouses and often have an earlier vintage than their big-box peers. Check sizes for these often poorly maintained facilities were not significant enough to create appetite from institutional capital. However, as demand trends shift toward urban distribution, the interest for aggregated portfolios of these smaller assets has gained traction. The appeal of last-mile logistics facilities has already translated into much higher rental growth when compared with big-box facilities and this widening gap is set to continue. Simultaneously, a portfolio aggregation strategy offers mitigated risk as a result of the broad tenant pool creating greater tenant diversification and lower individual covenant risk from smaller asset sizes.

Increase in individuals purchasing online in Europe



*France yet to post 2020 data
Source: Eurostat

INTRODUCTION

Urban logistics assets are generally utilised to provide the "last-mile" fulfillment for ecommerce operators. They have risen in importance due to ever-shortening delivery time expectations, as well as various new entrants to the market, such as grocery retailers. In addition to ecommerce, smaller-format units are generally favoured by traditional industrial operators as well.

This has already translated into much higher rental growth for urban logistics when compared with their big-box peers. Data produced by Property Markets Analysis, shows that urban logistics rents were almost 40 percent higher in 2020 than they were in 2007 — while other logistics rents have not progressed much over the past decade.

IN DEMAND ...

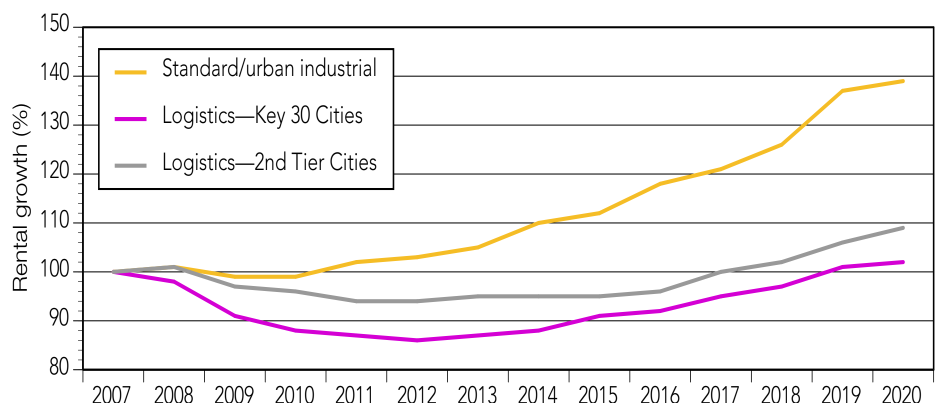
A key part of the higher rental growth story for urban logistics has been protection from the higher elasticity typically associated with industrial real estate.

Distribution warehouses have historically seen very dynamic supply cycles, particularly in countries with high land availability, such as Germany, France and Poland. Following the culmination of the last "super-cycle," precipitated by the global financial crisis, there was a significant supply overhang and vacancy rates reached as high as 25 percent in some areas. This led to a period of overall rental decline between 2008 and 2014.

Users of well-located urban logistics are prepared to pay higher rents as they can significantly reduce transportation costs. According to data gathered by Establish Inc., transportation accounts for more than 70 percent of total costs while rent is under 5 percent. For ecommerce operators, the last mile can account for 50 percent of total distribution costs, largely due to the extra expense of returns and missed deliveries. This trend is likely to become more pronounced as companies struggle with a shortage of lorry drivers and supply-chain frictions following the COVID-19 pandemic.

Additionally, the growth of re-shoring and near-shoring in Europe is likely to compound demand, as more domestic companies seek to de-risk their supply chains in the wake of the COVID-19 pandemic and locate production and distribution closer to their home markets. For certain strategic sectors, including battery production, chip manufacturing and the pharmaceutical industry, government agencies are the main driving force behind re-shoring. On 10 March, the EU announced plans to double its chip manufacturing capabilities. The return of these sectors amongst others will make the already limited industrial space even more coveted.

Industrial rent performance



Source: Property Markets Analysis (PMA) Prime Logistics and Industrial Rent Index 2021

TOP EUROPEAN LOCATIONS

- France: Paris, Lyon
- Germany: Berlin, Munich, Rhine-Ruhr, Frankfurt, Hamburg
- United Kingdom: London, Manchester, Birmingham, Bristol
- Benelux: Amsterdam, Rotterdam, Utrecht
- Southern Europe: Barcelona, Madrid, Valencia, Milan, Rome
- CEE: Warsaw, Prague

... BUT NOT SUPPLY

Due to their proximity to city centres, construction of urban logistics assets is difficult. Space is far more limited and planning permission harder to obtain. This has led to rapid rental appreciation in urban locations. In mega-cities, such as London and Paris, there have been rental premiums of up to between 400 percent and 500 percent, when compared with non-urban distribution centres.

A problem for investors trying to access this space is not just scarcity of product. Urban logistics typically range between 2,000-25,000 square metres in size and do not exceed €30 million in value, with many assets being priced in the €5 million to €10 million range. These assets are typically older and of a poorer quality, meaning there is often a significant value-add or development angle in the business plan.

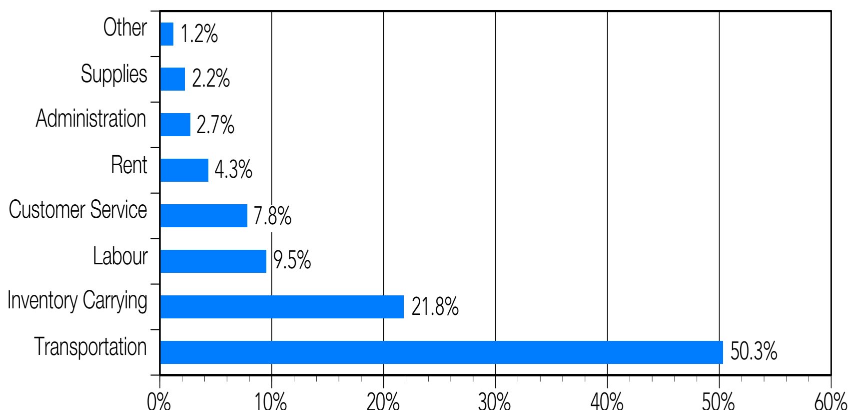
Institutional investors cannot generally buy such small lots as the costs of due diligence can be significant and there are often large capital pools to allocate. It is also harder for such investors to manage intensive development processes on such small assets. This has created opportunities for more nimble, private-equity buyers to acquire urban sites and assemble portfolios. Generally, it is possible to get an illiquidity discount due to the lower pool of investors interested and also to achieve a portfolio premium at exit as investors will pay more for scale. Appetite for such product is demonstrated by the recent sale of a portfolio of Spanish urban logistics by KKR and Roundhill to P3 Logistics for €108 million.

A FULL HOUSE

Given that favourable infill locations attract a wider tenant pool, urban logistics portfolios typically have higher tenant diversification, leading to lower overall risk. In addition, individual covenant risk is lower due to small asset sizes, which further reduces risk.

Competition for space between ecommerce providers and smaller traditional businesses that have always located themselves in cities has heated up considerably in recent years. What's more, this demand is robust, as infill locations are key to the operation of these businesses, many of which have been part of an area's fabric for many years.

Logistics operator costs



Source: Establish, Inc./HWD
Transportation costs include driver's wages

OUTLOOK

Going forward, urban industrial is expected to continue to outperform big-box logistics. The growth in ecommerce during the pandemic is unlikely to be reversed due to the now permanent nature of changed consumer habits. Moreover, the supply fundamentals remain strongly in favour of the landlord in this space. This is likely to be important for driving outperformance over the next few years. The smaller urban logistics assets that were previously overlooked are now being viewed under a new lens. Aggregation of these last-mile distribution facilities into portfolios provides the upside of rising user demand and rental growth and also mitigates risk factors to create an appealing investment opportunity.

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